Challenges in improving the measurement of the government financial position and in the classification of units as public or private

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Challenges in improving the measurement of the government financial position and in the classification of units as public or private (IPS111)

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1 Introduction

To deal with the consequences of the global financial crisis starting in summer 2007, several countries undertook various government operations to restore confidence in the financial system. Government expenditures and revenues as well as debt figures can be influenced heavily and over a longer period of time by such measures. The measures undertaken were not only of a general economic support nature, but also individual rescue operations for financial institutions in distress.. In connection with these supporting measures for the benefit of financial corporations often new units were created, sometimes abroad, in which large portfolios of assets and liabilities were transferred.

The allocation of such units to the government or to the private sector will have a substantially differing impact on government debt figures, which in turn may well affect the government's credit standing and on its capital market refinance conditions. On the other hand, such a consequence highlights the need for an internationally consistent allocation of such units to the government or private sector, above all to avoid distortions in government finance data and to ensure cross country comparability.

In particular against the background of the European Stability and Growth pact, comparability of public finance data is an essential issue in the budgetary surveillance of the member-states: sustainable public finances are seen as precondition for a common viable European currency. The sustainability of public finances is measured by two thresholds: a maximum deficit-to-GDP ratio of -3% and a debt-to-GDP ratio of 60%. Deficit as well as debt data are defined in acoordance with the European system of accounts (ESA-1995).[1] The assessment is carried out using the data provided by each member-state to the Statistical Office of the European Union (Eurostat). The task of Eurostat is, though, not only reporting the data but also making sure that the data are comparable and compiled according to the ESA-1995 provisions. In case of doubt, Eurostat has different tools for clarification (decision, advice or guideline) and to ensure a uniform interpretation of national accounts rules.

This paper deals with the sector classification of units created in connection with the financial crisis and its accounting consequences in national accounts. The leading question is, whether the established provisions at EU level allow portraying similar operations in a comparable way with regard to government deficit and debt. We deliberately focus on a few selected units.

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[*] We are grateful to Ms Marion Kuschel for her valuable comments.

[1] Cf. Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community of 25 May 2009.

2 The sector classification of units in national accounts

The sector classification of a unit is one of the most important tasks in national accounts. In general the classification of a unit to a certain national accounts' sector is rather straightforward. However, the financial crisis caused a lot of uncertainty concerning the classification of units, since it was difficult to assess the value of certain assets and thus the profitability of such units or the market character of transactions carried out by some units. In addition, a lot of new units were created with a temporary life span or with a full government guarantee on their assets or liabilities or with a detailed task description. The latter could put the autonomy of decision of such a unit concerning its principal activity into question. Some units were created with negligible own capital but with a comprehensive government guarantee, which allows them to incur huge risks in comparison with the own capital[2]. Other units substantially changed their original activity requiring a re-assessment of their sector classification.

Due to the economic importance in terms of assets and liabilities of these units their classification – especially if they are classified to the general government sector - can have an enormous impacts on government deficit and debt. Thus the classification of these "financial crisis units" has gained great professional and public interest. The difficulties stem from the fact, that the general classification approach assumes the availability of all necessary pieces of information as well as efficient markets. A special feature of the financial crises, however, was missing information and collapsing markets.

2.1 Standard classification approach according to ESA-1995[3]

In general, the legal form of a unit is not decisive for its sector classification in national accounts. The main unit in national accounts is the institutional unit which may take different legal forms. Only an institutional unit can be allocated to an institutional sector and according to ESA-1995 paragraph 2.18 it has be allocated to one sector only.

The sector classification according to ESA-1995 in a simplified form requests to answer the following three questions[4]:

1) Is the observed unit an institutional unit?
   a. Has the unit autonomy of decision in respect of its principal function?
   b. Does the unit keep a complete set of accounts?

2) Is the unit a public institutional unit?
   a. Is the unit controlled by general government?

