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Unit C-3: Statistics for Excessive Deficit Procedure I



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## **Eurostat Guidance on accounting rules for EDP**

### **Financial defeasance structures Manual on Government Deficit and Debt - Chapter IV.5**

This note is intended to provide statisticians with guidance on the issues of recording of problematic (impaired and illiquid) assets and the sector classification of public entities managing problematic assets. These issues have become highly relevant in many Member States during the financial crisis, and, in response to questions raised for some cases, Eurostat is releasing this guidance note to ensure a homogenous statistical treatment across countries.

The guidance note covers exclusively public entities (owned and controlled by general government). It does not cover the cases of problematic assets held by majority privately owned financial corporations. This guidance note is limited to the interpretation of the Financial defeasance - Chapter IV.5 of the Manual on Government Deficit and Debt. Further work would be necessary to cover more complex cases.

#### Definition of problematic assets

As a general definition, problematic assets are those non-performing assets (financial and, to a lesser extent, non-financial) that have negative consequences on the profitability of the financial intermediary that holds them and could endanger the solvency of the unit. They are assets that a “normal” financial intermediary would normally need to be relieved of. Such assets could be transferred through market transactions, however in this case the unit would incur immediate losses. Problematic assets are impaired or illiquid assets.

Impaired assets are valued in the balance sheet in excess of their long term market or fair value and are therefore expected to incur losses in the future.

The value of such impaired assets may have been already downgraded (or written down), generally in unusually high proportions compared to normal practice (observed on average for similar competitors on the market, which means that their nature diverges from market standards, and problematic assets are not defined by a minimum share of recorded or expected impairments). But further potential losses are usually still expected and the financial institution will not be in a position to meet such losses through its own loss-absorption mechanism. In the specific case of market assets, the unit could not dispose of them in a short term without incurring losses, such that the unit is de facto obliged to keep them and is subject to an involuntary exposure to market risk.

In some cases problematic assets take the form of illiquid assets, i.e. they cannot be disposed in the short term because of the absence of effectively functioning market.

### Involvement of the government

In this context, for various reasons the government puts itself in a position to bear the major risks attached to the assets and/or to ensure the long term management of such assets. In case of public units the government takes ownership of the entity (nationalisation) and intervenes, directly (capital injections for covering losses, loans etc.) or more indirectly, through the granting of guarantees, and sometimes through a public entity, owned directly or indirectly (through some public financial corporations) by government.

As a matter of principle when government is bearing the final risk (losses) attached to identified problematic assets, the latter should be allocated to government, as it is stated in the MGDD (Chapter IV.5), whatever the legal and practical arrangements.

### Classification of the different types of defeasance structures

When a public entity is created by government and has, at least, the task of assuming directly the cost of financial defeasance (the potential losses on the assets), the current Manual on Government Deficit and Debt (MGDD) states that the entity, called "defeasance structure" should be classified in the general government sector (see IV.5.2.1.7).

However, other cases have been observed recently where the assets are allocated to a publically-owned entity that is created through the restructuring of an existing financial institution particularly impacted by problematic assets. This may take various forms, such as:

- a) an existing financial institution is split between a new entity owned and controlled by government with the task to manage the problematic assets (impaired and/or in some cases illiquid), and a remaining entity(ies) that is assumed to continue its financial intermediation activity in competition on the banking/financial market, possibly under a new name;
- b) the financial institution transfers, under various procedures, its "commercial profitable activity" (such as deposit-taking, quality assets, low risk lending). As a consequence, the unit is left with the management of most or all problematic assets, which therefore become its main activity, and this is achieved with a strong support of the government and under its control (government being the main shareholder, directly or indirectly through other public bodies).

In all cases, the sector classification of the publicly-owned defeasance structure that will hold problematic assets as a major share of its assets has to be decided by analysing the degree of government sponsorship in the rescue process. Major share means that the book value of the assets on which exceptional losses (see above) have been recorded or are still expected is a predominant part (and in some cases 100%) of the "earning assets" held by the entity.

According to MGDD, Chapter IV.5.2.1.8, where there is evidence that the government will bear most of the risks attached to the assets, for instance by being committed to cover the majority of the expected losses from the assets or through providing guarantees on the financing of the entity holding the problematic assets, the entity must be considered as acting entirely on behalf of government. Thus, it should be classified inside the general government sector from its creation (or reclassified in case b mentioned above). This is based on the

rationale that the financial institution no longer places itself at risk (see ESA95 2.23) and thus it cannot be classified as a financial intermediary or, in some cases, at least for this part of its activity.

In most cases, this analysis is reinforced by some or all of the following features of the entity such as:

- being closed to new business (or partly open under restrictive conditions mainly in the context of management of existing assets),
- a clear prohibition to compete on banking and financial markets,
- a foreseen limited lifetime linked to the progressive liquidation of the assets by (partial) recovery or sales on the market,
- a restrictive access to market resources under normal conditions.

These elements might play a major role where the risks of additional future losses depend closely on contingent market scenarios.

There may be borderline cases where such entities, meeting most of the fundamental features of a defeasance structure mentioned above, are still on the list of the Monetary Financial Institutions (which provides for the production of the list of MFIs subject to the Eurosystem's minimum reserves as well as a list of counterparties eligible for Eurosystem operations and for statistical purposes). In these cases, Eurostat will publicly consult the ECB for the Euro area and the national Central Bank for the other Member States outside the euro area. If the ECB or the NCB publicly confirms that these units are, on the contrary, to be considered as banks which do not have the features of public defeasance structures to be classified in the government sector, Eurostat will take note of this in its final decision.

#### Impact on government deficit

Whatever the case envisaged (case of an entity created by government, case a above or case b above), when the reclassification implies a transfer of assets for an amount higher than the market value that can be independently estimated, the difference should be considered as a capital transfer, with the assets added to the government balance sheet at market value. Any future holding gains/losses on these assets will be recorded in the revaluation accounts.

In the case of the creation of new defeasance structure recorded within the government sector (case a) the transfer of the assets from the financial institution to government is recorded as a financial transaction with a possible counterpart of a capital transfer to the rescued financial institution.

In the case of a defeasance structure which results from restructuring of an existing financial intermediary (case b above), the reclassification of the assets and liabilities within government sector should be implemented in two steps:

- first, in order to take account of the support provided to the financial intermediary, the difference between the transaction value of the transferred assets and their market value is recorded as a capital transfer to the debtors of the defeasance structure;
- then, the classification of the defeasance structure within the government sector is to be recorded as "Other changes in volume of assets account" (changes in sector classification and structure - K.12.1).

This is in accordance with the provisions of the MGDD (see Chapter IV.5.2).

### Impact on government debt

In the case of restructuring under cases a and b above, the classification of these entities to government will mean that both their assets and liabilities are included in the government balance sheet, and therefore gross government debt will include the relevant debt instruments of the entities.

It is important that the stocks and flows relating to dealing with problematic assets are properly recorded in the supplementary tables relating to the financial turmoil.