

Background document for the CMFB on the statistical accounting consequences for government of the financial turmoil

1. Background

1. Recognising the major statistical questions arising from the ongoing turmoil in financial markets, and in particular the public sector's interventions in response, it was decided that an existing Eurostat task-force to deal with the accounting consequences of the financial crisis would be transformed into a CMFB one to draw up typologies and methodological principles for recording the public interventions in national accounts. The Task Force was chaired by Eurostat and consisted of members from 19 countries, the ECB, DG ECFIN, and the IMF (as an observer). The Task Force met twice, on 27-28 November 2008 and on 8-9 January 2009.

2. The financial turmoil and the European response

2. As the financial turmoil escalated from late summer 2008, governments and central banks in European countries massively intervened through various operations in an effort to restore confidence in the financial system. At first, operations in Europe were undertaken in order to rescue single financial institutions in distress. Additionally, coordinated actions were carried out by governments across countries. At a later stage, various general schemes were set up or existing schemes were reinforced, targeting financial institutions broadly regardless of whether they were in distress or not, recognising the systemic aspect of the situation.

3. The focus on the statistical response has been through the application of the existing legal framework of national accounts in the EU, the ESA 1995, and guidance developed in the past in the context of the Excessive Deficit Procedure and the Stability and Growth Pact. In addition the Task Force has kept a focus on the main philosophy in national accounts, i.e. to emphasise economic substance over legal form. The appropriate application of existing statistical rules during the financial turmoil is of fundamental importance in order to ensure the provision of reliable information for economic and financial analyses now and in future.

3. Typologies of cases

3.1 List of observed cases

4. The Task Force assisted Eurostat with the compilation of a list of observed cases of public intervention into financial institutions or markets, in the context of the financial turmoil. It is intended that Eurostat maintains this list dynamically.

3.2 Typologies

5. The typologies developed by the Task Force can be seen in two dimensions – the type of intervention and the institution making the intervention. The list has been drawn up to minimise the possible cases of overlap, but there remain some borderline cases, particularly between the recapitalisation and purchase of assets categories. There has been no attempt to classify operations by purpose (increasing liquidity, market stabilisation etc), or by the nature of the financial institution (healthy or unhealthy).

Type of Intervention

1. Recapitalisation

Recapitalisation occurs when a new equity-like instrument issued by a financial institution is acquired, thereby reinforcing the institution's capital structure. This may involve a range of instruments, including ordinary shares, preference shares and hybrid debt-equity instruments.

2. Lending

Lending occurs when a loan is granted to a financial institution. There will often be a form of collateral associated to the loan.

3. Purchases of assets and Defeasance

Purchases of existing financial assets commonly involve equity and securities other than shares with the acquisition of loans taking place in some cases. The term "defeasance" is used to describe a situation where government buys directly impaired assets from financial institutions, or instructs an existing or new public body to undertake this task.

4. Exchange of assets and collateral

Exchange of assets occurs when an asset is exchanged for another (different) asset, commonly over a fixed period of time. Examples include repurchase agreements and securities lending, but these cases may also encompass other types of arrangement. This type of operation commonly serves to improve the liquidity situation of one party to the exchange.

5. Guarantees

Guarantees provide an assurance that should a debtor be unable to meet its liability, the guarantor will meet the liability. In the context of financial institutions this includes guarantees on deposits and on borrowing. There is a possibility that guarantees might extend to the value of assets in some circumstances.

6. Debt assumption and debt cancellation

A debt assumption occurs when one party takes on the debt obligations of another party. A debt cancellation occurs when, by mutual agreement, a creditor cancels a debt owed to it.

Institution making the intervention

A. Existing General Government unit

B. Central Bank

C. Existing Public Corporation (other than Central Bank)

6. Category D for the institution making the intervention is not intended to be a new sector in the national accounts, but the institution's national accounts classification remains to be determined. Given the possible inter-dependence between the recording treatment of some operations and the statistical classification of the body undertaking them, it may not be possible to classify the body before its operations have been statistically classified. Institutions included in this category might be of a "Special Purpose Entity" (SPE) nature, or take the form of another type of body.

