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**National Accounts and Economic Statistics**

**CONCESSIONAL DEBT**

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*WORKING PARTY ON NATIONAL ACCOUNTS*

*To be held on 11-14 October 2005*

*Tour Europe - Paris La Défense*

*Beginning at 9:30 a.m. on the first day*

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**Eighteenth Meeting of the  
IMF Committee on Balance of Payments Statistics  
Washington, D.C., June 27–July 1, 2005**

**Concessional Debt**

**Prepared by the Statistics Department  
International Monetary Fund**

## BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

### OUTCOME PAPER (BOPTEG) # 29

JANUARY 2005

(1) Topic: **Concessional Debt**

(2) Issues – see BOPTEG Issues Paper # 29

3) Recommendations:

(i) It was agreed that the general principle should be that the concessional element of a debt should be recognized as a current transfer and the interest payable be adjusted upwards by the same amount.

(ii) It was recognized that there were no clear definition for concessional loans, but the existing guidance in the *Debt Guide* and features such as an intention to convey a benefit, and occurrence in a noncommercial setting (usually government-to-government) could be mentioned.

(iii) If loans continue to be expressed at nominal value as the primary valuation, as endorsed by the IMF Committee on Balance of Payments Statistics, the concessional element would be shown as an ongoing current transfer. The transfer would be measured as the difference between the actual rate and market rate for loans to borrowers of similar creditworthiness under similar loan conditions. It was noted that this principle was to measure the size of the transfer. (As discussed at (ii) above, that the intention of BOPTEG was not that any loan at apparently less than usual rates would be treated as concessional but rather that only loans as defined in (ii) above, should be eligible.) It was recognized that a fair valuation basis for loans would raise more complex valuation and allocation issues.

(iv) The desirability of bilateral cooperation between compilers in the two affected economies was emphasized to maximize consistency in identification and measurement.

(v) For the quantification of the transfer element and interest:

- Some members considered that the transfer element and interest for fixed-rate loans could be determined from market-equivalent interest rates at the time of inception. That is, subsequent changes in interest rates and borrower creditworthiness would not affect the value of the transfer. (The possibility that interest rate and creditworthiness could change so much that the loan was no longer concessional was discussed, but the problem was considered to be hypothetical in that such loans might well be renegotiated.) Similarly, for a floating-rate loan, it was considered that, in practice, the concessional element would also be expected to be maintained as an identifiable element in relation to the formula for the floating rate.
- Other members considered that quantification of the transfer element and interest should take into account subsequent changes in interest rates and creditworthiness.

The IMF will undertake further investigations of these issues and report to the Committee on Balance of Payments Statistics.

(4) Rejected Alternatives:

None.

(5) Questions for the Committee:

- (i) *Does the Committee agree with the general principle that concessional loans incorporate a transfer element to be recorded in current transfers with an equal adjustment of interest payable? See (3(i)) above.*
- (ii) *Does the Committee agree with the proposed approach to identifying concessional debt? See(3(ii)) above.*
- (iii) *Does the Committee agree with the proposed approach to quantifying the concessional element of debt? See (3(iii)) above.*
- (iv) *Does the Committee consider that the concessional element on a fixed-rate loan should be:*
  - (a) fixed over the life of the loan and quantified by reference to interest rates for nonconcessional loans with similar term lengths and creditworthiness at the time of inception; or*
  - (b) variable each period and quantified by reference to interest rates for nonconcessional loans with similar creditworthiness in that period?**See (3(v)) above.*

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS**  
**BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTTEG)**

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**ISSUES PAPER (BOPTTEG) # 29**

**CONCESSIONAL DEBT**

**Prepared by Robert Dippelsman and Andrew Kitili, IMF Statistics Department**

**October 2004**

**BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP**

**ISSUES PAPER (BOPTTEG) # 29**

**CONCESSIONAL DEBT**

**Background**

The *Debt Guide* recognizes that there is no unique definition of concessionality. Different institutions and analysts use different debt variables to quantify the level of debt concessionality (see *Debt Guide* para. 6.22). For purposes of discussion in this paper, we define concessional debt as lending extended by creditors at terms that are below market terms with the aim of achieving a certain goal. For example, governments may provide loans at low or zero interest rates, either to provide a benefit to the recipient or to encourage some action by the recipient (such as purchasing goods from the lender's country). It is believed that creditors generally extend concessional lending through loans but the lending could potentially apply to securities, trade credits, or even deposits.

