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Discussion Note on HIPC and Exceptional Financing in the Balance of Payments Statistics: Issues for Discussion

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International Monetary Fund

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International Monetary Fund

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I. Introduction

1. At the October 2004 meeting of the IMF Committee on Balance of Payments Statistics (BOPCOM), the Fund presented a paper on *HIPC and Exceptional Financing in the Balance of Payments Statistics* reviewing, inter alia, the various debt transactions relating to the HIPCs[2] debt relief initiative (HIPC Initiative) and how such transactions are captured in the current framework of the *Balance of Payments Manual, fifth edition (BPM5)*. BOPCOM members agreed that further methodological work be undertaken on the nine issues raised—see Box 1—and asked the Fund, in consultation with the Inter-Agency Task Force on Finance Statistics (TFFS), to develop methodological advice for discussion during the BOPCOM meeting in June 2005. The TFFS reviewed this note at its meeting in April 2005.

2. This note provides draft methodological guidance on the nine issues. In doing so, the note also attempts to clarify the treatment of certain debt relief transactions under the HIPC Initiative, which are deemed to be adequately covered within the *BPM5* framework, but for which debt compilers have raised concerns. Except for the issues below that are clearly HIPC specific, the methodological guidance can apply to non-HIPC Paris Club debt restructuring.

Box 1: Issues for Discussion

a. Debt-service falling due between Paris Club Agreed Minute date and specified implementation date

b. Debt-service moratorium extended by creditors before the completion point of the HIPC Initiative

c. Treatment of HIPCs debt-service transactions for creditors that opt out of the HIPC Initiative

d. Paris Club debt rescheduling agreements: Timing

e. Economic transfers arising from concessionality under the HIPC Initiative

f. HIPC debt relief transactions linked to social expenditure and the classification of transfers

g. Rescheduling of interest arrears and interest not yet due

h. Balance of payments transactions related to the Fund HIPC Trust

i. Identification of HIPC transactions

[1] This note was drafted by Andrew Kitili, IMF Statistics Department

[2] HIPC in this note refers to Heavily Indebted Poor Country.

II. Issues for Discussion

A. Debt-service Falling Due Between Paris Club Agreed Minute Date and Specified Implementation Date

3. Under the Paris Club debt rescheduling arrangements, creditor countries as a group usually agree in the non-binding "Agreed Minute," which they sign, that payments on applicable debt falling due before the specified effective (implementation) date of the Paris Club bilateral agreements need not be made on schedule and any penalties on late payments as specified in existing loan agreements need not apply. However, interest continues to accrue based on the existing loan terms up until the point when there is a formal bilateral agreement. Debt compilers in debtor countries have argued that debt payments due between the conclusion date of a Paris Club Agreed Minute and the implementation date—i.e., the specified conclusion date of bilateral agreement—should not be considered as arrears. It is argued that any payment made after the Paris Club Agreed Minute and based on the old loan terms is tantamount to violating the clause of "equal treatment of creditors."

4. While such arrears are not explicitly covered in *BPM5*, they are considered in the *External Debt Statistics: Guide for Compilers and Users* (*Debt Guide)* as arrears (paragraph 3.37) to be included under "short-term" under "other debt liabilities." The *Debt Guide* describes these types of arrears as *technical arrears*.

5. The *Debt Guide* recognizes that the creditors in this case have agreed in principle to reschedule debt—that is, to reorganize payments that are falling due—but the agreement has yet to be signed and implemented and so the liabilities remain outstanding. The *Debt Guide* further explains that if the agreement in principle lapses before a bilateral agreement is signed, "then any accumulated arrears are no longer technical arrears." The term *technical arrears* is being used to indicate that these arrears relate to payments on applicable debt falling in arrears under a mutually signed understanding between the creditors and the debtor.

6. The term "technical arrears" has also brought new issues for clarification. In particular, balance of payments economists have also sought clarification on (a) whether there should be a reclassification of "arrears" to technical arrears for debts in arrears at the beginning of the negotiations and, (b) the status of arrears (existing and on debt falling due in the transitory period during negotiations) on debt for which renegotiation is being sought on terms comparable to those agreed with the Paris Club.

7. Arrears arising before the onset of debt rescheduling negotiations should not be classified as *technical arrears* because they did not arise in a specified period under a mutually signed understanding between the creditors and the debtor[3]. Further, payments

[3] Arrears occurring in the transitory period during negotiations but before the Agreed Minute is signed could also be reclassified as technical arrears.

falling in arrears on debts owed to creditors outside the Paris Club for which debtors have yet to seek comparable treatment should not be classified as technical arrears until a mutually signed understanding is reached with the relevant group of creditors.[4]

8. Regarding the classification of arrears, BOPCOM and the Advisory Expert Group on National Accounts (AEG) have agreed that the treatment of arrears in various manuals be harmonized consistent with SNA and that no transactions be imputed when a debt goes into arrear if the terms and conditions remained unchanged. However, given the mutually signed understanding between the debtor and the creditors it is recommended that technical arrears be treated as transactions and classified as short-term debt under other investment, other liabilities.[5] Given interest in knowing the magnitude of *technical arrears* there may be merit in introducing a further breakdown to identify technical arrears explicitly. As with other arrears, transactions involving technical arrears should be recorded as exceptional financing in the analytical presentation.[6]

9. Issues for discussion by the Committee:

- *Does the Committee agree that the classification of arrears into technical arrears should be guided by a mutually signed understanding between a group of creditors and the debtor that liabilities falling due within an agreed specified period of time need not be paid on schedule?*

- *In such circumstances does the Committee agree that these technical arrears should be treated as transactions and classified as short-term debt under other investment, other liabilities?*

- *Does the Committee agree that debt liabilities falling due before the onset of debt rescheduling negotiations and debts owed to creditors outside the Paris Club for which no mutually signed understanding between debtor and its creditors has been established should not be classified as technical arrears?*

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[4] This means a condition in Paris Club Agreed Minute requiring a debtor to seek comparable treatment for its debt owed to other creditors such as the London Club group of creditors should not be sufficient to qualify payments falling in arrears on such debts as *technical arrears*.

[5] Liabilities falling in arrears are short-term debt as specified in the *BPM5* (paragraphs 123 and 528) and *Debt Guide* (paragraphs 2.29 and 3.36).

[6] Some arrears will no longer be recorded as transactions and so recorded in exceptional financing following the BOPCOM decision on the treatment of arrears transactions (BOPTEG Issue 3).

B. Debt-service Moratorium Extended by Creditors Before the Completion Point of the HIPC Initiative

10. Debt-service moratorium involves an individual creditor permitting the debtor a formal suspension of debt-service payments falling due within a given period. Debt-service moratorium may also be granted to non-HIPCs such as the moratorium granted to Tsunami-affected countries, and usually involves formal exchange of letters but not necessarily a formal bilateral agreement. In the case of debt-service moratorium extended by some HIPCs' creditors, the question has been raised of how to handle payments falling due within the moratorium period.[7]

11. Three possibilities can be considered: First, it can be argued that payments falling due during the moratorium period are deemed paid, but transformed into short-term debt liabilities—arrears. While plausible, this view is at variance with the expectation of both the debtor and the creditor. Both parties mutually understand that the payments falling due in the moratorium period are not yet payable, thus the question of arrears does not arise.

12. Secondly, since the amounts falling due within the moratorium period are earmarked for cancellation upon successful progression to HIPC Initiative completion point, another approach could be to classify such liabilities as contingent and hence not part of "external debt" as defined in the *Debt Guide.* Paragraph 9.3 of the *Debt Guide* defines contingent liabilities as "obligations that arise from a particular, discrete event(s) that may or may not occur." This approach would be justified by the uncertainty surrounding economic performance of the debtor between decision point and completion point. However, as moratorium obligations are recognized to be liabilities of the debtor, at least at the onset of the moratorium period, and all parties know the timeframe of transformation of such liabilities, it is not appropriate to classify moratorium payments as contingent liabilities.