4. Methodological issues

4.1 Valuation issues

7. Given the importance attached by ESA95 to market-based valuation for most securities and the interventions by government to support distressed corporations with assets whose markets are temporarily inactive or dysfunctional, the recording of these interventions in national accounts raises practical questions and a consequent need for caution. This is a particularly important issue for purchase of assets and recapitalisation operations, though it is important to note the ESA95 approach to valuation of loans in the national accounts balance sheets (at nominal value).

8. Two types of operations might be most affected by valuation issues – recapitalisation and purchase of assets (see sections 4.3 and 4.5 below) – and practical valuation issues are considered there.

4.2 Creation of new bodies and interventions by public corporations

9. Some issues relating to bodies that carry out activities in relation to the financial turmoil are dealt with below, notably those relating to the statistical classification of those bodies and their transactions.

10. It is important to recall the definition of the general government sector in national accounts (see ESA95 paragraphs 2.68-2.74). The Central Bank is not classified to the general government sector (but rather as a financial corporation in sub-sector S.121). If a financial institution is nationalised, it may still need to be classified within the financial corporations sector according to ESA95 rules.

11. Where an *existing public body*, classified outside the general government sector, undertakes an operation relating to exceptional situations like a financial turmoil, it is unlikely that this would call into question its sector classification, unless the operation is large and completely different from the body's existing remit.

12. Where a *new body is created* (which is the case in many EU countries), the sector classification of the body must be determined. In particular it must be assessed whether or not this body is a separate institutional unit and, if so, whether its activities are of a market or non-market nature. These aspects are treated in ESA95 Chapters 2 and 3, and also in the first part of the MGDD.

13. The identification of an institutional unit in the national accounts requires that the body has "autonomy of decision" in respect of its principle function and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required, as described in ESA95 paras 2.12 and 2.13. Autonomy of decision in respect of its principal function is defined in ESA95 para 2.12 and applies if the unit is:

- a) entitled to own goods or assets in its own right; and
- b) able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law; and
- c) able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts.

14. When examining the autonomy of decision of financial bodies, it is particularly important to examine the bodies' autonomy over the management of its financial assets and liabilities. Where a financial body has no autonomy of decision over its principal function, it would be classified with the unit that controls it.

15. There is existing guidance on the treatment of holding companies (MGDD part I, section I.2.3, and paragraph 2.58d of ESA95) which states that institutional units whose principal function is to provide guarantees of bills and loans should be classified as financial auxiliaries. This guidance appears to be applicable to cases observed during the financial turmoil, though it is important to also analyse the issues raised below for new bodies.

16. A challenging issue identified by the Task Force relates to when new bodies are set up jointly by governments and non-government parties, or by non-government parties themselves with government support.

17. If these bodies have particular legal characteristics (for example a trustee arrangement), which means that they are "off the commercial balance sheet" of the non-government owners, and if they have a very restricted and largely pre-determined¹ activity (perhaps as a special purpose entity²), then these bodies could be considered as not demonstrating the characteristics of institutional units. In this case, the bodies are classified to the sector of the unit which controls them. Thus, if they are controlled by government, these bodies would therefore be classified into the general government sector in national accounts.

18. The precise definition of government control is a relevant issue. Under ESA95 the description of control focuses on the "ability to determine general corporate policy by choosing appropriate directors, if necessary" (ESA95 para 2.26) and goes on to describe a

¹ The predetermination of activities may be linked to the controlling unit having a right of veto on all decisions made by the newly created body.

² This term has been introduced in the SNA 2008, and the situations under which these types of bodies may be identified and classified is extensively discussed. However no such guidance exists in SNA 1993 or ESA95.

situation of control through shareholding, whilst acknowledging that "government secures control over a corporation as a result of special legislative decree or regulation which empowers the government to determine corporate policy or to appoint the directors", which might include veto rights. The SNA93 (and more extensively the SNA 2008) provides a more complete analysis of control, and also reviews the forms of such control. It could be considered that the granting of a complete or substantial government guarantee to a special purpose entity would constitute a form of control.