The issue of concessionality is also relevant to government finance statistics. A related case, not discussed here, would be where a government funds a resident to provide loans or trade credit to nonresident. While it is recognized that concessional lending derives transfers, there is no clearly articulated framework in *BPM5* of the treatment of concessional debt in the position and flows. In particular, *BPM5* does not clearly articulate how to quantify concessionality in lending based on different debt valuation principles.

The three main possible options of the treatment of the positions and flows can be expressed as follows:

- (1) Debt at nominal value, interest at nominal value, no imputed transfer.
- (2) Debt at nominal value, interest at market rate, difference between interest at nominal and market values shown as a current transfer in each period.
- (3) Debt at market-equivalent value<sup>1</sup>, interest at market rate, difference between nominal and market-equivalent value of debt shown as a capital transfer in the initial period.

**Current international standards for the treatment of the issue**

*BPM5* para. 104 recognizes concessional loans as a case where a transfer needs to be imputed:

“other transactions may take place at implied prices that include some element of grant or concession so that those prices are not market prices. Examples of such transactions could include ... government loans bearing lower interest rates than those consistent with grace and repayment periods or other terms for purely commercial loans”

<sup>1</sup> Derived as the present value of future cash flows; see *Debt Guide* pp.18-24.

In such cases, a market price equivalent should be used:

“In conformity with the procedure used for the national accounts, such resources should be valued at the market prices that would have been received if the resources had been sold.” (para. 105)

The *Debt Guide*, by recognizing a lack of a unique definition of concessional debt points to the difficulty in deriving a quantifiable measurement of “concessional lending operations” (para. 6.22). The DAC<sup>2</sup> definition of concessional lending which is based on loan “grant element” computes concessional lending as “the difference between the *face value* of the loan and the sum of the discounted future *debt service* payments to be made by the borrower expressed as a percentage of the *face value* of the loan”. DAC uses a discount rate of 10 percent as the market rate of interest which raises the question as to whether the same discount rate should be applied in all cases irrespective of varying opportunity cost of capital in different economic environments. The DAC approach is also applied in estimating the level of concessional lending required in providing debt relief to the Heavily Indebted Poor Countries (HIPC). However, the HIPC Initiative uses discount rate based on OECD commercial interest reference rates (CIRR) for a given loan currency—i.e., the market interest rates available commercially to first class corporate borrowers for long-term fixed rate exports finance.

The *1993 SNA* para. 7.42 and *GFSM* para.. 6.14 recognize the subsidy element of concessional loans to employees as being in wages and salaries in kind. The consequent adjustment to interest required by a double-entry accounting system is not explicitly mentioned. The subsidy element for policy-related loans is noted in *GFSM* para.. 4.45, but as a basis for possibly showing them separately, rather than making adjustments.

The market-equivalent value is defined as the realizable value or what the creditor could expect to raise by selling the asset to a willing independent buyer.

### **Concerns/Shortcomings of the current treatment**

The main shortcoming is that none of the three options listed above for the treatment of positions and flows is explicitly stated in the current *BPM5* framework. The implementation of the general principles in *BPM5* seem to require a considerable amount of specific guidance, but there is none.

### **Possible alternative treatments**

To illustrate these options we use an example of a ten year interest-free loan of 1000 made on January 1 of Year 1, with no payments until maturity, and a market interest rate of 6 percent. The results for year 1 and 2 are tabulated in table 1 (a) and (b), respectively.