13. Finally, the creditor's decision to offer debt-service moratorium to debt liabilities falling due within the moratorium period could be considered akin to a debt rescheduling, in which case arrears are not created. This approach is consistent with the common understanding between the debtor and the creditor that obligations falling due in the moratorium period are neither payable nor forgivable until a decision is made at the completion date of the HIPC Initiative. So obligations falling due in the moratorium period could be considered as a series of debt rescheduling transactions and recorded as exceptional financing in the analytical presentation. It follows that moratorium payments falling due less than one year to the expected completion date of the HIPC Initiative should be classified in the balance of payments as short-term debt on original maturity basis and those with more than one year as long-term debt.

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[7] Debt-service falling due in the moratorium period is usually earmarked for cancellation when the country successfully reaches the HIPC Initiative completion point.

Table 1: Treatment of moratorium payments: in $000						
		Decision Point	Moratorium period			Completion point[4]
			Year 1	Year 2	Year 3	
1	Principal Schedule	0	0	100	100	0
2	Moratorium Principal	0	0	**100**	**100**	0
3	Interest Schedule[1]	0	40	42	44.1	0
4	Moratorium Interest	0	**40**	**42**	**44.1**	0
5	Debt stock[2] O/w Moratorium interest	800 0	840 **40**	882 **82**	926.1 **126.1**	926.1
6	Capital Transfers[3]	0	0	0	0	**926.1**

Notes

[1] Note that the annual interest increases due to the amount of interest accruing and not paid that is also accruing interest at the rate of 5%. [2] Note that the stock of debt increases annually during the moratorium period due to the accrued interest, which is added to the stock and rescheduled. [3] Note that capital transfers at completion point when the creditor forgives the debt comprise three elements: the interest accrued in the moratorium period that was rescheduled, principal payments rescheduled during moratorium period and principal outstanding not yet due at HIPC Initiative completion date. [4] Completion point in this case is the end of the third year when the total debt is cancelled.

14. Table 1 demonstrates the application of moratorium payments for outstanding loan—at decision point—of $800,000 attracting annual interest rate of 5 percent. It can be seen that the stock of debt increases during the moratorium period by the amount of interest falling due but not paid (see Table 1, row 5, year 1-3). In other words, interest accrues normally during the moratorium period but is rescheduled when due for payment.

15. Table 2 presents the proposed treatment of moratorium payments in both the standard and analytical presentation of balance of payments using output of Table 1. In the analytical presentation it can be seen that interest falling due in year 1 is debited above- the- line under income and contra credit entry recorded below-the line under exceptional financing, commensurate with the expected HIPC Initiative completion date. Similarly, in year 3, all credit entries are recorded under exceptional financing.

16. If a debt moratorium is provided by the creditor after the Agreed Minute is signed, it is proposed that the moratorium takes precedence in recording transactions for applicable debt falling due within the specified period.

17. Appendix 1, Figure 1 shows how debt-service moratorium could be recorded in government finance statistics.

18. Issues for discussion by the Committee:

- *Does the Committee agree that debt liabilities falling due within the moratorium period extended by a creditor be considered as rescheduled debt transactions?*

- *Should the implementation of such a recording be based only on a formal suspension of payment, such as occurs with an exchange of letters or a signed formal bilateral agreement?*

Table 2: Proposed treatment of moratorium payments in the balance of payments									
Standard Presentation					**Analytical Presentation**				
	Year 1		Year 3			Year 1		Year 3	
Current Account	Credit	Debit	Credit	Debit	**Current Account**	Credit	Debit	Credit	Debit
Income Income on debt (Interest)		40		44.1	Income Income on debt (Interest)		40		44.1
Financial & Capital A/c					**Financial & Capital A/c**				
Other Investment Long-term debt	40			100	Other Investment Long-term debt				100
Other Investment Short-term debt			144.1		Other investment Short-term debt				
Reserves Assets					**Reserves Assets**				
					Exceptional Financing				
					Rescheduling of existing debt	40		144.1	

C. Treatment of HIPC Debt-service Transaction for Creditors that opt out of the HIPC Initiative

19. Debt compilers in debtor countries have sought guidance regarding the treatment of debt-service when an agreement is reached in principle but specific HIPCs creditors subsequently opt out of providing debt relief and claim full payment. When payments on such claims fall due, debtors are left in a dilemma of making the payment (which amounts to violation of the broad Paris Club Agreed Minute) or reneging (which increases penalties on arrears and other financial risks). It is understood that a creditor's decision to opt out of providing debt relief does not modify its claim on the debtor and therefore if such claims are not paid when due the debtor is in arrears. Furthermore, it is also understood that the HIPC Initiative framework is not mandatory and creditors cannot be forced to grant debt relief even if they had already committed to do so. The *BPM5* framework is clear about regarding the debt as outstanding until either it is rescheduled or forgiven i.e., a change of ownership of assets and liabilities has occurred. Thus it is recommended that the *BPM5* framework be used to guide the treatment of HIPCs debts where creditors opt out of the HIPC Initiative or any other similar arrangements for debt relief.

20. Issues for discussion by the Committee:

- *Does the Committee agree that the BPM5 framework provides clear guidance on the treatment of HIPC debt where creditors opt out of the HIPC Initiative or is further guidance required?*
- *What are the Committee views on the treatment of technical arrears when a creditor opts out of the HIPC Initiative—should these debt liabilities be reclassified to the original instrument or remain under short-term liabilities?*

D. Paris Club Debt Rescheduling Agreements: Timing

21. The time of recording debt transactions before and after a Paris Club debt rescheduling agreement is an issue that deserves clarification in the revised *BPM5* given the different practices/perceptions among balance of payments economists and debt compilers. The practice of some balance of payments economists has been to reflect debt rescheduling in the balance of payments when it is agreed in principle by the Paris Club group of creditors rather than when the agreement is signed by the debtor and the participating individual creditors. Specifically some economists have sought clarification on (a) whether a rescheduling should be reflected when it is signed, or when the agreement is approved by parliament; and (b) whether debt rescheduling arrangements anticipated in the future should be reflected in the balance of payments projections as part of the financing gap, rather than exceptional financing in the analytical presentation.

22. Projections are not an issue for the *Balance of Payments Manual*. Under the concept of accrual accounting and change in economic ownership as defined in *BPM5* paragraphs 111 and 123, and the *Debt Guide* paragraphs 2.22-2.24, transactions in the balance of payments are recorded when economic value is created, transformed, exchanged, transferred, or extinguished. The *Debt Guide* in paragraph 8.13 is clearer in providing guidance on the time when debt transactions should be recorded: *" Any agreed change in the terms of a debt instrument is to be recorded as the creation of a new debt instrument, with the original debt extinguished at the time both parties record the change in terms in their books."* The *Debt Guide* also goes further to highlight the importance of "change in the terms", which is central in debt contracts. However, given that financial agreements usually specify the effective date of each agreement, it may be worthwhile to use the effective date as the transaction date rather than the date the agreement is signed i.e., in the context of debt rescheduling agreement the date when debt liability is transformed. Thus, debt rescheduling transactions should be recorded when the Paris Club agreement becomes effective and this normally takes place after the bilateral agreement has been approved by parliament and signed by the relevant authorities.

23. The different practices and perceptions in recording Paris Club debt-rescheduling agreements also highlight the need to elucidate how debt transactions should be reflected both in the actual and projected balance of payments statements. Typically for Fund program purposes, a balance of payments statement is a forward-looking statement that anticipates

balance of payments developments in the future. For this reason, it is normal to project debt-rescheduling transactions for the purpose of closing a projected financing gap in the balance of payments. Such a statement, however, will be different from the actual balance of payments statement, which is historically based, and records transactions on an accrual basis at the time they occur as opposed to the time they are expected to occur. A detailed summary of entries required in balance of payments accounts for various forms and aspects of exceptional financing transactions is provided in Tables 2 and 3 of the *HIPC and Exceptional Financing in the Balance of Payments Statistics* paper prepared for the October 2004 Committee meeting.