19. It is also helpful to recall that a financial body's activities should be analysed to determine if they are of a market or non-market nature. In the latter case, where the body is considered a non-profit body, this would lead to its classification in general government if it is considered to be controlled and mainly financed by government. Given the difficulties in determining the market/non-market nature of financial activities, the MGDD (part I, section I.2.2) recommends to analyse if a body is a financial intermediary. A financial intermediary – a market producer - is defined in ESA95 para 2.33 as placing itself "at risk by acquiring financial assets and incurring liabilities on its own account". Thus, for example, the ESA95 and MGDD (part I, section II.5.2) specifies that a public body created by government to assume the cost of a defeasance operation should be classified to the general government sector.

20. In summary, there are two key issues to be determined. The first is whether or not those financial bodies created under conditions of financial turmoil to execute specific tasks should conceptually be considered as institutional units. The second question is whether or not new financial bodies, even if the majority of their legal ownership rests with non-government units, can be considered as controlled by government, and under what circumstances.

Question 1: If the activities of a new financial body as described in paragraph 17, which was created to execute specific tasks in the context of financial rescue operations, are pre-determined by an existing institutional unit, is this a sufficient condition for it to be consolidated with that institutional unit?

- Yes
- No
- No opinion

Question 2: If a financial body in which non-government units hold a majority stake is considered as a separate institutional unit, under what condition(s) should it be classified within the general government sector?

	Only one option (X)
2.1 a) Under a limited set of conditions (then go to question 2.2)	
2.1 b) Never, as long as the government directly or indirectly holds only a minority stake	
2.1 c) No opinion	

2.2 If yes to 2.1 a, then under which conditions

	[yes/no]
2.2 i) If the government pre-determines the body's activity.	
2.2 ii) If the government assumes all or a majority of the risks associated with the body's activities, perhaps through the granting of a guarantee which covers all or most of its financing.	
2.2 iii) Only if both of the above are observed (<i>in this case the answers to i) and ii) should left empty</i>).	
2.2 iv) If the institutional unit administers and finances a group of activities that principally provide non-market goods and/or services, intended for the benefit of the community	
2.2 v) Other (please specify)	

21. ESA95 seeks to present an "economic" picture, and therefore legal or administrative arrangements are not the decisive factor. ESA95 includes the concept of "re-arranged transactions" such as rerouting, partitioning and recognising the principal party to a transaction (ESA95 paragraphs 1.38-1.41).

22. In the specific case of Central Bank liquidity operations, these operations would generally fall within the Central Bank's existing remit to preserve financial stability, and should therefore not be re-routed through government.

23. The scope of re-arrangement in the ESA95 and MGDD is limited (see ESA95 paragraphs 1.38 and 1.41), with social security contributions, grants for interest relief (ESA95 paragraph 4.51) and indirect privatisation receipts being the areas where it is mentioned. Yet in practice Eurostat has drawn upon the concept in several cases in the past, when it has been clear that a public body has been undertaking transactions on behalf of government, for example through written instructions or another form of irrefutable evidence (for example, a ministerial announcement or Parliamentary proceedings). There is therefore a need for caution when deciding if a re-arrangement should be shown in national accounts, with a need for evidence in such a case. The key question is the nature of the appropriate evidence required.

24. An existing public unit classified outside general government may be assigned by government a new task relating to the financial turmoil, which may be fully outside its existing remit and which may even be contrary to its own economic interests. One line of reasoning may be that the new task should be re-arranged to a government operation. Another line of reasoning may be that this would not lead to such a re-arrangement because remits of public units may be changed over time, and there would be major difficulties in practice to determine if a specific operation were in the unit's economic interests.

Question 3: Under what circumstances should rescue operations undertaken by public corporations classified outside general government be subject to re-arrangement through the government accounts ?

