Decision of Eurostat on deficit and debt

# The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis

## 1. Context

The ongoing financial crisis, which first affected EU countries in the summer of 2007, has been addressed by EU governments in interventions of unprecedented magnitude. These interventions have evolved in their nature over time, and have comprised both individual rescue operations for failing financial institutions and systematic programmes of support for financial institutions and markets more widely.

In cooperation with European Statistical System partners, Eurostat has closely monitored these public interventions and their implications for national accounts data, notably for the government deficit and debt statistics used for the excessive deficit procedure (EDP). A specific Task Force of statistical experts was established under the auspices of the Committee on Monetary, Financial and Balance of Payments statistics (CMFB) to investigate the consequences in national accounts of the interventions and, based on the Task Force's work, two consultations of the CMFB took place in February-March 2009, with the CMFB's opinions (publicly available on the CMFB website) being provided to Eurostat in March 2009.

This Eurostat Decision is providing a general framework of statistical rules, fully consistent with the European System of Accounts 1995 (ESA 95). Individual national interventions often have specific characteristics which must be carefully analysed in the context of this general framework. This Decision covers the main forms of public interventions observed to date, however it is possible that the Decision will have to be supplemented if new forms of public interventions emerge in the coming months.

This Decision is not intended to cover government interventions to address the wider economic downturn (these are generally dealt with adequately by existing practice in the application of statistical rules), nor to deal with those public interventions which may take place outside financial crisis conditions.

## 2. Applicable ESA 95 rules

The wide variety of public interventions observed leads to the need to draw upon many aspects of ESA 95, however the key rules are

***Substance over form**:* National Accounts principles imply that the accounting treatment of operations should reflect economic reality and not the legal or administrative framework in which those operations are carried out. This may lead to the need to record operations in the national accounts in a different way from the way in which they are recorded in other accounting frameworks, for example as set out in ESA 95 paragraphs 1.38 to 1.41 which refer to the re-routing, partitioning and recognising the principal party to transactions.

***The valuation of financial transactions****:* In principle the ESA 95 provides for financial transactions (which do not impact on the government deficit) to be recorded "*at the transaction values, that is, the values in national currency at which the financial assets and/or liabilities involved* are created, liquidated, exchanged or assumed between institutional units, or between them and the rest of the world, on the basis of commercial considerations only" (paragraph 5.134). However it is acknowledged in paragraph 5.136 that "*in cases where the counterpart transaction of a financial transaction is, for example, a transfer and therefore 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*".

***Contingent liabilities****:* ESA 95 paragraph 5.05 explains that "*Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities (NIFs) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is tradable or can be offset on the market. Otherwise, a contingent asset is not recorded in the system."* Usually, guarantees granted by government are not tradable.

***Classification of bodies****:* ESA 95 chapter 2 explains the national accounting rules for the classification of bodies. In particular it defines when an institutional unit should be recognised (paragraphs 2.12 to 2.16) and the characteristics of general government units (paragraphs 2.68 to 2.70). ESA 95 chapter 3 (paragraphs 3.27 to 3.37) sets out the rules for determining if a unit is undertaking predominantly market or non-market activities. It is also important to note that national central banks are not classified in the general government sector, but with financial corporations (paragraphs 2.45 to 2.47).

The analysis should also draw upon the existing guidance set out in the ESA95 Manual on Government Deficit and Debt (MGDD), notably with regard to classification of units, financial defeasance and the recording of guarantees.

## 3. Recapitalisation operations

*The issue*

Recapitalisation occurs when an equity instrument issued by a financial institution is acquired. This may involve a range of instruments, including ordinary shares, preference shares and hybrid debt-equity instruments.

*Decision*

In line with ESA 95 paragraph 5.136, recapitalisations in the form of ordinary shares (and conversions of preference shares) are financial transactions when they are considered to take place at market price. If they are conducted above market price, this would require the recording of government expenditure (capital transfer) - for the difference - to the unit selling the equity.

