



EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

Luxembourg,
ESTAT/D-3/LN/JV/PL/eb/D(2014) 948118

Ms Aija Žīgure
President
Central Statistical Bureau of Latvia
Lāčplēša Street 1
Riga, LV - 1301
LATVIA

Subject: Statistical treatment of the contract between Riga City and Deutsche Bank AG

Dear Ms Žīgure,

Following the delivery of the copy of the contract and its amendments on 11.02.2014, I am now in a position to give you our preliminary view on the statistical recording of the contract between Riga City and Deutsche Bank AG.

The accounting issue

The issue concerns determination of the correct EDP accounting treatment of the contract between Riga City and Deutsche Bank AG signed on 20.06.2008 and its amendments.

Documentation provided

The CSB provided to Eurostat on 17.01.2014 a short description of the case and its treatment in government accounts of Latvia and on 11.02.2014 a copy of the contract between Riga City and Deutsche Bank AG signed on 20.06.2008 and its amendments signed on 16.01.2009 and 05.03.2010. The CSB also provided information on the recording of the liabilities relating to this contract in public accounts in the e-mail of 07.03.2014.

In an e-mail sent to the CSB on 21.02.2014 Eurostat requested information on the market value of the contract as of the signature date of the contract and the amendments, but this information was not available by the time of preparation of this letter.

Description of the case

On 20.06.2008 Riga City (the city) signed a contract (called “Interest Rate Swap”) with Deutsche Bank AG (the bank) where both parties make monthly payments to each other during the period of 20.06.2008 - 26.06.2028. According to the contract, the bank makes fixed monthly payments during the whole period. The city makes fixed monthly payments until 23.07.2013 and then monthly floating payments starting from this date. Therefore, the payments’ schedule can be divided into two distinct periods: the “fixed for fixed payments” period until July 2013 and “fixed for floating payments” period starting from July 2013.

The calculation formula of the variable payments as specified in the original contract signed on 20.06.2008 includes the following components:

- fixed components, including the notional amount,
- “FRB performance” and
- “Strike”.

The FRB performance is calculated based on the DB Forward Rate Bias (FRB) Index and the strike % increases gradually on a monthly basis from 23.07.2013 to 26.06.2018. The contract also specifies the maximum and the minimum amounts of the monthly variable payments made by the city.

The original contract has been amended twice. The first amendment agreed between the city and the bank on 16.01.2009 changed one calculation parameter for the variable payments. The second amendment agreed on 05.03.2010 replaced the DB FRB Index with the DB Pulse Basket Index.

Methodological analysis and clarification by Eurostat

After an examination of the provided documentation, Eurostat has reached the following provisional views.

Applicable accounting rules

The sections “Financial derivatives” and “Loans” of ESA95 chapter 5 and chapters II.4 “Recording of interest” and VIII.5 “Off-market swaps” of the Eurostat ESA95 Manual on government deficit and debt (MGDD) are relevant in this case. The equivalent rules in ESA10 are the same.

Availability of national accounting analysis

The short description provided by the CSB on 17.01.2014 presents the main features of the contract and the EDP recording. According to the description, the working balance and, in turn, also the deficit of local government (EDP table 2B) is impacted by the amounts paid by the city and the bank: currently the impact is simply the net effect of these payments. During the period from 23.06.2008 to 23.06.2013 the city received from the bank 46.8 MEUR in total.

In addition, according to the CSB’s e-mail of 07.03.2014, the liabilities resulting from the contract, which are recorded under "other non-current creditors" in the public accounts, are recorded as accrued interest under AF.4L in the ESA95 financial accounts and is not included in the Maastricht debt.

Analysis

Eurostat carefully analysed the information and the copy of the contract provided by the CSB. In Eurostat’s view, this contract does not resemble the usual interest rate swap contracts used for hedging purposes. It seems that as a result of this very specific contract, the city effectively received a progressive loan from the bank in the first period until July 2013 and is effectively making repayments starting from July 2013 until the end of the contract in 2028.

Consequently, the recording of a loan from the bank should lead to recording of an AF.4 liability and related accrued interest (D.41) in the local government accounts of Latvia.

In the absence of additional information (e.g. on market value of the contract) Eurostat tentatively tried to calculate the stocks and flows of F.4 and D.41 (the latter would replace the

currently recorded D.41 flows). Eurostat proposes to consider separately the first period (from June 2008 until July 2013) and the second period (from July 2013 until June 2028), please see the annex. Eurostat would like to stress that in the proposed calculation model the market value of the swap at inception of any period has no influence on the treatment. In the proposed model, the market value is not relevant for the first period and has no influence as regards the loan.

According to the proposed model, the loan stock (AF.4) relevant for the Maastricht Debt increases gradually over the first period reaching 46.8 MEUR in July 2013 and then is recorded as being repaid in 15 equal instalments over the second period through the net payments under the swap contract starting from July 2013 onwards. The accrued interest (matched by AF.4 entries in the financial accounts) is calculated for the first period according to the “grace period” recording rules of the MGDD (interest payments are just postponed to the second period, so that interest must be accrued) and is considered as being reinvested under the asset, increasing the principal amount of the loan.