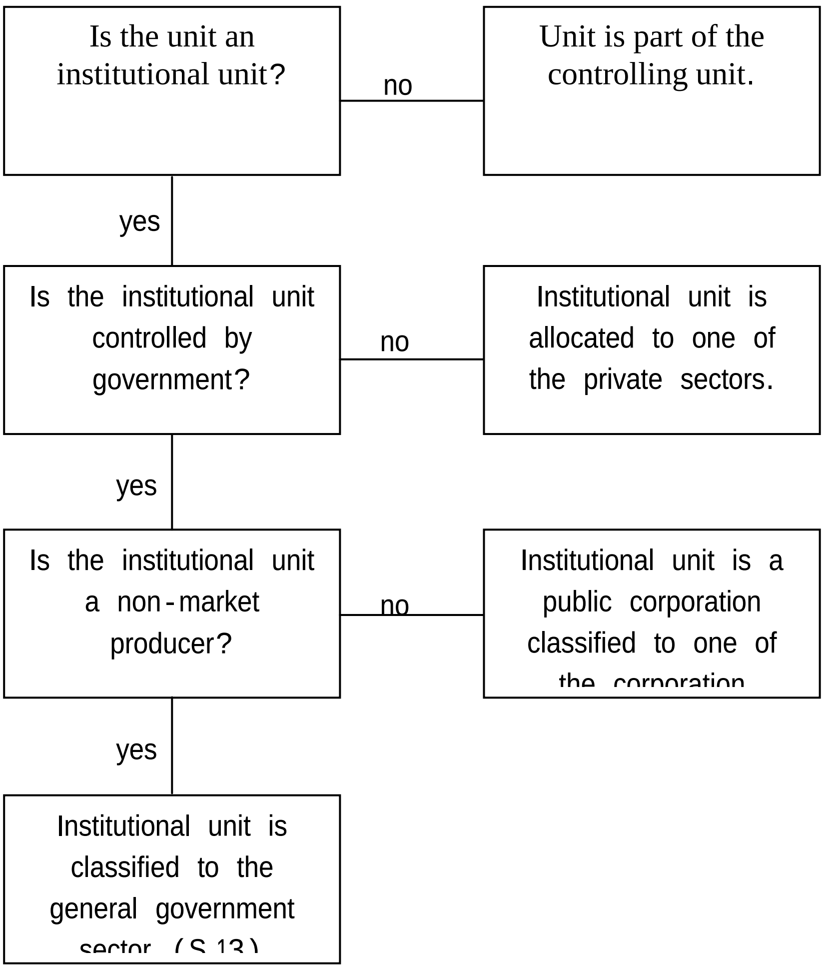
[2] In such cases it seems questionable that a guarantee is considered as a contingent liability i.e. with no impact on the classification of such a unit and on government debt, respectively.
[3] Council Regulation (EC) No 2223/96 on the European system of national and regional accounts in the Community of 25 June 1996.
[4] Cf. ESA-1995, paragraph 2.68 (definition of general government), paragraph 3.26. (definition of non-market producer), paragraph 3.27 (distinction between market and non-market output).

3) Is the unit a non-market public institutional unit?

   a. Are the prices charged for sale of goods and services economically significant, i.e. do the sales cover more than 50 % of production costs (50 %-criterion)?

For units which are not considered as an institutional unit, ESA-1995 paragraph 2.13 provides that they have to be combined with the unit controlling them. Therefore an institutional unit which is controlled by general government and in addition regarded as non-market producer has to be allocated to the government sector. Chart 1 shows the standard classification process.

Chart 1: Standard classification process of units according to ESA-1995



To distinguish between a public institutional unit being a non-market producer, which has to be classified to the general government sector on one hand and on the other hand such a unit being a market producer and therefore to be classified to the financial or non-financial corperation sector usually the 50 % criterion is used. According to this criterion a unit is considered as non-market producer, if its sales cover less than 50 % of the production costs (i.e. intermediate consumption, compensation of employees, capital consumption, and other taxes on production). In the case of a cost coverage of 50 % and more, it is assumed that the economic behavior of this unit is market-oriented.

However, the application of the 50 % criterion is particularly difficult for units which are active as financial intermediaries. The main proceeds of such units consist of interests revenues and holding gains and the main cost items are interests paid and holding losses. According to ESA 1995 these types of revenue and expenditure are not considered as sales nor costs. Therefore guidance on the interpretation of the 50 % criterion for units carrying out financial activites is provided in the MGDD-handbook: Units carrying out financial intermediation as main activity are to be classified to the financial corporation sector (S.12). The crucial point, however, is that they in fact carry out financial intermediation activities, according to paragraph 2.33 of ESA 1995, which means that they themselves are in the position of taking the risks related to financial intermediation. This is different from units carrying out auxiliary activities for banks or insurance companies, since here the 50 % criterion usually can be applied.