24. Issue for discussion by the Committee:

- *Does the Committee agree that the effective date of the Paris Club agreement should determine the transaction date of debt rescheduling agreement?*

E. Economic Transfers Arising from Concessionality Under the HIPC Initiative

25. A creditor's decision to reschedule existing debt by reducing the contractual interest rate to a concessional rate results in a transfer of value to the debtor if such reduction leads to a lower present value of the claim. Measuring the present value of such debt relief has assumed prominence in recent years because creditors can use such a benchmark when undertaking debt relief through alternative mechanisms under HIPC−such as the use of extended maturities, debt cancellation, and new inflows in the form of grants. Further, debt compilers in HIPC countries have sought guidance on how to record debt-rescheduling operations involving concessional interest rates in the balance of payments because it is not adequately covered in *BPM5*.

26. While *BPM5* recognizes that concessional loans encompass a transfer element that needs to be imputed (see paragraph 104), neither the manual nor the *Debt Guide* has a definitive framework for recording these transfers either in flows or positions. Balance of Payments Technical Expert Group (BOPTEG) issue paper 29 addresses the topic and it was discussed at the BOPTEG meeting in December 2004. BOPTEG supported the argument in the issue paper that the concessional interest element of a debt should be recognized as a current transfer and that the interest costs to accrue should be adjusted upwards by this amount. This is a different approach from current practice, which measures interest cost based on the amount of interest to be paid; so the change would result in interest accruing at a higher rate, offset by an on-going current transfer.[8] However, BOPTEG had some reservations about the approach proposed, not least with regard to the impact of changes in market interest rates on the measurement of transfers. BOPTEG supported a call for further work.

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[8] It might be considered that there are similarities with transfer pricing where the amounts actually exchanged do not determine the values of transactions recorded, although transfer pricing relates to transactions between affiliated enterprises and is described in *1993 SNA* as an example of "deceptive behavior" (paragraph 3.79).

27. BOPTEG also recognized that while there is no agreed definition of concessional loans[9], the existing guidance in the *Debt Guide,* and features such as an intention of the creditor to convey a benefit in a noncommercial setting, such as official loans,[10]could be drawn upon in drafting the revised *BPM5.*

28. Debt rescheduling involving interest rate reduction has two types of concessionality—(a) the concessional element arising from a specific reduction of the existing contractual interest rate to a lower rate; and, (b) the concessional element arising from the difference between the prevailing market interest rate at the time of debt rescheduling and the new contractual interest rate on the rescheduled debt. Regarding the market rate, there are many such rates in the debt markets but the OECD Commercial Interest Reference Rate (CIRR) has been the preferred proxy for market interest rate in computing present value of HIPC debt relief.

Transfers resulting from specific reduction of contractual interest rate

No conditions attached

29. The reduction of the existing contractual interest rate of a debt instrument constitutes a change of instrument terms, and leads to the extinction of the instrument and its' replacement with a new one. Such a transformation transfers economic value from the creditor to the debtor if the new contractual interest rate is lower than the prevailing market interest rate.

30. One approach is to record the transfer of economic value on an on-going basis as a current transfer. This has the logic that the debtor is accruing less in interest than they would have under the original contract. However, from the viewpoint of the macroeconomic statistics framework, the difficulty is that the debtor will continue to record interest based on a contract that has been extinguished. The idea that say 10 years after a contract is extinguished interest would accrue based on the interest rate of that contract, does not reflect current economic reality, not least as in the meantime market interest rates could have changed significantly. Rather, if there are no conditions attached to the stream of future interest payments following a debt rescheduling arrangement—such as the requirement of the debtor to meet certain obligations before the concessional rate is applied as in paragraph 546 of *BPM5*—it is plausible to say that transfers arising from the reduction of existing contractual interest rate occur only once, at the time of debt rescheduling.

31. So another approach is to record in the standard presentation a transfer at the time of debt rescheduling as a credit entry for the debtor under capital transfers, related to a reduction

[9] OECD defines concessional loans as loans with grant element of at least 25 percent—the grant element is defined as the difference between the face value of a loan and the present value, calculated at a discount rate of 10 percent, of the debt service payments to be made over the life time of the loan.

[10] Official creditors are defined in paragraph 6.5 of the *Debt Guide.*

in the value of the loan, with two contra entries in the loans category: the present value of the new loan (see Table 3, row 6), using the revised payment stream and the current market interest rate as the discount factor, [11] as a credit item, and the value at extinction of the old loan as the debit item.[12] In the analytical presentation the entries are the same as in the standard presentation except that the capital transfer is credited under exceptional financing. Interest would accrue at the market rate on the new loan, so taking account of both the interest payments to be made along with difference between the present value of the principal at inception and the principal amount to be repaid over the life of the loan (see the revised principal and interest repayment schedule in Table 3, rows 8 and 9).[13]

32. While internally consistent, such an approach is contra to the principle that loans are valued at nominal value and not at present/market value. Indeed, if a mixture of nominal and present value is adopted it could be considered that there are uncertainties about the determination of the value of capital transfers. The logic of the approach set out here is that the valuation of loans is determined by the interest rate (or rates if there is a concessional rate) at the inception of the loan. Given the nature of these loans, after inception the two parties are locked in, unless they agree to renegotiate the contract at which time the current market rate represents the new opportunity cost of capital, not the market rate at the inception of the original loan.

33. If the new loan was extinguished before maturity, under this approach, amount paid by the debtor to extinguish the loan would be recorded as a debit item under loans and a credit item under reserves, with the change in the loan value between the end of the previous period and the amount repaid recorded as a valuation change in the international investment position (IIP) because, for example, the debtor has paid more to extinguish the loan than the value in the position data. Alternatively, although not preferred in this paper, a capital transfer could be recorded from the debtor to the creditor.

34. If, under a voluntary agreement, the debtor and creditor agreed to replace the original concessional loan with a new loan with a lower interest rate, then a calculation of the capital transfer, on the same basis as above, would again be required. In the highly unlikely circumstance of the debtor and creditor agreeing to replace the concessional loan with a new loan at the market rate, a capital transfer would be recorded from the debtor to the creditor.

35. A third approach is to calculate the present value of the interest cost savings at inception. These savings can be calculated by taking the difference in the present value of the

[11] This section does not discuss which market rate to use. This issue could be determined once agreement in principle is reached on the approach to adopt.

[12] For a new concessional loan, that is a loan that is not replacing an existing loan, the capital transfer would be calculated by comparing the present value of the new loan with its nominal value.

[13] The approaches discussed in this section could also be extended to official development assistance lending as well as for domestic lending from government controlled lending facilities that provide loans at below market rates for targeted groups or purposes.

two streams of future interest payments[14] using as a discount rate the current market interest rate (see Table 3, row 4). In the standard presentation of the balance of payments, such transfers could be recorded in the year they occur (i.e., when the rescheduling becomes effective) as a memorandum item—perhaps as capital transfers.

36. Under this approach, if the new loan was extinguished before maturity, the value of the transfer not yet received—based on the interest differential savings used to make the initial calculation of the transfer element—would be recorded as a negative transfer for the debtor, partially reversing the originally recorded transfer. If the concessional loan were replaced by a new loan, the interest cost saving of the new loan would be calculated using the current market rate.