<sup>2</sup> OECD’s Development Assistance Committee. Quoted in the *Debt Guide*, para. 6.22 and p. 257)



Table 1 (a)				Table 1 (b)			
Year 1	Option 1	Option 2	Option 3	Year 2	Option 1	Option 2	Option 3
Debt as at Jan 1	1000	1000	558 <sup>b</sup>	Debt as at Jan 1	1000	1000	592 <sup>b</sup>
Interest <sup>a</sup>	0	60	34	Interest <sup>a</sup>	0	60	36
Current transfers	0	60	0	Current transfers	0	60	0
Capital transfers	0	0	442	Capital transfers	0	0	0
Debt as at Dec 31	1000	1000	592 <sup>b</sup>	Debt as at Dec 31	1000	1000	627 <sup>b</sup>

<sup>a</sup> Since there are no payments, the interest accrued is capitalized as part of the value of the loan.

<sup>b</sup> Market-equivalent value calculated as present value of future cash flows using market interest rate as the discount factor, e.g., value at end of year 1 is 592, i.e.,  $1000/(1.06)^9$ .

For the value of the debt, the treatment is determined from general valuation principles that are already well-established.

- € Options (1) and (2) are compatible with the nominal valuation of loans.
- € Option (3) is compatible with the valuation principles for debt that was issued as a security, that has become a traded loan, or that is valued at a market-equivalent valuation (as has been proposed as a memorandum item; see BOPTTEG Outcome Paper #4).

Options (1) and (2) provide position data that are an unsatisfactory as representation of realizable values, and there is inconsistency with the treatment of analogous debt in the form of traded securities. Option (3) involves more computation in amortizing the implied discount interest.

The associated flows are quite different for the different options. Option (1) follows the apparent transactions and can be easily implemented. However, it does not show the underlying reality that there is an intentional transfer element. Failure to take into account the underlying transfers may lead to economic policy decisions that distort resource allocation across economic sectors. Option (2) has the possible advantage of showing the implicit transfer as a continuing transfer over the life of the debt and is an option also preferred in quantifying the annual debt relief provided to HIPC's under the HIPC's Initiative. In Option (2), the interest and transfer adjustments cancel out, so that disposable income and the current account deficit are unaffected. The transfer increases the current consumption possibilities of the debtor compared to a loan extended on a market value basis. It is assumed that any transfer under Option (2) would be a current transfer, because it is related to interest, which is a current account item.

If loans are recorded at market-equivalent values, or the debt is a security or has become tradable, the preferred option is Option (3). If the loan (in our example) is valued at market-equivalent value, then interest is presumably measured in a way compatible with zero-coupon or deep-discounted bonds. The result is a higher (lower) annual disposable income to the borrower (lender) than Options (1) and (2), in that there is an adjustment to interest, but the compensating counter-entry is in the capital account for Option (3). Option (3) reflects the concessional nature of the loan as a transfer at the point of loan origination. The concessionality is classified as a capital transfer based on the difference between nominal value and discounted value of the debt being analogous to the forgiveness of a liability. An

implication of the valuation of the loan at market-equivalent prices is that the transfer would all occur in the initial period, rather than over the life of the debt.

As discussed, the estimation of the concessional element of the debt raises definitional and measurement issues. The *Debt Guide* notes that there is no unique definition of concessionality and does not offer nor recommend one. The determination of the market-equivalent interest rate for any particular loan arrangement is subject to a range of uncertainty. While these matters are beyond the scope of this paper, they would need to be addressed in the manual or a compilation guide in order to facilitate symmetric reporting by debtors and creditors.

Question 11.8(e) in the *AO* asked commenters to choose between the effects on interest and transfers of what are called Options (1) and (2) in this paper. Five commenters considered that there should be a current transfer. Of the six who thought there should not be a current transfer (i.e., that *BPM5* should be changed), concerns were expressed about symmetry, distinguishing between capital and current transfers, and a preference was stated for a memorandum item on the concessional element.

### **Questions/Points for discussion**

*(1) If loan valuation continues to be at nominal value, does the Group prefer Option (1) or (2) or some other possibility?*

*(2) For debt in the form of securities, traded loans, or in the event of adoption of loan valuation at market-equivalent values, does the Group prefer Option (3) or some other possibility?*

*(3) Do BOPTEG members have any advice on guidance that could be provided on measurement of these concepts?*

### **Supplementary information**

*BPM5* para. 93, 104 and 105.

*Balance of Payments Compilation Guide* para. 355

*Debt Guide*, paras. 2.54-90, 6.22, and App III

*GFSM* para. 6.14