	Only one option (X)
3.1 a) Rescue operations carried out by public financial corporations should be re-arranged through government accounts just in the explicit limited circumstances set out in ESA95	
3.1 b) Under a limited set of other circumstances (then go to question 3.2)	
3.1 c) No opinion	

3.2 If yes to 3.1 b, then under which circumstances

	[yes/no]
3.2 i) If there is a written instruction (or other form of irrefutable evidence) of the government requiring the corporation to carry out the operations	
3.2 ii) If the operations are undeniably against the economic interests of the public corporation carrying out the operations	
3.2 iii) Only if both of the above are observed (<i>in this case the answers to i) and ii) should left empty</i>)	
3.2 iv) Other (please specify)	

4.3 Recapitalisation

25. Governments may purchase newly-issued equity of public or private banks, in order to boost the banks' capitalisation ratios. Governments might also purchase other forms of assets, such as subordinated debt or hybrid debt/equity instruments, which can be assimilated to equity.

26. It is important to determine unambiguously the statistical nature of the tier 1 and tier 2 capital instruments³ that are often acquired by government, sometimes termed 'preference shares' or 'non-voting shares' or 'preferred shares'. Treatment in national accounts as securities other than shares or loans might be considered in some circumstances. For loans reference should be made to the discussion under sections 4.4 below. It may also be that there is a later conversion to another type of instrument (for example a conversion of preference shares into ordinary shares), but this is not considered further here.

³ The precise definitions of these terms are explained in Basel II: International Convergence of Capital measurement and capital standards.

27. With regard to injections in the form of new quoted equity (usually in the form of ordinary shares), ESA95 rules lead to the conclusion that a government payment above the prevailing market price of the equity, or an equivalent valuation, would require the recording of a capital transfer from government to the units selling the equity (see section 4.5 below on purchase of assets). It would be expected that the market price, or equivalent valuation, would take into account past losses, whether accumulated or exceptional.

28. With regard to injections in the form of new unquoted equity (which might also include the case where the equity will be quoted but has not yet been valued), many of the injections took the form of preference shares that pay a fixed income and may (or may not) provide for a participation in the distribution of the residual value on dissolution of the corporation. A key issue relates to the applicability of the principles on capital injections into public corporations in the MGDD relating to the role of accumulated losses in the statistical classification of capital injections. There is a difficulty in applying the guidance on accumulated losses in the situation where financial institutions were profitable over many past years but then suffered an exceptionally large loss in one year for a write-down of assets values due the ongoing turmoil in financial markets. There is also a question about whether the MGDD principles should be applied to injections into private financial corporations or be limited to injections into public financial corporations; in public financial corporations the government already held most or all of the corporations' shares and therefore was impacted by the loss, and therefore the recapitalisation could be seen as covering the loss.

29. There are two possibilities here. The first option is to treat the exceptional loss as statistically relevant (thereby treating the capital injection as a deficit-impacting non-financial transaction up to the amount of the exceptional loss), perhaps just for public corporations or for all corporations. The second option is to take the view that it is not statistically relevant under the current circumstances (in which case only the MGDD rules regarding an expectation of a return is important for statistical recording).

30. The expected return on an investment may be considered as a crucial indicator to test whether the government acts similarly to a private investor, so that the capital injection can be treated as an increase in equity. With respect to a "forward-looking approach" (expectation of a return) to the statistical classification of capital injections, the European Commission's State Aid authorities have established some thresholds for the rate of return at which government is considered not to be providing state aid, based on recommendations of experts in the field. The State Aid rules, defined with the aim to prevent distortions of competition within the EU, represent a reasonable level of return for a conventional approach in statistics – government injections at or above the prevailing levels for State Aid could therefore be considered as satisfying the requirement of a sufficient rate of return. In the event that the rate of return falls below State Aid levels, a partitioning of the injection may be needed into a non-financial and financial element.

Question 4: Should an exceptional loss made by a financial institution mean that any subsequent government injections into that corporation in the form of unquoted equity (see paragraph 28) be treated as a non-financial transaction up to the amount of the exceptional loss?

	Only one option (X)
4.1 a) Yes, whenever an exceptional loss is identified (then go to question 4.2)	
4.1 b) No, the exceptional loss is not relevant - a capital transfer is only recorded if the expected rate of return is deemed insufficient under the EU State Aid rules (see paragraph 30)	
4.1 c) No opinion	

4.2 If yes to 4.1 a, then under which circumstances

	[yes/no]
4.2 i) Irrespective of whether the injection is made into a private or public financial institution	
4.2 ii) Only when an injection is made into a public institution	

4.4 Government lending to financial institutions

31. The MGDD (part II, chapter 3) specifies that a government loan to a public corporation would usually be recorded as a financial transaction. However it specifies that if the government grants a loan to a loss-making public corporation, in a context where it is very likely that the corporation would not be in a position to repay the loan, the transferred funds are viewed as capital transfers (with an impact on the government deficit). The conditions under which this applies are that the corporation has made recurrent losses and there is no expectation of restoring profitability before the maturity date of the loan.