In addition to the main question, whether a new founded unit can be regarded as institutional unit, an assessment is required, whether the activities are carried out in a commercial, market-oriented manner[5]. Under normal market conditions the market-orientation of a public unit is doubtful if assets are taken over at a value above their market price, the units main activity is the compensation of losses, the relationships between own capital and risks is extraordinary[6] or if financial means are provided at conditions substantially below prevailing market rates. Such considerations are also the basis for the sector classification in the special case of financial defeasance.

2.2 Classification of units in case of financial defeasance

The creation of units which serve for instance to take over impaired assets from banks is not a totally new phenomenon. Already in case of difficulties of individual financial corporations some governments erected such units or supported them directly or indirectly by capital injections (loans, own funds) or guarantees. Although at first sight the activities of such units have much in common with financial intermediaries, they basically represent just a vehicle to rescue other units. Such constructs, usually called financial defeasance, only can be active due to support from general government. The MDGG-handbook mentions the following characteristics as typical for a defeasance structure[7]:

1. A financial institution has become financially distressed due to its involvement into bad assets.
2. In many cases a new entity is created in order to manage the bad assets and to restore the profitability of the transferring bank.
3. Direct or indirect Government involvement in the rescue process by facilitating the financing of the rescue in such a way that government may be viewed as taking over the risks attached to the transferred assets.

[5] Cf. Manual on Government Deficit and Debt, Implementation of ESA-1995, Chapter IV.5 Financial defeasance, page 176 ff, Chapter I.2.4 Market/non-market rule applied to public institutional units, page 13ff.
[6] The equity of a unit is an important issue when assessing the ability to bear risks: Only a unit having sufficient own capital is for instance in the position to bear losses in securities or due to interest changes without running the risk of insolvency.
[7] Cf. Manual on Government Deficit and Debt – Implementation of ESA 95, Edition 2010.

A public unit should be classified in the general government sector, if the unit is created by government and has the task of assuming directly the cost of the defeasance (the losses).

In cases where assets are allocated to another unit not created by government, “the sector classification has to be decided following the general rules governing the actual existence of an institutional unit, the characteristics of a financial intermediary and analysing carefully the degree of government sponsoring of the rescue process. Any time the government could be considered as bearing most of the risks in the rescue process […] this would imply that the rescuing entity is “acting on behalf” of the government. […] Therefore, it will be regarded as a government-sponsored defeasance structure and should then be classified inside the general government.

The question was, whether the provisions designed for single cases of financial distress can be applied in the case of the global financial crises affecting a whole industry or economy, respectively.

2.3 Decision on the classification of new units created during the financial crisis

The market imbalances caused by the global financial crisis are accompanied by a high insecurity about the value of certain assets and .hence the profitability and market conditions. This implies a high degree of uncertainty with regard to assessing the market oriented behaviour of a newly created unit. In addition, in such a situation it is difficult to answer the question, whether such a unit is in the position to bear the risks related to its financial activities. In the face of high uncertainties on one hand and the requirement to develop a classification approach for newly created units which renders comparable data across EU countries, on the other hand, Eurostat established special rules for this sector classification by its decision of July 2009[8]. The main provisions to be applied for the sector classification of units during the period of financial crises are as follows:

- Majority privately-owned special purpose entities which are established with a short temporary duration (their existence would be for a short period of time strictly linked to the actual duration of the financial crisis) 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[9].

