Appendix 2: Government Debt Operations

This appendix describes various debt and debt-related transactions and other economic flows in which a general government unit may be involved.

A. Introduction

1. In addition to normal interest expense and principal repayment transactions regarding their own debt, general government units may undertake a range of often complex debt and debt-related transactions, including assuming debt guaranteed for other units, rescheduling debt, and canceling debt. This appendix summarizes the transactions and other economic flows that arise from government debt and debt-related operations.

B. Interest, principal, and arrears

2. The most common debt transactions of general government units are interest expense and the repayment of principal. Interest is an expense incurred by a debtor for the use of another unit's funds. An interest-bearing financial instrument can be classified as deposits, securities other than shares, loans, or accounts receivable/payable. Interest accrues continuously and is treated as if the debtor pays it continuously to the creditor and the debtor continuously borrows an additional quantity of the same financial instrument, thereby increasing the debtor's total liability. When the debtor makes a payment, the liability is reduced.[1] Traditionally, the share of a periodic payment equal to the amount of interest that has accrued and is due for payment is referred to as an interest payment. The remainder is referred to as a principal payment.

[1]Interest accruing on deposits and loans may have to follow national practices and be classified under accounts payable/receivable rather than additional amounts of deposits and loans.

3. If the debtor does not make a payment on or before its scheduled date, including any grace period, a payment arrear is created. Depending on the contractual conditions, the existence of arrears may change the terms of the entire liability or only the portion in arrears. For example, failure to make a scheduled payment may convert the entire principal of a long-term loan into a loan callable on demand. If the terms and conditions have changed with respect to any part of the liability, that part should be treated as a separate instrument, possibly in a different category of liabilities. Thus, it is recorded as if a payment were made on the scheduled date equal to the amount being reclassified, and then the creditor lent the same amount to the debtor under the new terms. In this way, the amount of financing obtained by not making scheduled payments becomes clear. When arrears exist, either each relevant category of liabilities should be subclassified to indicate the amounts in arrears, or the amounts in arrears should all be classified as accounts payable.

C. Debt assumption

4. General government units often guarantee debts incurred by other units. Frequently the creditor is willing to lend funds to the debtor only if a general government unit guarantees the debt. Debt assumption takes place when the creditor invokes the contract conditions permitting the guarantee to be called, and the general government unit assumes responsibility for the debt as the primary obligor, or debtor. Thus, debt assumption involves three units—the general government unit, the creditor, and the original debtor. The government incurs a new liability to the creditor and the liability of the original debtor is extinguished. The new debt may carry the same terms as the original debt, or new terms may come into force because the guarantee was invoked.

5. When a general government unit assumes a debt, it may or may not acquire a claim against the original debtor. If it does acquire a claim, the claim may or may not be effective in the sense that there is a realistic probability that it will be paid. When the general government unit acquires an effective claim, it records an increase in liabilities to the creditor and the acquisition of a financial asset with the original debtor as the counterparty. There is no change in net worth, assuming the new claim is equal in value to the liability incurred.

6. If the general government unit does not acquire an effective claim on the original debtor, then the classification of the transaction depends on the relationship between the general government unit and the original debtor. If the original debtor is a public corporation owned or controlled by the assuming general government unit and the corporation continues to be a going concern, then the assumption amounts to an increase in the equity owned by the general government unit. In this case, the general government unit records an increase in liabilities to the creditor and an increase in shares and other equity. There is no change in the net worth of either unit. If the original debtor is bankrupt, no longer a going concern, or is not a unit owned or controlled by the assuming general government unit, then the general government unit has made a transfer payment. It records an increase in liabilities and an expense, which is classified as a capital grant if the original debtor is a foreign government or another general government unit and as other miscellaneous expense/capital transfers if the original debtor is any other unit. Net worth has decreased by the amount of the transaction.

D. Debt payments on behalf of other units

7. General government units may make one or more debt-service payments on behalf of other units, usually under guarantees or similar arrangements, without actually assuming the debt. These payments may involve interest or principal that is due to be paid by the other unit. Such payments cannot be classified as interest expense or repayment of principal because the general government unit does not have an actual liability. The treatment of these payments depends on whether the general government unit acquires an effective financial claim on the debtor and, if not, the nature of the unit.

8. If the general government unit obtains an effective financial claim against the original debtor, then it records an increase in financial assets and a decrease in cash. If the general government unit does not obtain an effective financial claim, then it records an expense. When a single payment of a small part of the debtor's liability or a series of such payments is involved, the expense is classified as a current grant when the debtor is another general government unit or a foreign government, as a subsidy when the debtor is a corporation, and as miscellaneous other expense when the debtor is any other type of unit. If the general government unit pays the entire liability of the debtor in a single payment, then the transaction is treated as debt assumption.

E. Debt forgiveness

9. Debt forgiveness is the cancellation of a debt by mutual agreement between a creditor and debtor. It is always recorded as the creditor providing a capital grant or transfer to the debtor. General government units may be involved in debt forgiveness as a creditor or a debtor.

10. Debt forgiveness results in a decrease in financial assets and usually a decrease in net worth for the creditor equal to the value of the debt forgiven and a decrease in liabilities and an increase in net worth for the debtor. If the second party to the transaction is a foreign government or a unit at another general government unit, then the transaction is a capital grant for both the creditor and the debtor. If the second party to the transaction is any other type of unit, then the transaction is classified as miscellaneous other expense/capital transfers when the general government unit is the creditor and as other revenue/capital voluntary transfers other than grants when it is the debtor.