32. However, caution is needed when recording any capital transfer at the time of granting of loan during the period of financial turmoil - such a recording should only be made where the evidence is irrefutable or documented. It could be expected that these cases would be rare.

33. The same statistical rules should apply to recording of government loans to public and private financial corporations.

4.5 Purchases of assets and defeasance

34. Commonly, financial institutions in difficulties hold a portfolio of impaired assets whose market value may or may not be determinable. An operation may be conducted to move these assets into a separate body in exchange for a payment (perhaps in the form of a

swap arrangement), thereby "cleaning" the bank's balance sheet. This is termed in the MGDD as "financial defeasance" (see part II chapter II.5.2, which is in the process of update by the MGDD Editorial Committee). The statistical classification of the defeasance body, if one is created, is an important factor in determining the potential impact on the government accounts (see section 4.2 above).

35. With regard to the purchase of loans (which are expected to be rare in the financial turmoil), ESA95 specifies that loans are to be recorded at nominal value in national accounts balance sheets. The MGDD (section II.5.2) makes the assumption that loans are sold by financial institutions at their redemption value, however it specifies that "if there is reliable information that these loans are irrecoverable (fully or for nearly their total amount)" then they should be written off by the financial institution before they are sold to the defeasance body, and therefore the operation should be partitioned into financial and non-financial transactions (the latter reflecting the difference between the price paid and the value of the loans after write-off) when they are purchased by the defeasance body.

36. Valuation is a key factor in the recording of purchases of assets. ESA95 (para 5.134) says that "financial transactions are to be recorded at transaction values" and (in para 5.136) that where the "financial transaction is undertaken other than for purely commercial considerations, the transaction value is identified with the current market value of the financial assets and/or liabilities involved". This means that if government has paid more than the market price for the assets, by a non-negligible amount, then a government expenditure (capital transfer) is to be recorded for the difference between the two values at the time of purchase. Nevertheless, this might be difficult or impossible to determine where no reliable market price exists due to financial turmoil, and therefore statisticians would need to exercise caution in the recording of operations in these conditions.

37. Thus it is recommended that the general approach to valuation of securities other than shares follow a series of clear steps. The following steps should be interpreted as an attempt to determine the appropriate valuation of securities other than shares which are acquired by the government. In effect the steps seek to identify if there are any reasons to call into question the recording of the transaction value in national accounts as the price paid by government.⁴

Step 1. Is the market adequately operating? Examples of features which would indicate this are a balance of buyers and sellers, market clearance, sufficient market volumes to establish a market price, smoothly evolving prices and/or an absence of large bid/offer spreads.

If yes, the appropriate valuation is the market value. If no, continue to step 2.

Step 2. Is the conduct of the transaction undertaken in such a way as to determine a market value? An example of this would be a conventional auction with many bidders.

⁴ The following steps are introduced in order to identify a value of the assets coherent with the principles of ESA 95 and decrease the risk of revisions. Naturally, mistakes which would be introduced in the evaluation of the different steps would leave open the possibility of future revisions.

If yes, the amount paid is considered to be a market value. If no, continue to step 3.

Step 3. Is the price paid greater than the carrying value of the asset in the business accounts of the seller? The conditions for this step are that the carrying value should be based on suitable business accounting principles and should correspond to a point in time reasonably close to the time of the transaction.

If yes, impute a capital transfer for the difference between the price paid and the book value.

If no, but the conditions set out above for step 3 are met, the amount paid is considered a market price. If these conditions are not met, continue to step 4.

Step 4. Is the price paid based on a demonstrably independent valuation founded on a market-based technique, or is at or close to a recent (possibly average) price observed in an adequately operating market for the same or very similar securities?

