

Directorate C: National and European Accounts

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Ms Aija Žīgure
President
Central Statistical Bureau of Latvia
Lāčplēša Street 1
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LATVIA

Subject: Methodological treatment of foreign exchange derivatives linked to the EDP debt

Ref.: Your e-mail "Impact of financial derivatives on the EDP debt" dated 24/05/2011

Dear Ms Žīgure,

In reply to the request for advice on the impact of financial derivatives on the valuation of Maastricht debt, I am in a position to inform you of Eurostat's provisional views.

The accounting issue for which a clarification is requested

The Latvian authorities asked for further clarification on the application of debt valuation rules as foreseen in Article 1 of the Regulation 479/2009, as amended.

Description of the case

The Latvian authorities informed Eurostat about their investigation of the possible impact of derivatives on the valuation of debt liabilities denominated in foreign currency. The Central Statistical Bureau of Latvia (CSB) has concluded that the Latvian government financial derivatives with possible impact on the value of foreign debt could be classified into 4 groups:

- 1) Currency swaps linked to actual underlying instruments with maturity equal or shorter than the maturity of the underlying debt instrument;
- 2) Currency swaps linked to a part of the debt portfolio, broadly referring to existing liabilities, but each swap is not exactly linked to one but to several underlying instruments, the term and amount of the swap can also differ from the totals of the indicators of the above mentioned several underlying instruments;
- 3) FX forwards and sequences of FX forwards linked to actual underlying instruments with maturity equal or shorter than the maturity of the underlying debt instrument(s);
- 4) FX forwards and sequences of regular short term FX forwards agreements linked to the part of debt portfolio, broadly referring to existing liabilities, but each FX forward is not exactly linked to one but to several underlying instruments, the term and amount of the FX forwards can also differ from the totals of the indicators of the above-mentioned underlying instruments.

The CSB assumes that cases (1) and (2) correspond to the 2010 edition of Manual of Government Deficit and Debt (MGDD) VIII.3.2 §5 "*These conversion rules only concern currency swaps based on existing liabilities, i.e. swaps "against the book" linked to actual underlying debt instruments*" and therefore the corresponding valuation adjustments should be included in the stock of the EDP debt. The CSB also noted that it seems being in line with MGDD VIII.3.2 §8 "*It is important to take note that, as long as the currency swap is based on an existing debt instrument /.../*".

The CSB sought Eurostat advice on the methodological treatment of foreign exchange derivatives linked to the EDP debt:

- 1) How large can be the "book" of debt instruments and what is the definition of the "book" of debt instruments?
- 2) Are there some rules regarding currency swaps linked to actual underlying instruments with maturity exceeding the reporting period but essentially shorter than the maturity of the underlying long term debt instrument?
- 3) Are there cases when FX forwards and sequences of FX forwards linked to actual underlying instruments with maturity equal or shorter than the maturity of the underlying debt instrument have an impact on the EDP debt?
- 4) In Latvian case the State Debt management strategy, approved by the Minister of Finance, determines strong criteria for financial risk management, ensuring that if not longer term then at least sequential financial derivative agreements, including currency swaps and sequential FX forwards, cover the whole maturity of the underlying debt instruments (groups of debt instruments as part of debt portfolio). Does application of sequential financial derivatives as opposed to longer term financial derivatives that cover all maturity of an underlying instrument in Latvian case make any difference from EDP debt statistical valuation viewpoint?

Methodological analysis and clarification by Eurostat

After an examination of the information provided by the Latvian authorities, Eurostat has reached the following provisional views.

Applicable accounting rules

Article 1, point 5 of the Regulation 479/2009, as amended, and MGDD VIII.3 Currency swaps (and, depending on the situation, MGDD VIII.5 "Off-market" swaps).

Analysis

The Article 1, point 5 of Council Regulation 479/2009, as amended, sets rules on how to value liabilities that are denominated in one currency and then, via derivative contracts, are exchanged into another currency.

The wording of the regulation does not provide any specific detail on what type of derivative contracts are to be considered. It implies that the rules are applicable only for hedging derivatives, but the regulation does not specify further on the links between derivatives and the underlying instruments.

These aspects were clarified within MGDD VIII.3 Currency swaps, where §3 says explicitly "*as far as the debt stock measurement is concerned, for the EDP purpose, all the three types of contracts (i.e. foreign exchange swaps, forward foreign exchange contracts and currency swaps) are subject to the 479/2009 Regulation provisions...*"

The MGDD VIII.3.2 §5 specifies that *"these conversion rules only concern currency swaps based on existing liabilities, i.e. swaps "against the book" linked to actual underlying debt instruments."*

In this MGDD paragraph the term "book" (of debt instruments) is used to describe a situation when a swap is hedging not a single debt instrument (e.g. specific government bond), but a group of debt instruments. Naturally there is no limit on the size of the "book", though debt instruments within a "book" should be in the same currency.

The VIII.3.2 §8 foresees that once the condition that derivative should be based on an existing debt instruments is met, there could be cases where *"a derivative contract may have any maturity within issuance and maturity of the underlying debt instrument"*. Therefore it can be concluded that there are no specific, different rules when there is a case that instruments have maturity shorter than the maturity of the underlying long term debt instrument. Clearly, at the end of the derivative contract, the remaining debt in foreign currency would revert to conversion at market exchange rates. It is also important to underline that if the derivative contract covers only a part of an instrument then the conversion rules specified in Council Regulation 479/2009 and MGDD VIII.3.2 apply only to that part of the instrument.

The question raised by the Latvian authorities on the cases of sequences of FX forwards would require further analysis, as there is insufficient information currently available.

At this stage (at least) three possible ways in which sequences are built could be foreseen:

- a) An existing derivative contract is amended and this leads to a change in future cash flows. Each amendment should be considered as if a new contract has been created to replace the old one, whereas the old one is considered cancelled. Such case should give rise to close examination, by reference to Eurostat rules on swap cancellations and off-market swaps (described in MGDD VIII.4 and VIII.5);
- b) There is a sequence of derivative contracts agreed in advance with different exchange rates specified in the contracts. Also these cases could imply existence of off-market elements of the swaps (see the rules described in MGDD VIII.5);
- c) There is a sequence of derivative contracts agreed in advance with the same exchange rate specified in the contracts. There is no further impact on the Maastricht debt, provided that the rate of exchange is effectively the spot market rate observed at the time of the signature of the contract.

Eurostat believes that these calculations should be made using a detailed instrument by instrument database. However, it is for the Member State to decide on how responsibilities would be shared between the national authorities. At a minimum, the NSI should be able to verify the method used and it should also have access on request to the detailed data on the derivatives and the underlying instruments.

Procedure

This preliminary view of Eurostat is based on the available information on the methodological treatment of foreign exchange derivatives linked to the EDP debt in Latvia. If this information turns out to be incomplete, 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 the amended Council Regulation 479/2009. Eurostat intends, therefore, to publish all 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 18 July 2011.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'FL', written over a diagonal line that extends from the bottom left towards the top right.

François Lequiller
Director