COMMISSION OF THE EUROPEAN COMMUNITIES

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2000/0019 (COD)

Proposal for a

EUROPEAN PARLIAMENT AND COUNCIL REGULATION

amending Council Regulation (EC) No 2223/96 on the reclassification of settlements under swaps arrangements and under forward rate agreements

(presented by the Commission)

EXPLANATORY MEMORANDUM

According to present ESA 95, all flows of interest under swaps arrangements (and FRAs) are to be considered as interest included in the property income, following provisions in paragraph 4.47. Originally, SNA 1993 and BOP 5th Manual stated a similar treatment.

The main ground for this classification was the "cost of capital principle". It means that it is necessary to consider both the interest flows exchanged under a swap contract and the interest paid/received on the underlying instrument, in order to get a "fair" measure of the exact cost of capital for a borrower. Debt managers usually consider that such settlements are to be recorded in this way. In addition, the basic definition of interest, as in SEC 95 4.42 ("the amount that the debtor becomes liable to pay to the creditor over a given period of time without reducing the amount of principal outstanding"), could be applied to interest flows under swap contracts. In the case of swaps or FRAs, the outstanding amount is notional but it is really used for calculating the amounts of interest effectively exchanged between two parties.

However, from the beginning, as for national accounts compilers as for BOP compilers, the original treatment was considered as raising some conceptual problems.

– Thus, as a result there is an income flow but without provision of funds, in the case of interest rates swaps or FRAs. It was argued that there was a contradiction with the definition of interest as "the income receivable by the owner of a financial asset...in return for providing funds".

– Moreover, presently on the markets, only a very minor part of these swaps are linked to a debt operation; for a part, they are purely instruments of speculation; they also may be included in a broader strategy of risk management or be used in the framework of other financial derivatives operations. In addition, when markets are developed, large fluctuations in interest flows (notably between residents and non-residents) could be observed. It would be difficult to interpret them properly.

– It was also stressed that the argument concerning the cost of capital should be applied to other costs, and not only for interest. For instance, commodity futures may allow reducing the purchasing price paid by a buyer.

– Finally, it was pointed out a redundancy in matter of derivatives. Several instruments can help to manage interest risk and a comprehensive approach of all financial derivatives seems more consistent.

It is the reason why changing the classification of interest flows under swap contracts and FRAs from income property to financial account was proposed. Net settlements of interest are considered as transactions in financial derivatives, included in the financial accounts. Although there is in this case real funding, it was also proposed for consistency reasons that interest flows under cross-currency swaps (with an exchange of principal in two different currencies) be classified as financial account transactions.

This proposal was first accepted in the framework of BOP statistics, then discussed in the context of SNA. During a meeting in Luxembourg, in October 1997, of the Inter-secretariat working group on national accounts (ISWGNA) Eurostat approved the change.

This position was supported by a majority of members of NAWP and FAWP. This reclassification was on the agenda of three joint meetings, held in October 1997, April 1998 and July 1998. It was approved by CMFB and SPC in 1999.

This reclassification in ESA95 will keep a full consistency between international standards, SNC93, Balance of Payments Manual, ESA95. Such consistency must be assumed both for compilation purpose (BOP is a main source for national accounts) and for the needs of users of data.

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amending Council Regulation (EC) No 2223/96 on the reclassification of settlements under swaps arrangements and under forward rate agreements

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 285 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Central Bank,

Acting in accordance with the procedure laid down in Article 251 of the Treaty,

Whereas:

(1) Council Regulation (EC) No 2223/96 of 25 June 1996 on the European System of National and Regional Accounts in the Community[1] contains the reference framework of common standards, definitions, classifications and accounting rules for drawing up the accounts of the Member States for the statistical requirements of the European Community, in order to obtain comparable results between Member States;

(2) In ESA 95, as in SNA 93, swaps are defined (5.67) as "contractual arrangements between two parties who agree to exchange, over time and according predetermined rules, streams of payments on the same amounts if indebtedness", being specified that "the two most prevalent varieties are interest swaps and currency swaps";

(3) In original versions of ESA 95 and of SNA, interest flows exchanged between two counterparts under any kinds of swaps and under forward rate agreements have been considered as non-financial transactions, recorded in property income, under the item interest;

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[1] OJ L 310, 30. 1. 1996, p. 1

(4) Problems raised by this statement are such that the Commission considers it necessary excluding these interest flows from property income, similarly to revised SNA 93;

(5) It is thus appropriate recording these flows in financial transactions under the item financial derivatives, included in ESA 95 in F3 "Securities other than shares";

(6) The Committee on the statistical programmes of the European Communities, established by Decision 89/382/EEC, Euratom[2], and the Committee on Monetary, Financial and Balance of Payments Statistics, established by Decision 91/115/EEC[3], have been respectively consulted in accordance with Article 3 of each of the aforesaid Decisions,

HAVE ADOPTED THIS REGULATION:

Article 1

Annex A of Council Regulation (EC) No 2223/96 is modified in accordance with Annex of present regulation.