If yes, the price paid is considered to be a market value.

If no, provisionally record the price paid as equivalent to the market value, then continue to step 5.

Step 5. Has the asset been sold or re-valued in the year following the transaction?

If yes, analyse to see if the sale value can be considered as arising from a market under similar conditions as the original purchase, or if the accounting revaluation makes an assumption of markets under similar conditions as the original purchase. If this is the case, impute a capital transfer (at the moment of sale or revaluation) where the sale or new carrying value is lower than the original payment to purchase the asset.

If no, keep the existing recording from step 4 above.

Step 6. Has the asset been sold at a later stage following the transaction?

If yes, and if steps 3-4 above were used to determine the initial value at time of purchase, compare the sale value with the original purchase price of the assets. Where the original price paid was higher, impute a capital transfer for the difference at the time of sale.

If no, keep the existing recording from steps 1-4 above.

Question 5: Should the steps recommended in paragraph 37 be applied under the conditions of financial turmoil?

Yes
No (please explain)
No opinion

38. With regard to the purchase of existing equity (i.e. as distinguished from the recapitalisation operations taking place for new equity), the Task Force made a distinction between quoted equity and unquoted equity. For existing quoted equity, which is likely to be the most common case (for example, where government acquires shares in private banks) the series of steps outlined above for securities other than shares are considered to apply. For the purchase of existing unquoted equity, which seems not to be a common operation in Europe, some of the steps for securities other than shares (for example steps 3 and 4) may be seen as more relevant.

4.6 Exchange of assets and collateral

39. With regard to the exchange of assets and collateral, the Task Force noted that governments and, more commonly, Central Banks may provide, or engage in reverse operations with, government securities to financial institutions in exchange for certain assets of those institutions, with a return of the government securities programmed for some time in the future.

40. An actual case observed in the United Kingdom - the Special Liquidity Scheme - and the possible recording options have been considered. No conclusion was reached and the Scheme is the object of a separate CMFB consultation. It is important to stress that at this point there are no other such schemes in operation in the EU, though some countries have been examining their possible use.

4.7 Guarantees

41. In principle the treatment of a guarantee in national accounts is the same, irrespective of whether it is a guarantee on bank deposits, on assets, on inter-bank lending, or a guarantee on general bank debts. All of these cases have been observed in Europe, though not all in every country.

42. ESA95 (paragraphs 5.05 and 7.22) specifies that a guarantee is a contingent financial instrument that is not recorded in the national accounts system. Provisions established to meet future guarantee calls are not recorded in national accounts according to ESA95 4.165f. The recording of a call on a guarantee will usually result in the government making a payment to the original creditors or assuming a debt. In both cases, a capital transfer will be recorded from government for the amount called. These rules are not called into question by the situation of financial turmoil.

43. The MGDD (part II, chapter II.4.3) describes a special case when a guarantee is considered "systematically exercised" at issuance through the certainty that government is committed to meeting future payments of interest and principal on the debt. Three specific conditions are mentioned there: (a) the law authorising issuance of the debt by the corporation specifies the government's obligation of repayment; (b) the budget of the State specifies each year the amount of repayment; and (c) the debt, issued by the corporation, is systematically repaid by the State (interest and principal). The liability, with an accompanying capital transfer, must then be recorded directly – as soon as at issuance in the government financial account and balance sheet. This guidance should also be applied in cases of financial turmoil.

44. As for loans, there should be a caution in recording any imputed call on a guarantee during the period of financial turmoil – such a recording should only be made where the evidence is irrefutable or documented.

45. Fees paid to government for the guarantee schemes observed during the financial turmoil should be recorded as payments for a service.

4.8 Debt assumption and debt cancellation

46. The existing rules (ESA95 para 4.165f) that apply if the government agrees to cancel the debt of a financial institution to which it has made a loan and if government assumes the debts of financial institutions lead to the recording of a deficit-impacting capital transfer. Government debt would then increase by the amount of the assumed debt. These existing rules could be readily applied to any cases observed in a period of financial turmoil. In this context it might be underlined that statisticians should avoid the recording of such types of operations as debt write-offs (other changes in volume of assets).