Table 3: Transfers arising from debt rescheduling at concessional interest rate: loan of $1000

		PV[1]		Year 1	Year 2	Year 3	Year 4	Year 5
1	Principal repayment	820.1		200	200	200	200	200
2	Interest at 5%	135.2		50	40	35	20	10
3	Interest rescheduled at 4%	102.9		40	32	24	16	8
4	Interest transfers (row 3-4)	32.3						
5	PV based on original interest rate (5%) = (row 2+3)[2]	955.3						
6	PV based on new interest rate (4%) = (row 2 +4)	923						
7	Capital Transfer ($1000-923)	77						
8	Loan repayment schedule at market rate[3]			175.4	179.7	184.2	189.1	194.4
9	Interest accrues at market rate[4]			64.6	52.3	39.8	26.9	13.6

[1]Discounted present value (PV) = $\sum_{t-1}^{n}(Cash\ flow)_t/(1+i)^t$ where *(Cash flow)$_t$* denotes the cash flow in a future period (*t*), *n* denotes the number of future periods for which cash flows are expected, and i denotes the interest rate that is applied to discount the future cash flow in period *t*.; In this case discount rate is 7%.[2] Present value reflects the concessional element in the original loan interest rate. [3]The repayment schedule is based on a prorated present value of the loan. [4] The market interest rate at the time of debt rescheduling is used to estimate the stream of future interest payments.

37. Finally, another approach is to include transfers arising from concessional loans as a memorandum item, with the transfer value calculated at the inception of the loan as the difference between its nominal value and its present value using the payment stream and the current market interest rate as the discount factor. See the calculation for Loan B in Table 4. The value of any transfers not yet received on the original loan that is replaced would need to be subtracted from the original transfer value calculated otherwise the amount of concessionality recorded over time would be overstated. This can be done by recalculating the transfer at inception using the actual payment schedule outturn, including the retirement of the entire remaining loan at the time of rescheduling.[15] This recalculated value should

[14] Interest payments as defined in the *External Debt Guide* (paragraph 2.5).

[15] This would include any amount that is forgiven.

replace the originally calculated value in the historical memorandum series, so the historic data reflects the actual transfers received and does not mix the new concessional transfer with the value not received on the original loan. Such calculation would also apply if the new loan was extinguished before maturity.

38. For example, in Table 3, the initial transfer value was calculated at inception at $77 (row 7). Subsequently, at the end of year 2, the loan was extinguished and the present value saving is recalculated at $49 (Table 4, row 4). The latter value should replace $77 as transfer value at inception.

Table 4: Transfers arising from debt rescheduling at concessional interest rate

			Year 1	Year 2	Year 3	Year 4	Year 5
RETIRED LOAN IN TABLE 3: $1000							
		Revised schedule of old loan at 4%					
		PV[1]	Year 1	Year 2			
1	Principal repayment	885.7	200	800			
2	Interest rescheduled at 4%	65.3	40	32			
3	Revised PV of retired Loan = (PV row 1 + PV row 2)	951					
4	Capital Transfer ($1000-$951)	49					
NEW LOAN B DERIVED FROM RESCHEDULING OF LOAN IN TABLE 3: $600 [2]							
					Payment schedule of new loan at 2%		
				PV*	Year 3	Year 4	Year 5
5	Principal repayment			524.9	200	200	200
6	Interest rescheduled at 2%			21.2	12	8	4
7	PV of rescheduled loan = (PV row 5 + PV row 6)			546.1			
8	Capital Transfer ($600-$546.1)			53.9			

[1]Discounted present value (PV) = $\sum_{t-1}^{n}(Cash\ flow)_t/(1+i)^t$ where *(Cash flow)$_t$* denotes the cash flow in a future period (*t*), *n* denotes the number of future periods for which cash flows are expected, and i denotes the interest rate that is applied to discount the future cash flow in period *t*.; In this case discount rate is 7%.[2] The loan amount is the remaining balance of old original loan rescheduled at end of the second year after two payments installments.* PV of loan B assumes market interest rate remains 7 %.

Conditions attached

39. If, on the other hand, the rescheduling arrangement is such that the interest payments are reduced as they fall due, such as the case where conditions must be met by the debtor before the concessional rate is applied, the transfers generated would equal the difference in amounts between the two streams of interest payments as shown in Table 5, row 4, year 1 through 5. In other words, unlike the previous case, the transfers occur on an on-going basis and the original instrument is not extinguished. Furthermore, the reduction of interest as it falls due is similar to an ongoing subsidy on interest rate thus increasing the debtor's current consumption possibilities. This approach is also in conformity with the recommendation in paragraph 546 of *BPM5*.

40. In the standard presentation, a debit entry is recorded under interest income, accrued at the interest rate on the loan. In the period in which interest is paid, there is a credit item under current transfers, representing the interest rate differential since interest was last paid; a debit item under loans, representing any interest accrued at the original contractual rate since the last time interest was paid that has not been offset by a current transfer (e.g., if interest is paid semi-annually and balance of payments data are compiled quarterly, for one quarter interest will accrue at the contractual rate with no current transfer offset); and a credit item under reserve asset representing the amount paid. (see Table 6). In the analytical presentation the entries are the same as in the standard presentation, except that the current transfer is credited under exceptional financing, transfers (see analytical presentation in Table 6). Appendix 1, Figure 2 shows how concessionality where conditions are attached could be recorded in the government finance statistics.

Table 5: Transfers arising from debt rescheduling at concessional interest rate: Loan of $1000

		Year 1	Year 2	Year 3	Year 4	Year 5
1	Principal repayment schedule	200	200	200	200	200
2	Interest schedule at 5%	50	40	35	20	10
3	Interest schedule at 2%	20	16	12	8	4
4	Transfers (row 3- row 4)	30	24	23	12	6

Table 6: Proposed treatment of concessional interest payments in the balance of payments*

Standard Presentation					**Analytical Presentation**				
	Year 1		Year 3			Year 1		Year 3	
Current Account	Credit	Debit	Credit	Debit	**Current Account**	Credit	Debit	Credit	Debit
Income Income on debt (Interest)		50		35	Income Income on debt (Interest)		50		35
Current Transfers	30		23						
Financial & Capital A/c					**Financial & Capital A/c**				
Other Investment Long-term debt					Other Investment Long-term debt				
Other Investment Short-term debt					Other investment Short-term debt				
Reserves Assets	**20**		**12**		**Reserves Assets**	**20**		**12**	
					Exceptional Financing				
					Transfers	30		23	

Notes:
* Data based on output of Table 5, which is based on conditions, attached.

41. Such an approach could also be adopted for any concessional loans based on a variable interest rate (as defined in the *Debt Guide*, paragraph 6.15), such as those linked to a reference index such as LIBOR. In such instance the amount of the transfer is not known at inception but varies with market rates.

42. Issues for discussion by the Committee:

- *Does the Committee see a need to record transfers arising from concessionality?*
- *If so, where there are no conditions attached, does the Committee consider that when a new contract replaces the old: (a) an on-going current transfer be recorded (paragraph 30), (b) a capital transfer be recorded along with the present value of the loan (paragraph 31), (c) the present value savings on interest costs be recorded as a memorandum item (paragraph 35), or (d) a present value saving using current market interest rates be recorded as a memorandum item (paragraph 37).*
- *What are the Committee views on the approach to be used for instruments for which (a) conditions are attached (paragraph 39) and for (b) variable rate instruments (paragraph 41)?*

F. HIPC debt transactions linked to social expenditure and the classification of transfers

43. *BPM5* does not discuss the treatment of HIPC debt relief transactions that are linked to government budget expenditure. Some HIPC debt relief savings are linked to government expenditure in that the local currency equivalent of the debt-service forgiven—as it falls due—is earmarked to finance social development projects. The issue arises as to whether such savings should be classified in the balance of payments based on the type of expenditure outlays they finance in the government fiscal budget or the type of debt obligation forgiven. In reference to the latter, another issue arises as to whether all such debt relief savings should be classified in the balance of payments as capital transfers or should be classified to capital transfers or current transfers depending on whether the savings relate to principal or interest payments, respectively.