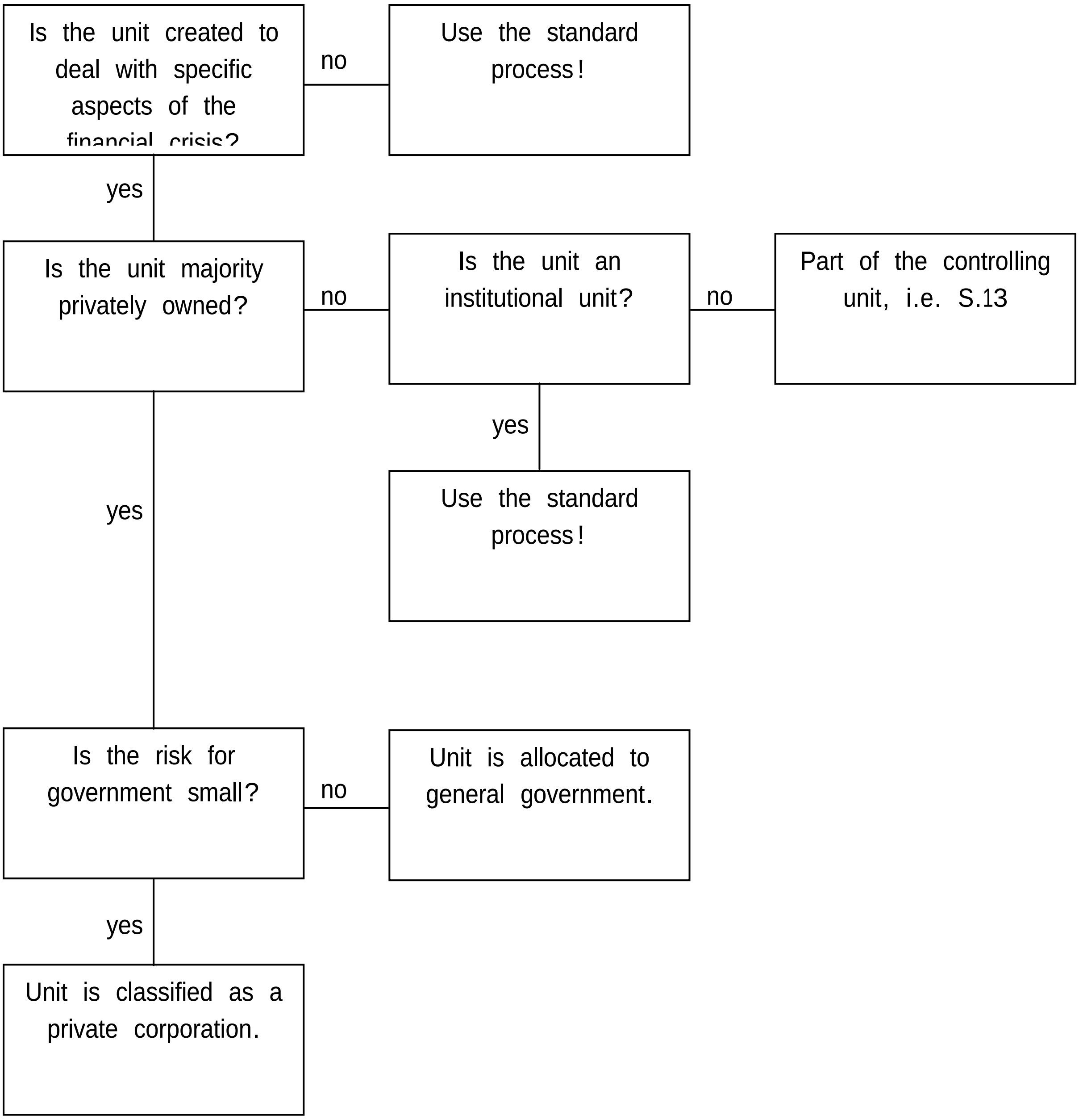
- Government-owned special purpose entities, which have as their purpose to conduct specific government policies (for example with regard to defeasance or recapitalisation) with no autonomy of decision, are to be classified in the general government sector.

[8] Cf. Eurostat Decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis of 15 July 2009.

[9] Eurostat has not give a quantitative measure fort his relationship, but provided a qualitative interpretation: Losses for general government are considered small if for instance substantial haircuts are applied.

In a graphical form the Eurostat decision may be presented as follows:

Chart 2: Classification of units according to the Eurostat decision



2.4 Conceptual differences

The intention of Eurostat, to develop new rules clarifying the sector classification of units created during the global financial crisis seems more than understandable on one hand. On the other hand the crucial point is the establishment of provisions deviating from the standard ESA-1995 procedure. Particularly interesting in this context is that the focus of the decision is an ownership as main criterion for the sector classification.

According to ESA 1995 ownership and control seem closely related, but the possibility to exercise control goes beyond the purely formal legal ownership. Therefore it is not astonishing that control is assumed if a unit owns more than 50 % of the voting rights of another unit. However, control may be exercised without the majority of voting rights, for instance by legal, statutory or contractual provisions. Special rights for general government, which may be stipulated by specific provisions, may reach far beyond the general business policy and instead define in detail operational tasks, so that there is almost no margin of manoeuvre for the unit concerned. As an extreme example, one can image such detailed provisions that the unit de facto acts like an autopilot. Given that in practice control of a unit cannot be assessed by just looking at voting rights, for a proper sector classification this has to be examined in a comprehensive way.

