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Directorate C: National and European Accounts

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**Subject: Methodological treatment of the recording of financial flows connected to short-term interest rate options by Belgium**

**Ref.: Your letter T/C2/2007/000959 dated 19 January 2007**

Dear Mr Verjus,

Following your letter of 19 January 2007, I am in a position to reply to the question you asked on the appropriate statistical classification for the case you have presented.

***The accounting issue for which a clarification is requested***

The issue for which an opinion is being sought is a determination of the correct EDP accounting treatment of financial flows connected to short-term interest rate options called "caps", "floors" and "collars".

The Belgian government intends to use short-term interest rate options for the purpose of its debt management. An example of an interest rate option is provided, whereby the Belgian government buys, say, for 5 million euro a cap option with a strike price of 4% interest rate on a 100 million euro notional value. This option protects the Belgian government from the financial cost of market interest rates higher than 4%.

In particular, in the context of previously concluded 5-year interest rate swap with a fixed interest rate of 4%, the above mentioned "cap" option would mean the following:

- If the floating interest rate of the swap is determined to be higher than 4%, the Belgian government would exercise the option, receiving at time of option maturity the difference between the floating interest rate thus determined and 4%,
- If the floating rate of the swap is determined to be lower than 4%, the Belgian government would not realise the option and will not receive any financial flow from the option.

It is recalled that whereas EDP must follow identical accounting principles to ESA95, and data reported must align, there is an exception for "*streams of interest payments resulting from swaps arrangements and forward rate agreements*", which are considered financial transactions in ESA95 but non-financial transactions under EDP.

### ***Methodological analysis by Eurostat***

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

The accounting treatment of certain derivative instruments, i.e. swaps and forward rate agreements (FRAs) is covered by the Regulation (EC) 2558/2001, amending the Regulation (EC) 2223/96.

The ESA95 paragraph 4.47 (as amended) states that: "*No payment resulting from any kind of swap arrangement is to be considered as interest and recorded under property income. (See paragraphs 5.67(d) and 5.139(c) relative to financial derivatives). Similarly, transactions under forward rate agreements are not to be recorded as property income. (See paragraph 5.67(e))*".

Nevertheless, on the basis of the above-mentioned Regulation 2558/2001, for the purposes of the Excessive Deficit Procedure reporting, the net borrowing / net lending of general government (EDP B.9) includes "*streams of interest payments resulting from swaps arrangements and forward rate agreements*". The Regulation (EC) 2558/2001 gives, however, no direct guidance on the accounting treatment of payments from option contracts.

According to ESA95 paragraph 5.67 (a) both tradable and off-market options are included in the sub-category financial derivatives (AF.34): "*(...) options, tradable and over-the-counter (OTC). Options are contingent assets which give their holders the right, but not the obligation, to purchase from (in the case of a call option) or to sell to (in the case of a put option) the issuer of the option (the option writer) financial or non-financial assets (the underlying instrument) at a predetermined price (the strike price) within a given time span (American option) or on a given date (European option). The purchaser of the option pays a premium (the option price) for the commitment of the option writer to sell or to purchase the specified amount of the underlying asset or to provide, on demand of the purchaser, appropriate remuneration. By convention, that commitment is treated as a liability of the option writer because the option price represents the current cost to the option writer of buying out his contingent liability*".

Derivatives such as swaps and FRAs are considered in the ESA95 system as assets only if they are subject to market valuation. ESA95 paragraph 5.67 includes in the sub-category financial derivatives (AF.34) only tradable swaps and FRAs: "*(d) swaps, but only if they have a market value because they are tradable or can be offset. (...); (e) forward rate agreements (FRAs), but only if they have a market value because they are tradable or can be offset. (...)*".

There can be a doubt whether there was an intention of the legislator to include within the EDP B.9 the payments resulting from option contracts: premium or deliveries/settlements. In contrast to forwards and futures, the contractual features of options can be negotiated freely between two interested parties. Consequently, the strike price can be set at arbitrarily low (or high) level with an impact on the premium to pay and an ability to achieve potentially large amounts of settlement payments. It would seem that such flows should generally not be allowed to be reported as non-financial transactions.

In addition, in this context, it should be noted that the time of recording as interest of the premium on such short-term interest rate options (as well as that of settlements) would also be questionable.

### ***Conclusion***

On the basis of the above considerations, Eurostat cannot agree at this time to extend the exception foreseen for EDP purpose to deviate from ESA95, for "*streams of interest payments*

*resulting from swaps arrangements and forward rate agreements",* and thus cannot agree for the purposes of the EDP reporting to record the financial flows (premium and settlements) on short-term option contracts as property income (interest).

However, Eurostat is considering bringing to the attention of the FAWP the whole issue of the recording of financial derivatives, and the more specific rule applicable for determining the *"streams of interest payments resulting from swaps arrangements and forward rate agreements"*.

### ***Procedure***

There is no explicit Community legislation which governs a procedure by which Eurostat gives its views on operations which have not yet been enforced. Nevertheless, 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 Belgian 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. To this end Eurostat would request to be informed of the final details of the operation (contract and accompanying papers where relevant) when they are available, or (should this be the case) information that the planned operation has been abandoned.

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 3605/93 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 16 March 2007.

Yours sincerely,



Låurs Nørland  
Director