44. From the point of view of government expenditure outlays, these transactions could be classified in the balance of payments in the categories that match the flow of funds in the government accounts. However, it is also recognized that, while such matching is desirable, in reality no direct mapping might be possible given the diversity of the government's financial actions. For example, budget savings arising from interest payment forgiveness may be used to finance construction of schools, which is a capital expenditure item in government fiscal budget. Similarly, savings arising from forgiveness of principal payments may be used to finance medical supplies, which is a recurrent expenditure item in the government fiscal budget.

45. From the point of view of balance of payments, the methodology in *BPM5* and the *Debt Guide* dictates that such transactions should be recorded based on the concepts of accrual accounting and change in ownership status (see *Debt Guide*, paragraph 8.13). Thus it is recommended that the guiding principle in recording HIPC debt relief transactions in the balance of payments should be based on the type of debt obligation forgiven rather than the subsequent use of the funds in the government budget. *BPM5* recommends that all debt

forgiveness be recorded as a capital transfer (paragraph 455), as the transfer affects the stock of liabilities of the debtor in the financial accounts.

46. Table 7 gives an example of forgiveness of debt-service as it falls due, while Table 8 demonstrates the recommended methodology of recording the transactions in the balance of payments. In Table 8 it can be seen that, as the debt falling due is forgiven, transactions relating to principal are debited under other investment, long-term loans and contra credit entries under capital transfers. Similarly, transactions relating to interest are debited under income and contra credit entries under capital transfers. Appendix 1, Figure 3 shows how forgiveness of debt-service linked to government expenditure could be recorded in government finance statistics.

47. Issues for discussion by the Committee:

- *Does the Committee agree that the guiding principle in recording HIPC debt relief transactions in the balance of payments should be based on the type of debt obligation forgiven rather than the subsequent use of the funds in the government budget?*

- *Does the Committee agree that both interest and principal forgiveness should be recorded as capital transfer as recommended in BPM5?*

Table 7: Forgiveness of debt-service linked to government expenditure[1]

	Year	1	2	3	4	5
1	Principal repayment schedule	200	200	200	200	200
2	Interest schedule at 5%	50	40	35	20	10
3	Total (row 1 and 2)	250	240	235	220	210
4	Capital Transfers (Row 1 and Row 2)	250	240	235	220	210

Notes:
[1] Loan of $1000 repaid in five equal annual installments at an interest rate of 5%.

Table 8: Recording of debt-service linked to government expenditure in the balance of payments

Methodology

	Year 1		Year 2		Year 3		Year 4		Year 5	
Current Account	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
Interest		50		40		35		20		10
Current Transfer										
Financial & Capital A/c										
Capital Transfers	250		240		235		220		210	
Long-term loans*		200		200		200		200		200
Short-term loans*										
Reserve Assets										

Notes: *All under other investment based on data in Table 7.

G. Rescheduling of Interest Arrears and Interest Not Yet Due

48. Rescheduling of interest arrears and interest not yet due deserve elaboration in the revised *BPM5* to eliminate misinterpretation. The rescheduling of interest payments is articulated in paragraph 458 of *BPM5.* However, *BPM5* does not provide adequate guidance on rescheduling of (a) interest payments due and not paid and, (b) interest payments not yet due. Paragraph 457 of *BPM5* likens debt rescheduling with debt refinancing. It states that: *"Rescheduling or refinancing of existing debt involves a change in an existing contract and replacement by a new contract to extend debt service due to lenders. This rescheduling constitutes a formal deferment with new maturities replacing those of the former contract.*" By contrast, paragraph 545 of *BPM5*—which is also adopted by the *Debt Guide* (see paragraphs 8.10 and 8.11, and the definitions on page 253)—tries to be more elaborate in defining debt rescheduling by distinguishing it from debt refinancing. It states that: "*Debt rescheduling refers to the formal deferment of debt service payments and the application of new and extended maturities to the deferred amounts; debt refinancing refers to the conversion of an original debt, including any arrears, into a new loan.*"

Rescheduling of interest arrears

49. The words "*change in an existing contract and replacement by a new contract"* in paragraph 457 of *BPM5* could be considered as having the connotation that rescheduling of interest due and not paid translates into a change in an existing contract and thus calls for a rescheduling of the whole financial instrument. This approach is not only analytically misleading, but is also incongruent with the way financial world treat instruments with payments arrears. As regards "change in existing contract," so long as the terms of remaining debt (not yet due) are unchanged, the existing financial contract remains intact and so rescheduling of interest payments in arrears should not affect the recording of its transactions.

50. As for the "replacement by a new contract," the terms that govern the payment of interest arrears are not normally used to govern the payment of debt not yet due, and so rescheduling of interest payment arrears does not necessarily lead to altering its existing contract—unless in special cases when the whole debt is recalled as a consequence of sustained arrears. For these reasons, it is recommended that rescheduling of interest arrears should not automatically lead to a rescheduling of the whole financial instrument.

Rescheduling of interest not yet due

51. Rescheduling of interest not yet due, however, requires a different treatment. Given that the profile of future interest payment obligations can be rescheduled independent of the actions on principal, such rescheduling transforms economic value (paragraph 13 of *BPM5*) and constitutes a ground for a change in an existing financial contract. In other words, a debt instrument is composed of a stream of future payments, and a rescheduling of some or all of those payments constitute a change in the existing contract, which under *BPM5* methodology

creates transactions involving the replacement of the existing instrument with a new one. This means that although no transactions are recorded in the balance of payments for interest not yet due (*BPM5*, paragraph 545), transactions should be recorded in the financial account to reflect the retirement of the old instrument and replacement by a new one (see also paragraph 8.13 of the *Debt Guide*). This approach is analytically useful for debt sustainability analysis as it facilitates better assessment of balance of payments projections, and by so doing, supports external vulnerability assessment. It is recommended therefore that an agreement to reschedule interest payments due in the future should lead to a retirement of an existing instrument and replacement with a new one.

52. In clarifying rescheduling of future interest payments, it is also important to synchronize the definition of debt rescheduling in *BPM5* to clear apparent indistinctness in a number of places. Firstly, the use of the words "existing debt" and "debt service due" in paragraph 457 of *BPM5* indicate that rescheduling only applies to stocks and not to flows contrary to what actually happens in most HIPC debt rescheduling arrangements. Unlike *BPM5*, the *Debt Guide*, recognizes that "*rescheduling can be characterized as flow or stock rescheduling*" (see paragraph 8.12) although it does not elaborate on rescheduling of interest payments falling due in the future.

53. Secondly, while paragraph 545 of *BPM5* distinguishes between debt rescheduling and debt refinancing, its definition of debt rescheduling does not clarify whether "debt service payments" referred to in the statement are due or not yet due. Moreover, the use of the word "original" in reference to debt refinancing is ambiguous as original debt is not always equal to outstanding debt at the point of conversion. It should also be noted that the "maturities" referred to in the paragraph may not necessarily be extended—a debt rescheduling arrangements may retain the existing maturities but at reduced interest rates. It is therefore recommended that a more explicit definition of debt rescheduling be provided that covers rescheduling of future interest payments.

54. Issues for discussion by the Committee:

- *Does the Committee agree that rescheduling of interest arrears should not lead to the whole loan being rescheduled?*
- *Does the Committee agree that rescheduling of interest payments due in future should lead to creation of a new instrument?*
- *Does the Committee agree that there is a need to clarify the definition of debt rescheduling in BPM5?*

H. Balance of Payments Transactions Related to the HIPC Trust

55. Following successful progression to completion point of the HIPC Initiative, a country is entitled to receive the full HIPC assistance available through the IMF's PRGF-HIPC Trust. Debt compilers have expressed the need to clarify (a) the treatment of grants

provided to HIPC through the IMF's PRGF-HIPC Trust, (b) the classification of interest income earned from the undistributed part of such grants, (c) the sectors to which the transactions relating to such grants should be recorded, and (d) the time of recording of the transactions.