Article 2

This regulation shall enter into force on the day of its publication in the *Official Journal of the European Communities.*

This Regulation shall be binding in its entirety and directly applicable to all Member States.

Done at Brussels,

For the European Parliament	*For the Council*
The President	*The President*

[2] OJ L 181, 28. 6. 1989, p.47.
[3] OJ L 59, 6. 3. 1991, p. 19. Decision as amended by decision 96/174/EC (OJ L 51, 1. 3. 1996, p. 48).

ANNEX

Annex A of Council Regulation (EC) No 2223/96 shall be amended as follows:

1. In Chapter 4, paragraph 4.47. shall be replaced by the following:

"4.47. 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))."

1. In Chapter 5:

a) paragraph 5.67. (d) and (e) shall be replaced by the following:

" (d) swaps, but only if they have a market value because they are tradable or can be offset. Swaps are contractual arrangements between two parties who agree to exchange, over time and according to predetermined rules, streams of payment of the same amount of indebtedness. The most prevalent varieties are interest rate swaps, foreign exchange swaps and currency swaps (also named cross-currency interest swaps). Interest rate swaps involve an exchange of interest payments of different character, such as fixed rate for floating rate, two different floating rates, fixed rate in one currency and floating rate in another, etc. Foreign exchange swaps (including all forward contracts) are transactions in foreign currencies at a rate of exchange_stated in advance. Currency swaps involve an exchange of specified amounts of two different currencies with subsequent repayment flows, over time according to predetermined rules. None of the resulting payments is considered as property income in the system and all settlements are to be recorded in the financial account;

(e) forward rate agreements (FRAs), but only if they have a market value because they are tradable or can be offset. FRAs are contractual arrangements in which two parties, in order to protect themselves against interest rate changes, agree on an interest to be paid, at a settlement date, based on a notional amount of principal that is never exchanged. The payments are related to the difference between the agreement rate and the prevailing market rate at the time of settlement. These payments are not considered as property income in the system but are to be recorded under the item financial derivatives."

b) paragraph 5.139. (c) and (d) shall be replaced by the following:

" (c) any explicit commissions paid or received from brokers or intermediaries for arranging options, futures, swaps, and other derivatives contracts are treated as payments for services in the appropriate accounts. The parties to a swap are not considered to be providing a service to each other, but any payment to a third party for arranging the swap should be treated as payment for a service. Under a swap arrangement, where principal amounts are exchanged the corresponding flows are to be recorded as transactions in the underlying instrument; streams of other payments (excluding commissions) are to be recorded under the item financial derivatives_(F34). While the premium paid to the seller of an option can conceptually be considered to include a service charge, in practice it is usually not possible to distinguish the service element. Therefore, the full price is to be recorded as acquisition of a financial asset by the buyer and as incidence of a liability by the seller;

(d) where swap contracts involve an exchange of principal amounts, for example as occurs with currency swaps, the initial exchange is to be recorded as a transaction in the underlying instrument exchanged and not a transaction in financial derivatives (F.34). Where contracts do not involve an exchange of principal, no transaction is recorded at inception. In both cases, implicitly, a financial derivative with zero initial value is created at that point. Subsequently, the value of a swap will be equal to:

1. for principal amounts, the current market value of the difference between the expected future market values of the amounts to be re-exchanged and the amounts specified in the contract;

2. for other payments, the current market value of the future streams specified in the contract.

Changes in the value of the derivative over time should be recorded in the revaluation account.

Subsequent re-exchanges of principal will be governed by the terms and conditions of the swap contract and may imply financial assets being exchanged at a price different from the prevailing market price of such assets. The counterpart payment between the parties to the swap contract will be that specified within the contract. The difference between the market price and the contract price is then equal to the liquidation value of the asset/liability as it applies on the due date and should be recorded as a transaction in financial derivatives (F.34). On the contrary, other flows under a swap arrangement are recorded as a transaction in financial derivatives for the amounts effectively_exchanged. All transactions in financial derivatives must match the total revaluation gain or loss throughout the duration of the swap contract. This treatment is analogous to that set out with respect to options, which proceed to delivery (see (a) above).

For an institutional unit, a swap or a forward rate agreement is recorded under the item financial derivatives on the assets side where it has a net asset value, positive net payments increasing the net value (and conversely). Where the swap has a net liability value, it is recorded on the liabilities side, negative net payments increasing the net value (and conversely)."