The basis of the applied rate of interest for the first period is an approximate average of Latvian government bonds interest rate over 2008 – 2013 (5%). A single fixed rate has been used over this period for simplicity, instead of different rates to specific “tranches” of the loan. The Latvian government bonds interest rate observed in July 2013 has been used for the second period (3.2%). The remaining net amounts, after deduction of the amortisation of the loan and the corresponding interest, paid by the city starting from July 2013 should be recorded as financial transactions under financial derivatives (AF.34) and as revaluation the change of the value of the derivative after deductions. As the cash flows are made on a monthly basis, Eurostat considers that there is no need to calculate an adjustment between interest accrued and interest paid.

Eurostat has carried out a calculation by semester (which can be allocated proportionately for the quarterly accounts) and invites the CSB to introduce the result of the calculation, if agreed, in the April 2014 EDP notification.

Conclusion

On the basis of the above considerations, Eurostat concludes that under this contract the city effectively received a loan from the bank in the first period until July 2013 then effectively makes repayments starting from July 2013, which should lead to recording of loan liability and relating accrual of interest in the local government accounts of Latvia. In the absence of additional information and given the time constraints (April 2014 EDP notification is approaching), Eurostat proposes a tentative calculation of stocks and flows of F.4 and D.41 to be reviewed by the CSB and to be introduced in the April 2014 EDP notification.

Procedure

Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it is in possession of all of the necessary background information. The preliminary view is given in accordance with the guidelines for ex-ante advice published on the Eurostat web-site.

This preliminary view of Eurostat is based on the information provided by the country 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.

In this context, 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, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat intends, therefore, to publish all future official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than **31 March 2014**.

Yours sincerely,

(eSigned)
Laurs Norlund
Director

Annex

1st period: loan increase (fixed-fixed swap)

Date	Year	Outstanding amount of debt	Semester interest rate	Accrued interest for semester starting with 1 July/1 Jan
01-Jul	2008	450000	2.5	11250
01-Jan	2009	900000	2.5	22500
01-Jul	2009	1800000	2.5	45000
01-Jan	2010	2700000	2.5	67500
01-Jul	2010	3600000	2.5	90000
01-Jan	2011	10800000	2.5	270000
01-Jul	2011	18000000	2.5	450000
01-Jan	2012	25200000	2.5	630000
01-Jul	2012	32400000	2.5	810000
01-Jan	2013	39600000	2.5	990000
01-Jul	2013	46800000	-	-

2nd period: loan redemption (fixed-floating swap)

Date	Year	Outstanding amount of debt	Semester interest rate	Accrued interest for semester starting with 1 July/1 Jan	Amortization of loan	Amounts to be deducted from the flows under the swap
01-Jul	2013	46800000	1.6	748800	1560000	2308800
01-Jan	2014	45240000	1.6	723840	1560000	2283840
01-Jul	2014	43680000	1.6	698880	1560000	2258880
01-Jan	2015	42120000	1.6	673920	1560000	2233920
01-Jul	2015	40560000	1.6	648960	1560000	2208960
01-Jan	2016	39000000	1.6	624000	1560000	2184000
01-Jul	2016	37440000	1.6	599040	1560000	2159040
01-Jan	2017	35880000	1.6	574080	1560000	2134080
01-Jul	2017	34320000	1.6	549120	1560000	2109120
01-Jan	2018	32760000	1.6	524160	1560000	2084160
01-Jul	2018	31200000	1.6	499200	1560000	2059200
01-Jan	2019	29640000	1.6	474240	1560000	2034240
01-Jul	2019	28080000	1.6	449280	1560000	2009280
01-Jan	2020	26520000	1.6	424320	1560000	1984320
01-Jul	2020	24960000	1.6	399360	1560000	1959360
01-Jan	2021	23400000	1.6	374400	1560000	1934400
01-Jul	2021	21840000	1.6	349440	1560000	1909440
01-Jan	2022	20280000	1.6	324480	1560000	1884480
01-Jul	2022	18720000	1.6	299520	1560000	1859520
01-Jan	2023	17160000	1.6	274560	1560000	1834560
01-Jul	2023	15600000	1.6	249600	1560000	1809600
01-Jan	2024	14040000	1.6	224640	1560000	1784640
01-Jul	2024	12480000	1.6	199680	1560000	1759680
01-Jan	2025	10920000	1.6	174720	1560000	1734720
01-Jul	2025	9360000	1.6	149760	1560000	1709760
01-Jan	2026	7800000	1.6	124800	1560000	1684800
01-Jul	2026	6240000	1.6	99840	1560000	1659840
01-Jan	2027	4680000	1.6	74880	1560000	1634880
01-Jul	2027	3120000	1.6	49920	1560000	1609920
01-Jan	2028	1560000	1.6	24960	1560000	1584960
01-Jul	2028	0	1.6	0	0	0