According to the Eurostat decision on the treatment of units erected during the financial crisis, the question of control is restricted to examine the ownership. Thereby the construction of units is possible, which due to the voting rights are to be considered as private and not as part of the government sector, although in reality these units may be under the control of government. An assessment, whether these unites are institutional units is rendered obsolete by the Eurostat decision. The usual classification criteria “institutional unit” and “control” have de facto lost their importance (temporarily).

3 Treatment of units created during the global financial crisis

During the global financial crisis various new units were created in the European Member-States. Subsequently selected units in Germany, France and Ireland are considered, their sector classification in national accounts is presented and the accounting consequences with regard to the deficit as well as debt of general government is analysed.

3.1 The German winding-up agencies

With the German Act on the Further Development of Financial Market Stability[10] the already existing instruments to handle the financial crisis as stipulazed by the Financial Market Stabilisation Fund Act[11] (i.e. recapitalisation, guarantees and direct purchase of impaired assets by government) were extended. The extension of the previous act enables banks, financial holding corporations as well as their domestic or foreign subsidiaries to create special bodies in which impaired assets (e.g. structured assets, non-performing loans) or even non-strategic business divisions can be transferred.[12] This allows banks to liquidate their assets without time pressure and to re-align their business in order to achieve financial sustainability.

The act mentions explicitly two models: the special purpose vehicle and the liquidation sub-agency model. In practice only the liquidation sub-agency model – primarily designed for state banks (Landesbanken) – was used in Germany.[13] The liquidation sub-agency model

[10] Gesetz zur Fortentwicklung der Finanzmarkstabilisierung – FMStFEntwG, vom 17. Juli 2009.
[11] Finanzmarktstabilisierungsfondsgesetz – FMStFG, vom 17. Oktober 2008.
[12] Cf. §6a of the Gesetz zur Fortentwicklung der Finanzmarkstabilisierung – FMStFG, vom 17. Juli 2009.
[13] Cf. § 8a and § 8b of the Gesetz zur Fortentwicklung der Finanzmarkstabilisierung – FMStFG, vom 17. Juli 2009.

("Anstalt in der Anstalt" or "AidA" for short) allows a transferor bank to split-off risky assets and/or non-strategic business divisions into a newly created unit called AidA. A key factor in this model is that an AidA is not subject to the capital and liquidity requirements of the German Banking Act.[14] The owners of the transferring bank are involved in the AidA in accordance with their share ratio and remain liable for any losses of it.

3.1.1 First Winding-up Agency (EAA)

The first winding-up agency (German: Erste Abwicklungsanstalt, EAA) is a structurally and financially independent public law entity with partial legal capacity operating under the umbrella of the Financial Market Stabilisation Authority (Bundesanstalt für Finanzmarktstabilisierung - FMSA). The FMSA established the EAA on 11 December 2009. Its task is to take over and wind up WestLB's risk exposures and non-strategic businesses/assets with an original total (nominal) volume of approximately EUR 77 billion[15] in order to stabilise WestLB and the financial market. The owners of the EAA are two public saving bank associations (having 25.0% share each, classified as financial institutions in national accounts), one state government (North Rhine-Westphalia) and two local government associations.[16]

The EAA is administrated by a management board composed of at least two members and appointed by the board of directors (Verwaltungsrat) of the AidA. The management board of the AidA is independent; it is not subject to instructions. Neither the board of directors of the AidA nor the owners' meeting (Trägerversammlung) has the right to impose instructions on the management board. In operational matters, the board of directors has neither a right to issue instructions nor a general right of approval. The range of transactions for which approval by the board of directors is required is – as with other companies – limited. With respect to the requirements of the Further Development of Financial Market Stabilization Act (FMStEntG), AidAs are subject to a supervision by the FMSA to ensure compliance with the legal and statutory requirements. However, the business activities of the First Aida are restricted to the liquidation of the risk positions and non-strategic assets transferred to it. The liquidation plan is drafted by using valuation assumptions and must ensure at any time the solvency of the EAA. Insofar the liquidation plan is considered similar to a business plan of a corporation which constitutes only the general corporate policy and not the operational business.

