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Directorate D: Government Finance Statistics (GFS) and quality

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Subject: Ex-ante consultation on the recording of the foreign claims renegotiations in government accounts

Ref.: Discussions in the context of the EDP Statistics Working Group meetings in June 2018 and December 2017 and of the Task Force on Methodological Issues meeting in May 2017

Your emails of 27 February 2017 and of 20 March 2017

Dear Mr Rybáček,

Following your emails of 27 February 2017 and of 20 March 2017 and following methodological discussions at the European level (*Excessive Deficit Procedure Statistics Working Group* and *Task Force on Methodological Issues*), Eurostat would like to provide you with its advice on the recording of claims of the Czech government towards the Republic of Cuba and the former Socialist Federal Republic of Yugoslavia (SFRY).

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

The issue for which an opinion is being sought is the recording in national accounts of the value of government claims towards the Republic of Cuba and the former SFRY.

1.1 Documentation provided

The Czech authorities provided a document explaining the origin of the claims of the Czech Republic towards both debtor countries the Republic of Cuba and the former SFRY, recent developments in the negotiation on debt settlements and their own analysis on the possible future recording in national accounts. In the case of the claim towards the Republic of Cuba, two recording options were proposed. Following a Eurostat enquiry, additional information was provided later on for both cases by the Czech statistical authorities.

1.2 Description of the case

Claim towards the Republic of Cuba

The claims of the Czech Republic towards the Republic of Cuba originated in 1970's and 1980's from the trade relations within the Council of Mutual Economic Assistance (CMEA). A part of the claims were loans on investment projects which should have been paid in a delivery of goods or services. These loans were granted in an artificial billing currency called the '*transferable rouble*' (XTR) which was used by trade members for accounting and clearing purposes. In 1990, following the constitution of the Czech and Slovak Federative Republic (CSFR), an official conversion rate of the Czechoslovak koruna (CSK) against the convertible roubles was set by a Czechoslovak legislative act. The *transferable rouble* ceased to exist in 1992 as a result of the geopolitical changes. In 1993, after the split of the CSFR, the exchange rate of the *transferable rouble* against Czech koruna (CZK) was set by the Czech authorities for accounting purposes using the exchange rate 1 CZK = 1 CSK.

Later on, the Czech Republic initiated a negotiation on the future settlement of the Cuban debt. According to the information provided by the Czech authorities, the Cuban authorities recognise the existence of the debt towards the Czech Republic in *transferable roubles*. The stocks of the claims are regularly agreed between the CSOB bank and the Banco Nacional de Cuba, both administrating the respective accounts. However, it is the conversion rate fixed by legislation in 1990 which is disputed by the Cuban authorities.

Claims towards the former SFRY

Following the split of the CSFR in 1993, the Czech Republic became the owner of two thirds of foreign claims, including claims towards the former SFRY. A legal basis of the claim was the 'Payment Agreement' concluded between the CSFR and the government of the former SFRY in 1991 and the '*Protocol on the settlement of the clearing account balance*' from 1992 which fixed the billing exchange rate between the clearing dollar (YUSD) and the American dollar (USD) and the interest rate. In 1992, after the split of the former SFRY, Croatia, Bosnia and Hercegovina, the former Yugoslav Republic of Macedonia, Slovenia, Serbia and Montenegro became independent states. In order to allocate the original claim towards the former SFRY among individual successor countries, the Czech Republic concluded in 2004 the '*Agreement on Succession Issues*'. In this Agreement, two different principles for the calculation of debt ratios were to be applied, depending on the ability to identify a final beneficiary. In case a final beneficiary (debtor) could be identified, the debt was to be allocated to the successor State of the beneficiary. Otherwise, the debt was to be proportionally assigned to all successor States, applying fixed ratios concluded in the Agreement.

According to the Czech authorities, until now, the government claim towards the former SFRY has not been divided among individual successor countries because the consensus on the allocation of debt and application of fixed ratios has not been reached. Currently, the total amount of claim, not officially divided between the Czech and Slovak Republics, is administered by the CSOB bank for both creditor countries. On the amount of principal, interest revenue is accrued as a capitalised interest.

On the debtor's side, the liability is recorded in the accounts of the National Bank of Serbia, a former national bank of the SFRY, since it was originated. As there is an uncertainty on the amount of individual debts, no interest is accrued. Although none of the successor countries

refuse the principle of the obligation related to interest; it is the calculation of interest that is questioned. This issue is subject to negotiation between parties.

