Was it Debt Swap or Collateralised Foreign Currency Loan? Substance over Legal Form Considerations

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Abstract

This is a transaction analysis in which deposit placement by PTA Bank in Malawi was classified as debt swap instead of a medium term loan. There was violation of substance over legal form principle and the study recommends that proper disclosures be made to rectify probable material misstatement of the financial statements.

Type of Paper: Transaction Analysis

Key words: Currency; Swap; FCY; Loan, Debt, Malawi

1.0 Introduction

This paper strives to evaluate the substance over legal form of the Swaps transactions undertaken by Reserve Bank of Malawi as declared in the publicly available documents as emanated from Financial Stability Report (2015:4) which stated:

[Appreciation of the Kwacha was partly aided by issuance of three directives by the RBM and the swap debt facility with Preferential Trade Area Bank, (PTA), Box 1.1.].

Financial Stability Report (2015) further disclosed:

[a) PTA Bank Investment into a 3 year Treasury Note
The PTA Bank invested K122.3 billion into a 3 year Treasury Note issued by the Malawi Government in the fourth quarter of 2014. By investing in the Treasury Note, the PTA Bank had to find Kwachas by selling its US dollars to ADBs in Malawi. Eventually, RBM managed to buy these dollars from the ADBs.].

World Bank (2022:30) annotated:

[The RBM has supported Malawi kwacha stability through substantial foreign exchange swaps (both new and rollovers) and medium-term borrowing facilities (Figure 1.21) to maintain the reversion to a "stabilized" exchange rate regime, despite a de jure "floating" arrangement (IMF, 2020). While reserves have also been affected by poor export performance and the rising costs of imports, relinquishing some control of the exchange rate has the potential to support the build-up of official reserves].

2.0 Definition and accounting of currency swaps

ACCA Global (2022) provides a synopsis of currency swaps as follows:

[A currency swap is an agreement in which two parties exchange the principal amount of a loan and the interest in one currency for the principal and interest in another currency. At the inception of the swap, the equivalent principal amounts are exchanged at the spot rate.

During the length of the swap each party pays the interest on the swapped principal loan amount. At the end of the swap the principal amounts are swapped back at either the prevailing spot rate, or at a pre-agreed rate such as the rate of the original exchange of principals. Using the original rate would remove transaction risk on the swap.

Currency swaps are used to obtain foreign currency loans at a better interest rate than a company could obtain by borrowing directly in a foreign market or as a method of hedging transaction risk on foreign currency loans which it has already taken out.].

3.0 Analysis of foreign currency swap transactions

Foreign currency swaps are part of the derivatives – Wang and Lin (2020). Derivatives are financial instruments with all the following aspects: there is no initial or just modesty capital outlay; the underlined value of the financial instrument changes in respect to changes in macroeconomic factors such as interest rate, exchange rate, inflation etc; and last, they are settled at a later date – Ramin and Reiman (2013).

PTA Bank did not have a debt in Malawi but rather a deposit in USD which was converted into Malawi Kwacha with a promise that it would be given back in USD after three years and obviously there must have been forward rate of converting the Malawi Kwacha proceeds from the three year Treasury Note into USD. Consequently, there was no debt swap. It was rather a medium term collateralised loan in USD fully secured by Malawi Kwacha Currency and a forward rate agreement. Looking at the objectives of the underlining transaction was that Reserve Bank of Malawi was looking for forex while PTA was looking for lucrative investment avenue. These objectives do not qualify as derivatives because they were not like terms. One party had a deposit placement with another. It was therefore a mere financial instrument and not debt swap or foreign currency swap. This argument is backed by Oktavia et al (2019:70) who stipulated that derivatives are used by companies to reduce cash flow and earnings volatility caused by market risk factors such as fluctuations in interest rates, exchange rates, commodity prices and other risk factors. The purchase of the three year Treasury Note by PTA Bank did not achieve any of the underlined objectives of the derivatives.

Classifying the transaction as debt swap might have materially misstated the financial statements of central bank because the Treasury Notes are treated as assets in its books while loan was possibly excluded since swaps are off-balance sheet financing instruments. This was violation of substance over form principle which compels reporting entities to disclose the true nature and intent of particular transactions are not hide the technicalities, professional jargon or other legal instruments.

4.0 Conclusion and recommendations

Debt swaps purportedly concluded by Reserve Bank of Malawi are actually collateralised loans in which the central bank seeks to borrow foreign currency from other parties to boost the country's forex reserves. The 2014 PTA transactions might appear to have adopted short termism by pursuing short-term gains of increasing monthly import cover as part of the planned monetary policies and therefore influenced the exchange rate through bypassing the demand and supply mechanisms.

The current debt swaps as disclosed by World Bank (2022) above could also be tainted as they are supposed to be classified as loans and not debt swaps as there was no exchange of debts but mere receipt of foreign currency denominated deposit/loan from counterparties. Lack of proper disclosures result in material misstatement of the financial statements as there is probable violation of the financial statement assertion of disclosures which should show the true intentions of the counterparties.

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