The assets of the EAA consist of an initial portfolio comprising structured securities, loans and advances to credit institutions, and receivables from currency transactions and interest rate and currency swaps. The EAA is equipped with an equity of around 3 bn. Euro, which is not directly paid-in equity but created as difference of assets less liabilities in connection with the spin-off process. Thus the assessment of the intrinsic value of the own capital depends on the valuation of the (impaired) assets. In the case of the EAA the assets are valued on the

[14] Kreditwesengesetz – KWG.
[15] This amount includes also the transfer of contingent liabilities which have to be recorded in business as well as in national accounts below the line. In addition it includes assets (Phoenix) which are still allocated to general government through rerouting.
[16] Cf. Bundesanstalt für Finanzmarktstabilisierung – FMSA Statut der Erste Abwicklungsanstalt vom 11. Dezember 2009 in der Fassung vom 22. Dezember 2010.

basis of the German Commercial Code (Handelsgesetzbuch–HGB) which does not value the assets on fair value basis (market value).

In addition to the equity of 3 bn Euro, the EAA benefits also from a 1 bn euro shareholder guarantee provided in connection of the spin-off. Losses above 4 bn euro are covered by a further guarantee scheme amounting to 8 bn Euro provided by its owners (each up to 4 bn euro). In the event of further losses these are to be born by the state of North Rhine-Westphalia and by the Financial Market Stabilisation Fund.

Sector classification of EAA

The EAA is a publicly owned unit (direct and indirect shareholders are the state government and local governments of North Rhine-Westphalia). Therefore the Eurostat decision of 15 July 2009 with regard to majority privately owned units does not apply and hence the standard classification procedure is to be used (see figure 2).

The EAA is considered to meet the characteristics of an institutional unit pursuant to ESA 95 paragraph 2.12 because it keeps a complete set of accounts and has autonomy of decision. Autonomy of decision is given due to its possibility of taking economic decisions, is ability to incur liabilities and obligations and the entitlement to own goods and assets in its own right.

In order to assess whether the EAA is a market or a non-market producer it is to decide on the characteristic of being a financial intermediary. If the EAA can be considered a financial intermediary, it is classified to the sector “financial corporations”, otherwise it is classified within the general government sector.

For monetary financial institutions (MFI) ESA95 paragraph 2.41 determines, by convention, that these institutions have to be allocated to financial corporations sector (i.e. sub-sector S.121 for the central bank and S.122 for other monetary financial institutions). The EAA, however, is not a bank in the sense of the German banking law (KWG) nor of the European Banking Directive; furthermore, it does not appear on the MFI list of the European Central Bank.

The other financial intermediaries sub-sector consists of all financial corporations which are principally engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional units other than MFIs (ESA95, paragraph 2.53). The business activities of the EAA comprise the active management of all assets and liabilities of the transferred business divisions. Therefore for the non-strategic assets transferred the business activities of the EAA could be similar to the activities of other financial intermediaries.

However, paragraph 2.33 of ESA-1995, requires that a financial intermediary does not simply act as an agent for other institutional units. A financial intermediary has to place itself at risk by acquiring financial assets and incurring liabilities on its own account.

A main point in the ability of a financial intermediary to place itself at risk is its equity which could be used to cover costs associated with the risks.[17] The value of the equity highly depends on the valuation of the transferred assets and according to the valuation approach used in the case of the EAA, i.e. book values, it can be assumed that the realisation value of the assets is significantly lower, which implies a very low or even “negative” equity. This makes it very improbable, that the EAA can place itself at risk, which would deprive. it of any basis for classification as a financial intermediary. In addition the substantial guarantees provided to all losses of the EAA also leads to the conclusion that it does not place itself at risk.

Similar cases of removing bad assets from a financial institutions’ balance sheet is specifically dealt with in the MGDD chapter on financial defeasance. According to this, the EAA is to be regarded as a government-sponsored defeasance structure which is acting on behalf of the government. Therefore, the EAA cannot be considered as financial intermediary and is classified inside the general government sector.

Accounting consequences of EAA

Due to the classification of the EAA to the government sector all assets and liabilities of this unit are shown in the government accounts. According to the gross debt concept used for EDP purposes the debt effect is approximately EUR 23 billion.

The deficit effect depends on the transaction values agreed upon for the assets and the actual market values of these assets. The difference between the transaction value and the market value is to be treated as capital transfer in national accounts . A major problem is that no reliable market values were available during the financial crisis. In practice, the estimated real economic value compiled in the state aid procedure could be seen as a suitable first approximation and a means to reduce the difference between the accounting value and the market value. One could argue that due to this valuation the recorded immediate deficit effect could be too low[18] against the background of the general national accounts rules. However, due to the Eurostat decision the recording of further effects are possible in the future, if assets are sold to a price below the transfer value recorded in national accounts. Thus the possible “deficit advantage” gained will be balanced in the future, unless the asset will be hold to maturity. In the latter case any differences between the real economic value and the value at maturity will be treated as deficit neutral revaluation effect.