Recapitalisations in the form of preference shares will be recorded as financial transactions if EU State Aid rules on rates of return are complied with. Where EU State Aid rules are not complied with, the injections should be partitioned into a financial and a government expenditure component, the latter representing the difference between the actual rate of return and the appropriate EU State Aid rate of return, over the expected life of the instrument.

## 4. Lending

*The issue*

Lending occurs when a loan is granted to a financial institution.

*Decision*

Lending is to be recorded as a financial transaction when granted, if there is no written or other irrefutable evidence that the loan will not be repaid. Any subsequent cancellations or forgiveness of loans will lead to the recording of government expenditure (capital transfer) for the full amount of the loans involved.

## 5. Guarantees

*The issue*

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. Guarantees might also be extended to the value of assets in some circumstances.

*Decision*

Guarantees are contingent instruments with no direct impact on government accounts when they are granted, unless there is written or other irrefutable evidence that they will be called.

In all cases, calls on government guarantees relating to the financial turmoil, whether met by cash payment or assumption of debt, are to be recorded as expenditure of government (capital transfers).

## 6. Purchase of assets and defeasance

*The issue*

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 creates a public body to undertake this task.

*Decision*

The purchase by government of financial assets (notably securities other than shares) will be recorded as financial transactions if they take place at market price, which may be determined (directly or by proxy) by reference to the following steps:

> 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.
>
> > 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.

## 7. Exchange of assets

*The issue*

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 may also encompass other types of arrangement. This type of operation is commonly made to improve the liquidity situation of one party to the exchange.

*Decision*

The government securities exchanged in temporary liquidity schemes, where the securities will return to government at a pre-determined date in a short period of time (and the risk of loss is expected to be small), are recorded as a securities lending transaction (i.e. they remain under the economic ownership of government and do not form part of government consolidated gross debt). This holds for both schemes directly between the government and financial institutions, and for schemes conducted via the National Central Banks.

Where the liquidity scheme is of indeterminate or not short duration and/or where the risk of loss is not expected to be small, the government securities concerned will either be considered as not remaining under the economic ownership of government (schemes operated via central banks) or recorded as back-to-back repurchase agreements (schemes operated directly by government). In both cases, government consolidated gross debt would be higher by the value of the securities concerned.

General liquidity operations carried out by national central banks are to be recorded in the accounts of the central banks, which are classified within the financial corporations sector in national accounts.

## 8. Classification of certain new bodies

*The issue*

New bodies may be created by government, by public corporations or by private corporations, to address specific aspects of the financial turmoil.

*Decision*

Government-owned special purpose entities, which have as their purpose to conduct specific government policies (for example with regard to defeasance or recapitalisation) with no autonomy of decision, are to be classified in the general government sector.

Majority privately-owned special purpose entities which are established for a short temporary duration and have a sole purpose to address the financial crisis, even if they receive a government guarantee, are to be recorded outside the general government sector if the expected losses that they will bear are small in comparison with the total size of their liabilities. This latter condition may be determined, for example, by the extent and form of collateral arrangements which are in place.

**9. Recording of certain transactions carried out by public corporations**

*The issue*

Certain public corporations, classified to the corporations sectors in national accounts, may undertake transactions to support financial markets or individual financial institutions.

*Decision*

Transactions conducted by public corporations are to be considered as undertaken by general government as a principal party if there is written or other irrefutable evidence that government has issued an instruction to the public corporation to carry out the transactions for public policy purposes. In all other cases the transactions are recorded as undertaken by the public corporations concerned. (Reference ESA 95 paragraphs 1.38 to 1.41 which refer to the re-routing, partitioning and recognising the principal party to transactions)

**10. A supplementary table for certain financial turmoil operations**

Eurostat intends to establish a supplementary reporting table to collect data on guarantee, liquidity support measures, and special purpose entity operations relating to the financial turmoil, which Member States will complete. The data in this table will then be published by Eurostat alongside its EDP Press Releases.