2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

2.1 Applicable accounting rules

The following accounting guidance is relevant for this case:

- ESA 2010 paragraphs 20.225 on debt cancellation, 20.231 on debt revaluation, 20.233-20.236 on debt write-offs, write-downs and other debt restructuring
- MGDD chapters VII.2 on debt assumption and debt cancellation and VII.3 on debt rescheduling

2.2 Availability of national accounting analysis

Claim towards the Republic of Cuba

In their note, the Czech statistical authorities proposed two recording options, recalling that the Cuban authorities did not dispute the existence of the debt, but the valuation, in particular the conversion of XTR to CSK in 1990. The first option proposed the recording of revaluation, not impacting the deficit, as a result of the change of exchange rate. In the second option, a certain share of the claim would be recognised by the debtor and recorded as debt forgiveness in national accounts, impacting the deficit.

Claims towards the former SFRY

The Czech statistical authorities consider the issue as a renegotiation of the existing claim which would lead to the recording of the difference between the original and new amount of claim as a capital transfer, i.e. revenue or expenditure of the general government. As further stated in their note, the impact on the deficit should not exceed a change in the value of claim resulting from negotiations.

2.3 Eurostat's analysis

Claim towards the Republic of Cuba

The claim of the Czech Republic towards the Republic of Cuba is administered by the Banco Nacional de Cuba. The account balances are bilaterally and regularly agreed between both sides. According to the Czech authorities, the Cuban party recognises the existence of debt, however, there is a dispute on the valuation of the claim. The original claim was booked in a currency that no longer exists and currently, it is neither possible to set up any adequate exchange rate.

As the debtor still exists, Eurostat considers that the issue cannot be treated as a debt write-off: *"Debt write-offs are the reduction by a creditor in the balance sheet of the amount owed to it, usually when a creditor concludes that a debt obligation has little or no value, because the debt is not going to be paid; the debtor is bankrupt, has disappeared or cannot be realistically pursued for recoveries that would justify the various costs incurred. Debt write-*

downs refer to the reduction by a creditor in the carrying value of an asset in its balance sheet." (ESA 20.233).

The debt settlement is not a debt rescheduling either, as the terms and conditions to service the existing debt have not changed and they are not expected to be changed, according to the explanation of the Czech statistical authorities. ESA 20.236 says: "*Debt restructuring is an agreement to alter the terms and conditions for servicing an existing debt, usually on more favourable terms for the debtor. The debt instrument that is being restructured is considered to be extinguished and replaced by a new debt instrument with the new terms and conditions. If there is a difference in value between the extinguished debt instrument and the new debt instrument, it is a type of debt cancellation and a capital transfer is necessary to account for the difference.*"

Eurostat disagrees with the recording of the change of value of the claim in the revaluation account, as proposed by the Czech authorities in the first option. Nothing is to be recorded in the revaluation account upon renegotiation unless in "*In rarer cases where the discount negotiated with the third party or with a debtor offering the repurchase of its debt only reflects changes in market interest rates*" (ESA 20.231).

In several meetings of the *Task Force on Methodological Issues* and the *EDP Statistics Working Group*, Eurostat presented to other Member States the discussed issue and proposed some recording options to establish the valuation of the claim. Originally, claims were provided to Cuba as loans on investment projects that were supposed to be repaid in kind by way of a delivery of goods and services. Member States broadly supported the four recording options for valuations proposed by Eurostat and, notably, accepted to apply these options in a cascade (starting from Option 1 as the first considered one, etc.), implying that the value to be recorded in national accounts depends on which valuation is considered to be sufficiently established.

First, in the situation where the fair value of the claim at inception can be established (e.g. using the market value at inception of the goods/services to be delivered), the carrying value to be recorded in national accounts should reflect this fair value, and the stock of claims (AF.4) in national accounts is to be recalculated, and the accrued interest is to be corrected accordingly (Option 1). This option implies that, at the time of final settlement, the difference between the carrying value of the claim in national accounts at that time and the value of the settlement is recorded as debt forgiveness (D.9) with a negative impact on government net lending/borrowing (B.9) at that time.