56. Under the terms of the PRGF-HIPC Trust, the Trustee makes a determination of the amount of assistance at the decision point (i.e., after a member has established a track record of strong policy performance under Fund-supported programs and a thorough external debt sustainability analysis). The Trustee may advance to the member, as interim assistance, a portion of the committed assistance by transferring resources to the HIPC Umbrella Account—an account specifically used for servicing HIPCs debt owed to the Fund when they fall due. Disbursements can be made from the Umbrella Account as long as the member has met the performance conditions. When the member reaches the completion point (i.e., specified performance-related conditions are met), the remaining committed grant is transferred irrevocably to the Umbrella Account for the benefit of the member.

57. According to the administration of the Umbrella Account, the grant resources earmarked for HIPC debt-service as it falls due are invested in fixed income assets for the direct benefit of the debtor i.e., the interest accruing from such assets is credited to the debtor's account within the HIPC Umbrella Account, which is later used for debt service to the loans received from PRGF Trust (see Table 9). Therefore once the HIPC grant is provided irrevocably, there is a clear change of economic ownership of the financial assets—the debtor attains economic ownership of new funds, which are transferred from PRGF-HIPC Trust to the Umbrella Account.

58. The total HIPC grant once provided in full and irrevocably should therefore be recorded as a credit entry under capital transfer and as an asset (debt entry) in the balance of payment. Debit entries for IMF debt falling due and serviced out of the proceeds of the grant should be recorded (when they are made) under other investment (with interest continuing to accrue in the income account) and contra credit entries under reserve assets or other investment assets, currency and deposits depending on where the grant is classified. If further relief is given through grants, the same recording procedure is followed.

59. The classification of the financial asset—contra debit entry to the capital transaction—is not straightforward. Notwithstanding that the grant is fully committed for payment of IMF debt, one possibility is to classify it under reserve assets given that assets held with the Fund are usually regarded as readily usable. This view is in line with paragraph 426 of *BPM5* which states that: "*assets that are pledged, committed, earmarked, set aside in sinking funds, sold forward, or otherwise encumbered by the holders are nonetheless existing assets and are not precluded on those grounds alone from being included in reserve assets.*"

60. On the other hand, the grant should be excluded from reserve assets based on paragraph 432 of *BPM5,* which states that: "*assets with uses blocked or otherwise effectively restricted by issuers are examples of assets that are not considered reserve assets.*" In many respects, the HIPC grant can be regarded as highly restricted—the grant is provided to

service the debt owed—and for that reason does not qualify to be included under reserves assets. This view is also in line with paragraph 72 of the *International Reserves and Foreign Currency Liquidity: Guidelines for data template,* which states that: "*assets pledged are typically not readily available. If clearly not readily available, pledged assets should be excluded from reserves.*" Disqualifying the grant from reserve assets classification implies that it should be classified under other investment assets, currency and deposits—either under general government or monetary authorities depending on the sector with legal and economic ownership (see Table 10).[16]

61. The question arises as to whether a country's future debt-service to the IMF utilizing the proceeds of the HIPC grant should be shown as part of exceptional financing or not. While *BPM5* is not clear about this issue, failure to record such transactions as exceptional financing on an ongoing basis would be somewhat misleading because without the grant the debt would be unsustainable. It may be worthwhile, therefore, to consider including an additional line item under exceptional financing to capture such transactions.

62. As to the treatment of interest earned from undistributed part of the grant which is invested in fixed income assets, such interest should be recorded as credit entry under income (see Table 10). As to the sector classification of PRGF-HIPC Trust related transactions, different countries may have different classifications depending on whether the debts are obligations of the monetary authorities or the general government. Usually PRGF-HIPC Trust Fund resources are used for government budget support and therefore debt transactions should be recorded under the general government sector.

63. The timing of transactions relating to HIPC Trust Fund resources should be governed by the change of ownership criteria as specified in paragraph 111 of *BPM5*. Appendix 1, Figure 4 shows how debt transactions related to the HIPC Trust could be recorded in government finance statistics.

64. Issues for discussion by the Committee:

- *Does the Committee agree that the HIPC grant should be regarded as an asset of the debtor once it is provided irrevocably? If so, does the Committee agree that given the highly restricted use of the funds, these assets should be classified under other investments—currency and deposits—rather than reserve assets?*

- *Does the Committee agree that the income generated from investments of the undistributed portion of the HIPC grant be recorded as interest income in the balance of payments?*

[16] The IMF has prepared a paper on reserve assets for *BOPCOM*.

- *Does the Committee agree that the HIPC grant should be recorded to the sectors in which the forgiven debt liabilities are recorded?*

- *Does the Committee consider that there is a need to include an additional line item under exceptional financing to capture transactions relating to utilization of the HIPC grant?*

Table 9: Statement on HIPC Umbrella Account for Ghana	
Country Ghana PRGF-HIPC Trust	
UMBRELLA ACCOUNT FOR HIPC OPERATIONS	
Summary Position and Movements for the Month of November 2004 (in SDR)	
Balance[1], October 31, 2004	65, 647,597
Investment income[2]	**18,781**
	65,666,378
Less Disbursements[3]:	
November 30, 2004	1,347,328
Balance, November 30, 2004	64,319,050
[1] This is the grant amount set aside to meet Ghana's debt service payments on its existing debt to the Fund in accordance with the agreed schedule for use of PRGF-HIPC proceeds. [2] This is monthly-distributed cash income from HIPC Trust Fund fixed income investments. [3] Disbursement refers to payments from the HIPC Trust Fund to service Ghana's debt to the Fund which is falling due.	

Table 10: HIPC Umbrella Account transactions in balance of payments: (in SDR)		
Standard presentation	Credit	Debit
current account, income, other investment: interest	18,781	
other investment: liabilities, loans, general government, long-term		1,347,328
other investment, assets, currency and deposits	1,309,766	

I. Identification of HIPC Transactions

65. The HIPC framework for debt rescheduling is viewed by balance of payments economists as broadly in line with the menu of options available for debt rescheduling under the Paris Club and the London Club arrangements. For this reason, it is argued that there should be no need to provide a separate statistical framework in the balance of payments specifically targeted to HIPC debt. Moreover, it is argued that the HIPC framework is expected to expire eventually, but debt rescheduling is bound to remain relevant in the international debt arena. Nonetheless, it is also considered that while a separate statistical framework dedicated to HIPC debt may not be necessary, comprehensive and clear memorandum items are needed to address the unique features of the HIPC debt. It has also been suggested that a chapter could be included within the *Balance of Payments Textbook*

