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Directorate C: National and European Accounts

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Mr Carlos Coimbra
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Subject: Treatment of lump sums paid on early termination of interest rate swaps

Ref.: Your letter of 24 July 2008

Dear Mr Coimbra,

In reply to your request for advice on the recording of a lump sum paid at cancellation of an interest rate swap, I am in a position to inform you of Eurostat's preliminary observations.

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 the lump sum paid on early termination of an interest rate swap (IRS).

Documentation provided

INE, in its letter dated 24 July 2008, described the case of a bond hedged by an IRS, and provided an example illustrating the current recording of interest on a bond, as well as the recording of interest flows on IRS and a lump sum paid at cancellation. For the latter INE identified two possible recording alternatives (table covering 2004-2008).

Description of the case

Following the information provided, a 4 year bond having a nominal value of 1000 is issued on 10/7/2004 (coupon payment date) with a coupon of 10%. At issuance this bond is hedged by an IRS, where government is receiving a fixed 7.5% rate and paying a floating rate. The amounts corresponding to the fixed and the floating legs are paid on a net basis on the aforementioned coupon payment date. The IRS is cancelled on 7/7/2006, just before the coupon payment date. The provided example suggests that under the current Portuguese practice, lump sums received at cancellation of an IRS partially are treated as revenue/expenditure (thus impact EDP B.9) at time of cancellation. INE intends to apply the Eurostat guidance and to correct this recording in a way that the lump sum will be spread over the theoretical life of a swap.

The question asked by INE is the determination of the exact composition of the amounts to be spread: the lump sum exchanged (being a sum of the discounted expected net flows), or the amount exchanged netted for the amounts of interest payment accrued to date between the last payment date and the cancellation date.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swaps arrangements and under forward rate agreements.

See also Eurostat's guidance note "*Eurostat Guidance note on Financial derivatives*", dated 13 March 2008.

Availability of national accounting analysis

In its letter INE describes the issue and provides a numerical example on the current practice and the proposed two recording alternatives.

Analysis

Firstly, we note that in the provided numerical example, government paid 10% coupon on the issued bond and received 7.5% on the fixed swap leg, while paying a considerably high interest of 12% or 13% on the floating leg. One would expect a considerable lower floating rate for the years 2007 and 2008, unless the IRS was in fact an off-market swap.

The Eurostat guidance on financial derivatives, *paragraph 30,* reads: "*A lump sum on swaps cancellation corresponds to the present value of expected stream of interest payments (in future), as measured at time of cancellation.*" and paragraph 31: "*In concept this same lump sum can analytically also be split into two parts: an element of prepayments made and an element of holding gains/loss*"

In a swap operation, cash payments in the past have counterpart cash payments in the future. Thus this cash flow expected in the future could analytically be split into these components: cash payments in the past (including interest accrued on those), genuine holding gains/loss (from the economic point of view) and interest accrued between the last payment date and the cancellation date.

It seems that in the example provided by the INE, item 8 is in fact the lump sum exchanged at time of cancellation, while item 9 reflects the past cash payments and holding gain/loss (from the economic point of view).

The Eurostat guidance on financial derivatives, paragraph 50, reads: "*Lump sums paid or received by government on swap cancellations do not enter the EDP correction at time of cancellation, and are thus without impact on the government deficit/surplus at that time, but enter the EDP correction spread over the remaining theoretical life of the swap, with an impact on the government deficit/surplus, for all swaps and for the whole amount of the lump sum (discounted value of expected streams of payments).*"

The question is whether the amount to be spread should include the accrued interest payment between the last payment date and the cancellation date. In fact this amount could be considered as a part of *"stream of interest payments"* and upon cancellation, this accrued amount could be deemed to be settled. In that manner, interest accrued between the last payment date and the cancellation date, would enter EDP correction line at once, instead of being spread as for the rest of the lump sum. This approach would be closer to the accrual perspective. Also, this approach would seem more appropriate, as the accounting impact would not depend on when the swap was cancelled (just after the payment date or just before the next payment date).

Conclusion

On the basis of the above considerations, Eurostat agrees with the scenario 2 proposed by the Portuguese statistical authorities. That is the interest accrued between the last payment day and the swap cancellation date could be deemed to be paid and recorded as D.41 at time of cancellation with the impact on the EDP B.9. The interest is excluded from the lump sum and the lump sum *"enter the EDP correction spread over the remaining theoretical life of the swap, with an impact on the government deficit/surplus".*

Procedure

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 25 August 2008.

Yours sincerely,

Helena Figueira

Maria-Helena Figueira
Acting Director