Second, in the situation where it is deemed that the value of a claim was established on a credible basis by the creditor, i.e., by some authorities representing the creditor (e.g. the exchange rate set by Parliament), this existing carrying value in public accounts (book value) can be considered plausible and can be used to value the claim in national accounts (Option 2). The difference between the book value (which is also the carrying value in national accounts) and the value of settlement at the time of final settlement would be treated as debt forgiveness, similarly to the Option 1.

Third, comparable cases observed for other debtors/contracts within a similar framework may be used, if they were concluded at a date close to the contract under review, in order to approximate the fair value of the claim at inception. In such situation, the stock of claims (AF.4) in national accounts is to be recalculated, including the correction of accrued interest (Option 3). A possible difference between the carrying value in national accounts and the

value of settlement at the time of final settlement would be treated as debt forgiveness, similarly to the previous options.

Fourth, in the situation where the value of the claim cannot be established on a credible basis (Option 2) nor a plausible fair value at inception can be established (Options 1 and 3), the settlement value agreed between the creditor and debtor after renegotiation (that might also cover commodities/services other than those subject to the contract) can be considered a plausible carrying value to be recorded in national accounts (Option 4). Consequently, the stock of claims (AF.4) in national accounts is to be recalculated (to be back-casted), also adjusting for accrued interest not paid over the whole reporting period (1995-2017).

Whatever the valuation option taken, in no circumstance should there be an entry in the other economic flow, at time of settlement.

Claims towards the former SFRY

The claim towards the former SFRY is a case of dispute where a number of countries – debtors cannot reach an agreement on the division key for the amount of principal, after the original debtor country was split into several successors.

Unlike the previous case, the exchange rate was agreed between both parties (creditor and debtors) and the total amount of the debt was recognised by all successor countries in a specific agreement. It is the allocation key on the side of debtor countries which is under discussion, as an agreement could not be reached on whether the debt is to be partitioned, for instance according to the final recipient of funds in the past or according to a fixed ratio. In addition, the debtor countries contest the interest technical formula (i.e. capitalised versus non-capitalised interest).

From the description provided by the Czech authorities in their note, Eurostat considers that the settlement of the claim cannot be treated as a debt restructuring, as the terms and conditions to service the existing debt are not being changed, which is foreseen by ESA 20.236. Therefore, Eurostat is of the opinion that, in this particular situation, recording of the claim in national accounts is pending final individual agreements between the Czech government and debtor countries on the debt settlement.

Concerning the dispute on interest formula, Eurostat's view is that, as a matter of caution, the creditor should preferably not record the interest that it considers to receive, but the interest that the debtor already recognises due, pending their final agreement – unless serious reasons would support otherwise. This recording was broadly supported by the *Task Force on Methodological Issues* and the *EDP Statistics Working Group*.

Given the particular case of the claim towards the former SFRY, the interest revenue accrued in the Czech government accounts should preferably follow the calculation of non-capitalised interest recognised by the debtor(s). Accordingly, stock of government claims (AF.4) towards the former SFRY would be revised for the full time series, correcting the capitalised accrued interest, even prior the result of the renegotiation. After the final agreement on the interest technical formula is concluded following the negotiation, the value of the claim is to be recalculated backwards, correcting the interest accrued on the principal. This recording

implies no impact on the government net lending/borrowing (B.9) at the moment of final agreement, aside from the correction of interest, if any, nor any other change in volume in the claim.

3. CONCLUSION

On the basis of the above considerations, Eurostat considers that the recording of the claim towards the Republic of Cuba should follow one of the four recording options described in the analysis. The recording options are applied in a cascade and depend on the valuation that is considered well-established. The first three options imply debt forgiveness at the time of settlement – impacting the government deficit (B.9). According to the fourth option, the claim is recalculated backwards and no debt forgiveness is foreseen at the time of a final settlement. As a result, no 'other economic flow' (revaluations or 'other change in volume') should be occurring at time of settlement.

Concerning the claim towards the former SFRY, Eurostat's view is that the recording of the claim in national accounts is pending final individual agreements between the Czech government and debtor countries on the debt settlement. In the case of dispute on the interest formula, Eurostat considers that using the debtor's view is to be preferred, for prudential reasons. Therefore, the interest recognised by the debtor, i.e. non-capitalised interest instead of capitalised interest, should preferably be accrued on the principal in the government accounts, as a temporary recording pending the final agreement.

Eurostat notes that this advice received broad support from the *EDP Task Force on Methodological Issues* and the *EDP Statistics Working Group*.

4. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the Czech authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site.

Yours sincerely,

(e-Signed)

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