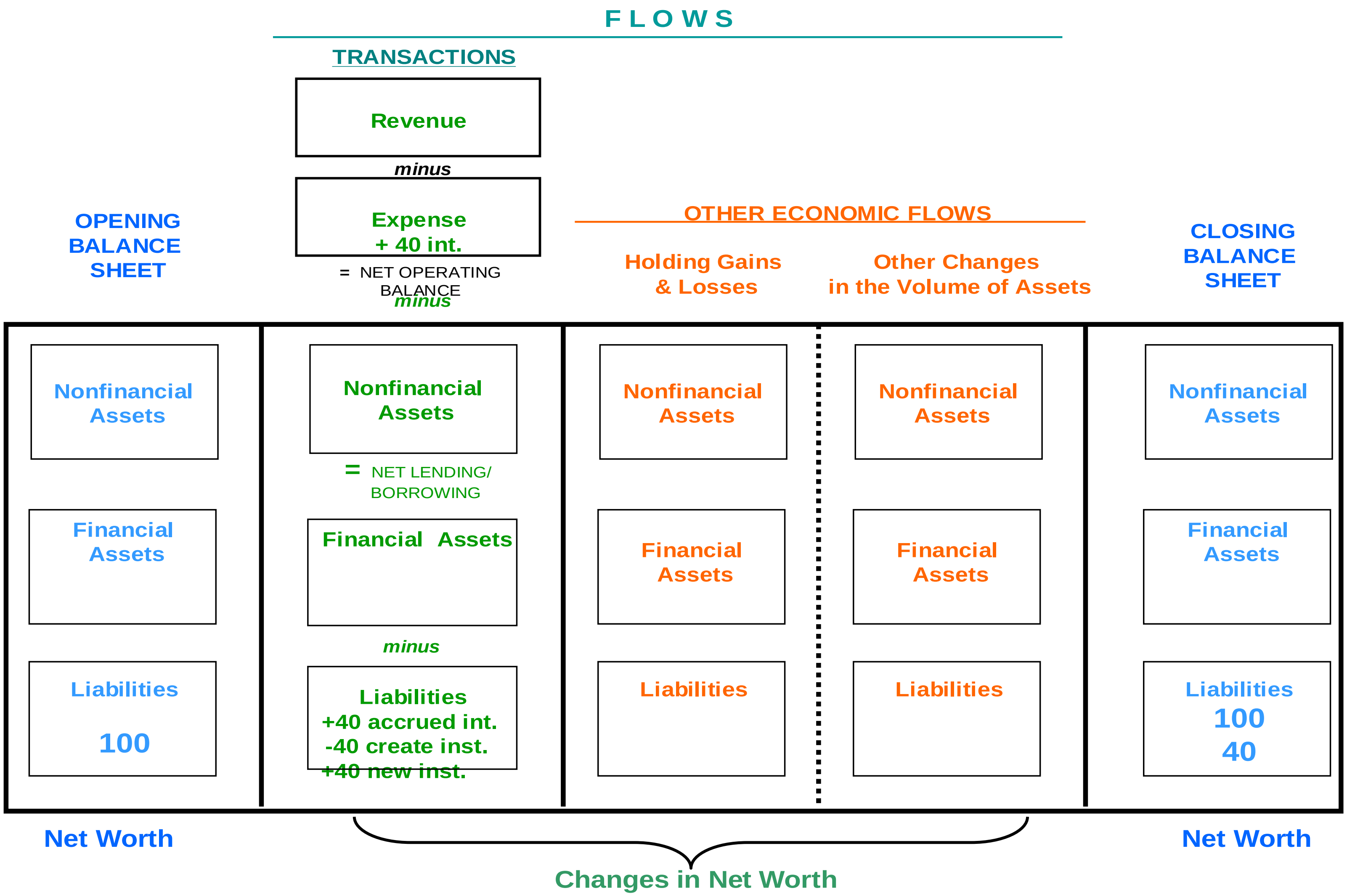
and *Balance of Payments Compilation Guide* to include a number of examples covering all types of transactions under HIPC initiative.

66. *Issue for discussion by the Committee:*

- *Does the Committee consider that there is a need to have comprehensive memorandum items in the balance of payments covering HIPC debt transaction?*

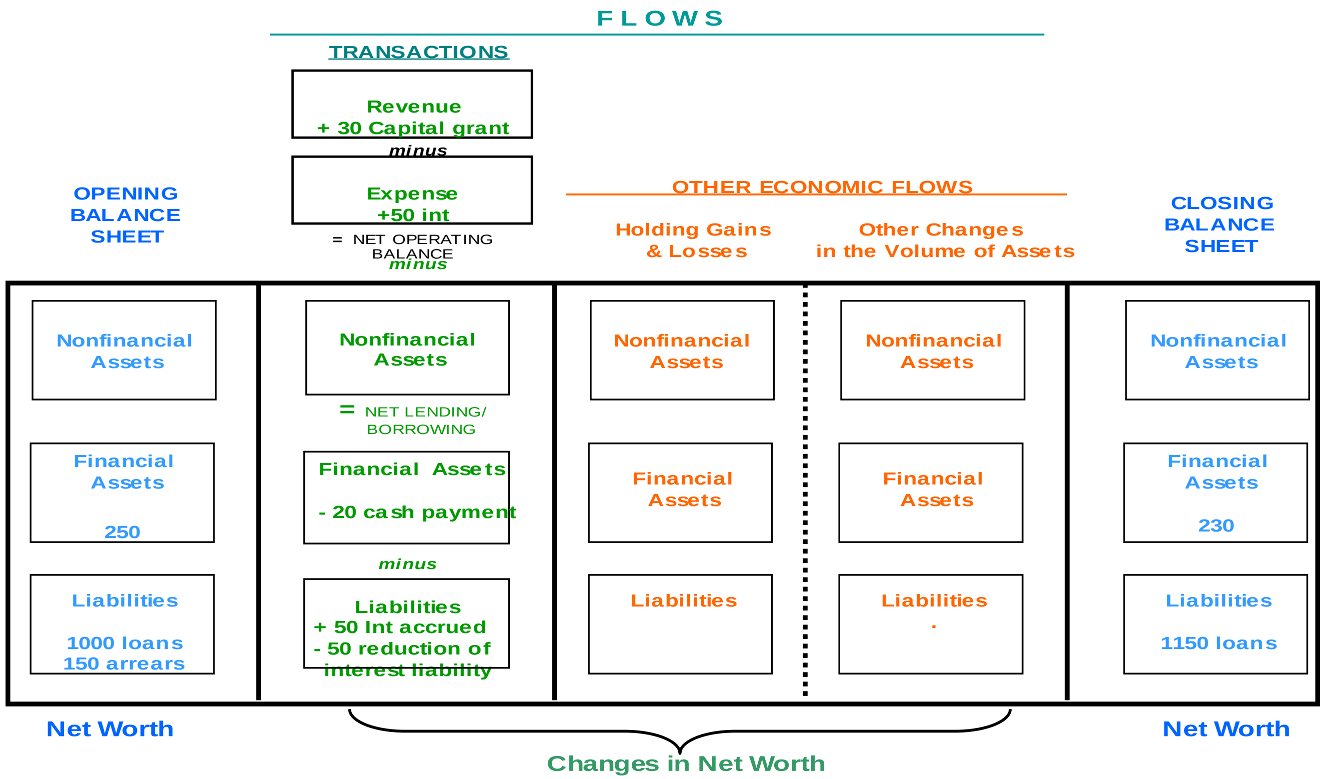
Appendix 1: HIPC Debt Relief Transactions in Government Finance Statistics

Figure 1. Treatment of Debt-Service Moratorium Extended by Creditors Before Completion Point Under the *GFSM 2001* (Issue B)



