INTEREST RATE SWAP

Interest rate swaps: An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.

Amortising interest rate swaps: An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

An interest rate swap is likely to be an effective: hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item.

Whether an interest rate swap is a derivative financial instrument

A) Net or Gross settlement: The definition of a derivative does not depend on gross or net settlement.

Example: Entity S enters into an interest rate swap with a counterparty (C) that requires S to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a Rs. 100 million notional amount. S and C do not exchange the notional amount. S pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative

a. its value changes in response to changes in an underlying variable (LIBOR),
b. there is no initial net investment, and
c. settlements occur at future dates.

B) Fixed rate payment obligation prepaid at inception or subsequently:

Example: Entity S enters into a Rs. 100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of Rs. 50 million (Rs. 100 million X 10 per cent X 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the Rs. 100 million reset quarterly based on three-month LIBOR over the life of the swap.

The contract meets the definition of a derivative

a. its value changes in response to changes in an underlying variable (LIBOR),
b. there is significantly less initial net investment, and
c. Settlements occur at future dates.

if the fixed rate payment obligation is prepaid subsequent to initial recognition that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under AS 30.

C) Prepaid variable obligation at inception or subsequently:

Example: Entity S enters into a Rs. 100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, i.e., Rs. 10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on Rs. 100 million per year.

The contract does not meet the definition of a derivative as the cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive Rs. 10 million per year over the life of the swap.

For this reason, the instrument fails the "no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors" criterion of AS 30.