F. Debt restructuring and rescheduling

11. General government units may agree in a bilateral arrangement to alter the terms for servicing an existing debt, either as a creditor or a debtor, usually on more favorable terms for the debtor and possibly with partial debt forgiveness. These terms may include extending repayment schedules, adding or extending grace periods for interest and principal payments, or rescheduling debt-service payments that are due and/or in arrears. All such changes in the contractual relationship between debtors and creditors are accounted for by transactions that reduce liabilities by the amount of debt that has been reorganized and increase liabilities by the market value of the new debt.[2] Any debt forgiven is accounted for as a capital transfer as described in paragraphs 9 and 10. Other adjustments, such as to take into account changes in foreign exchange rates, are accounted for as a holding gain or loss.

G. Debt write-offs and write-downs

12. General government units that are creditors may write off financial assets without an agreement with the debtor in cases such as bankruptcy of the debtor. For example, a public corporation that has borrowed from the general government unit may be insolvent and its assets liquidated. As a result, the general government unit's claim has no value and is eliminated from the balance sheet by recording an other economic flow. A unilateral write-down of a partial value of a debt is treated similarly, but the reduced amount of the debt remains on the balance sheet. A unilateral write-off by a debtor, or debt repudiation, is not recognized.

13. In general, loans are valued in the balance sheet of both creditors and debtors at nominal value. Loans that have become marketable in secondary markets should be reclassified as securities other than shares and valued at market prices. In addition, general government units may find that other loans are worth less than their nominal value on the evidence of similar debt that has been traded in the market (for example, under loan-for-equity swaps). In such circumstances, a memorandum item should be recorded noting the apparently lower value of the loans.

H. Debt-for-equity swaps

14. A general government unit acting as a creditor might exchange a debt instrument for shares and other equity issued by the same unit that issued the debt instrument. The recording of this event depends on the value of the shares and other equity received by the general government unit and whether there has been an agreement to forgive debt.

15. In all cases, the general government unit will record transactions reflecting an exchange of financial assets as debt has been exchanged for equity. The value of the shares and other equity received may be the same or differ from the value of the debt given up. If there was a bilateral agreement to forgive part of the debt, then a capital transfer would be recorded for the amount forgiven. The remaining difference between the value of the shares and other equity and the value of the debt should be recorded as a holding gain or loss. If there is no bilateral agreement to forgive debt then any difference is a holding gain or loss.

16. Determining the value of the shares may be difficult if the shares are not actively traded on a market, as is likely to be the case if the unit that issued the shares is a controlled public corporation. If the shares are not traded, then most likely they will have to be valued based on the total value of the corporation's assets less the total value of its liabilities, where the shares and other equity are not included as liabilities.

I. Financial and operating leases

17. A general government unit may be involved in leasing fixed assets, most likely as the lessee, but possibly as the lessor. If so, the lease must be classified as an operating or financial lease. If it is an operating lease, the lease payments are treated as use of goods and services expense if the general government unit is the lessee and as sales of goods and services if it is the lessor. If it is a financial lease, then the lessor is treated as having sold the asset to the lessee and financed the sale with a loan. This treatment of leases of fixed assets is the same as the treatment in the *1993 SNA*.

18. Operating leasing is a productive activity that involves renting fixed assets for terms less than the expected service lives of the assets. It is a form of production in which the lessor provides a service to the lessee in exchange for the lease payments. Operating leasing can be identified by the following characteristics: (a) the lessor normally maintains a stock of equipment in good working order which can be hired on demand or at short notice, (b) the equipment may be rented out for varying periods of time, and (c) the lessor is frequently responsible for the maintenance and repair of the equipment as part of the service provided to the lessee.

19. In contrast, financial leasing is an arrangement for financing acquisitions of fixed assets. It is a contract between a lessor and a lessee whereby the lessor owns a fixed asset and puts it at the disposal of the

[2]Nominal value if a loan is involved.

lessee, and the lessee contracts to pay rentals that permit the lessor to recover all or almost all of its costs, including interest. As a result, the risks and rewards of ownership pass from the lessor to the lessee. In order to capture the economic reality of such arrangements, a change of ownership from the lessor to the lessee is deemed to take place, even though legally the leased good remains the property of the lessor, at least until the termination of the lease when the legal ownership is usually transferred to the lessee.

20. The rental payments made each period by the lessee include an interest payment and a principal payment. If the market value of the asset is known at the inception of the lease, then it is the value of the transaction, and the rate of interest on the loan is determined implicitly by the total amount paid as rentals over the life of the lease in relation to the price of the asset. If the market value of the asset cannot be determined reliably, then its value is estimated as the present value of the lease payments discounted at an appropriate market rate of interest.

J. Defeasance

21. Another debt-related operation is defeasance, in which a debtor unit removes liabilities from its balance sheet by pairing them with financial assets, the income and value of which are sufficient to ensure that all debt-service payments are met. Defeasance may be carried out by placing the assets and liabilities in a separate account within the institutional unit concerned or by transferring them to another unit. In either case, the GFS system does not recognize defeasance as affecting the outstanding debt of the debtor. Thus, no transactions with respect to defeasance are recorded in the GFS system as long as there has been no change in the legal obligations of the debtor. When the assets and liabilities are transferred to a separate account within the unit, both assets and liabilities should be reported on a gross basis. If a separate unit is created to hold the assets and liabilities, that new unit should be treated as an ancillary unit and consolidated with the defeasing unit.