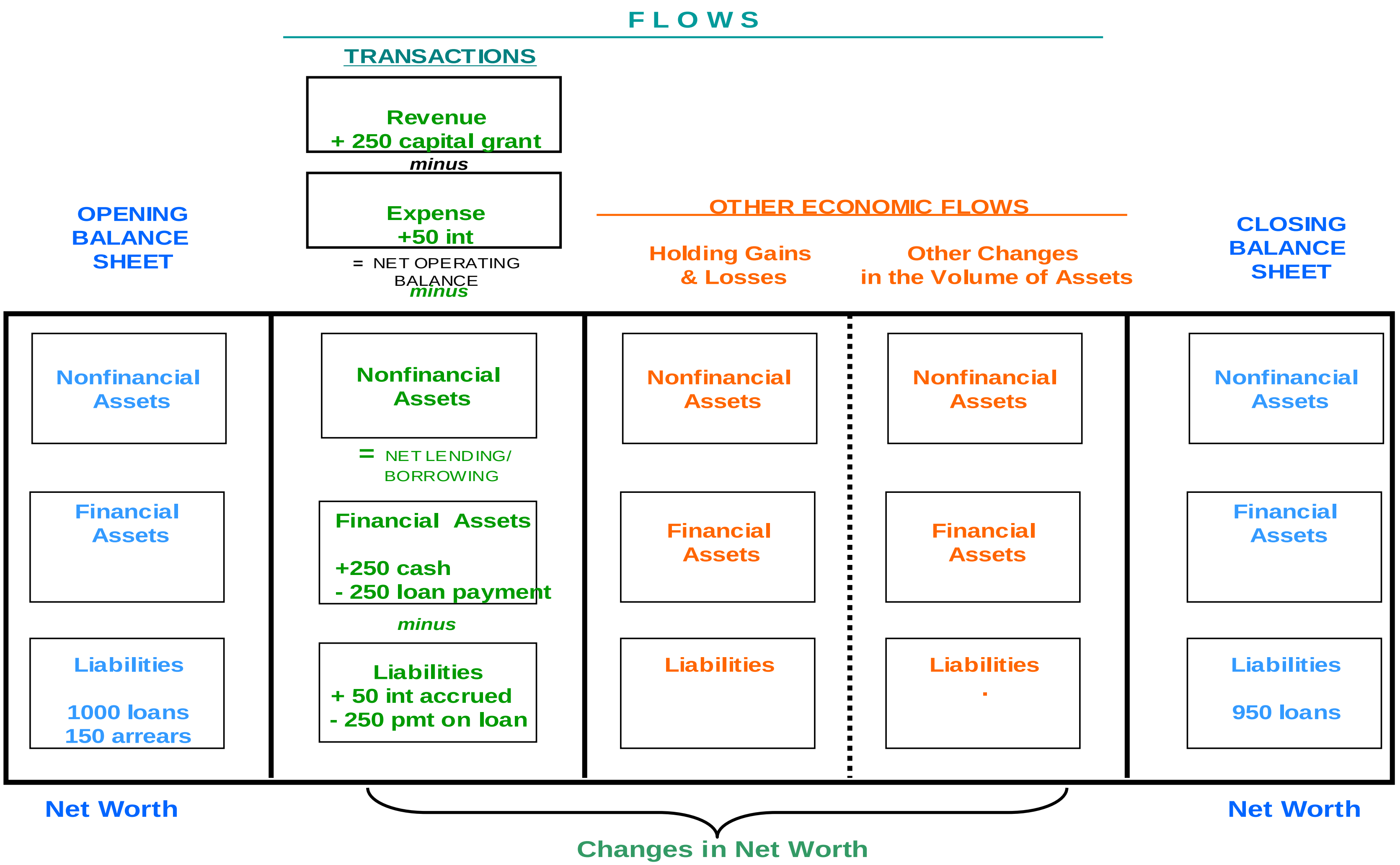
The interest arrear created under the moratorium is reflected as an increase in liabilities (+ 40 accrued interest) which has as its counterpart an increase in expense and the possible creation of a instrument separate from the original instrument, negatively affecting total net worth.

Figure 2: Economic Transfers Arising from Concessionality (Issue E)



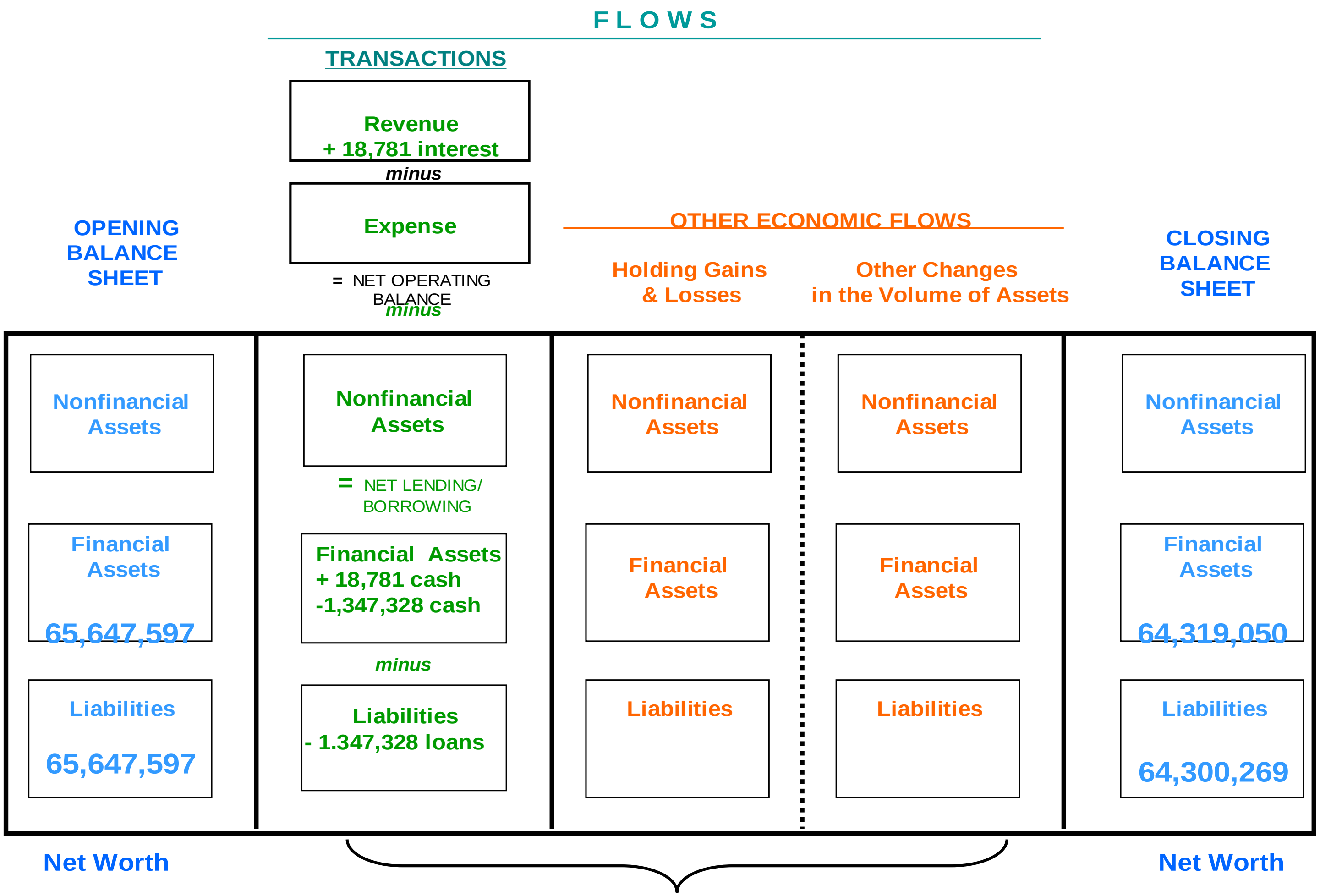
The grant resulting from the concessionality in interest increases revenue. The interest that has accrued on the original debt liability has its counterpart as an expense, the payment of which reduces this interest liability. The net operating balance (- 20) is reflected as a decrease in financial assets (cash), reducing net worth.

Figure 3: Recording of Debt Service Linked to Government Expenditure (Issue F)



The grant component (+250) results in an increase in revenue, which is used to reduce the debt liability thereby improving net worth. However, the interest that has accrued results in a liability (+ 50) that reduces overall net worth.

Figure 4. HIPC Umbrella Account Transactions (Issue H)



The interest income increases the financial assets of the debtor, also reflected in the change in financial assets. Financial assets and liabilities in the closing balance sheet reflect payments (disbursement 0f 1,347,328) from the HIPC Trust Fund to service Ghana's debt.