[17] The possibility to transfer risks to another unit via an insurance contract, for example, through a credit default swap is not considered.
[18] And vice versa the debt effect too high.

Table 1: General Government and EAA gross debt as percentage of GDP[19]

Year	Debt (% of GDP)	
	General government	of which EAA
2008	66,3	0,0
2009	73,5	1,0
2010	83,2	1,0

Data source: EDP Notification Tables, April 2011, own calculations

3.1.2 The Second Winding-up Agency (FMS-W)

The second winding-up agency **(**FMS Wertmanagement, FMS-W) is a structurally and financially independent public law entity with partial legal capacity operating under the auspices of the Financial Market Stabilisation Authority (Bundesanstalt für Finanzmarktstabilisierung - FMSA).

On 1 October 2010, FMS Wertmanagement acquired risk positions and non-strategic business units from the Hypo Real Estate Holding AG and its direct and indirect subsidiaries and structured investment vehicles in Germany and abroad (collectively referred to as the HRE Group) for the purpose of stabilising the HRE Group and the financial market. The HRE Group was nationalized in October 2009. FMS Wertmanagement will wind up these positions and business units according to economic principles, which will minimize losses and enable FMS Wertmanagement to seize opportunities for profits.

The winding-up plan is to be performed over a period of ten years. The owner of the FMS Wertmanagement is the Financial Market Stabilisation Fund (SoFFin). The SoFFin is obliged to compensate for losses so that FMS Wertmanagement can cover its due and payable liabilities at all times.

Sector classification of FMS-W

The core structure of the FMS Wertmanagement does have a lot of similarities with the EAA. Thus for the sector allocation of the FMS Wertmanagement the same procedure as in the case of the EAA has been used. The FMS Wertmanagement is a publicly owned unit which should be considered as an institutional unit. On the other hand, it cannot be considered as a financial intermediary even though it has a lot of similarities to other financial intermediaries. The FMS Wertmanagement is not able the bear the risks associated with its business activities and general government will take over all losses and will be liable for all of its debt. Thus all risks associated with the activitiy of the FMS-W are with general government.

[19] General government gross debt for 2009 and 2010 already includes the debt effect resulting from the EAA since it was allocated to the general government sector in national accounts. In 2010 also the effect of the FMS Wertmanagement is included.

Accounting consequences of FMS-W

The EDP debt effect resulting from the allocation of the FMS Wertmanagement is around 220 bn euro and is determined by its liability side. The difference between the take over value of the impaired assets (which is in fact the book value before depreciation) and their market value has been estimated at 24.4 bn euro. Since no market values for the assets were available the fair value of the assets published in the annual report of the FMS Wertmanagement has been used as best approximation.

Table 2: General Government and FMS-W gross debt as percentage of GDP[20]

Year	Debt (% of GDP)	
	General government	of which FMS-W
2008	66,3	0,0
2009	73,5	0,0
2010	83,2	9,0

Data source: EDP Notification Tables, April 2011, own calculations.

3.2 New units in selected other EU Member States

3.2.1 The Société de financement de l'économie francaise (SFEF)

The French government interventions supporting financial institutions are carried out mainly by using two measures: a capital injection scheme for banks[21] and a scheme for refinancing banks[22]**.** The whole refinancing scheme respectively guarantee scheme established by the French government add up to 320 bn euro and consists of two parts. A direct granting of guarantees to financial institutions in urgent and exceptional cases via the Minister of Economy and a government guarantee on the debt issued by a new unit especially created for the purpose of refinancing credit institutions. Especially the sector classification of this new unit in national accounts gained great attention in Europe.

The new unit called the Société de financement de l'économie francaise (SFEF) was created in October 2008 on the basis of the Supplementary Finance Act for the financing of the economy. The SFEF has the task to raise funds on the capital markets by issuing securities guaranteed by the French government and on-lend the funds to eligible credit institutions in return for collaterals. The bonds issued by the SFEF have a maturity of less than 5 years. The

[20] General government gross debt for 2010 already includes the debt effect resulting from the FMS Wertmanagement since it was allocated to the general government sector in national accounts.
21 Cf. European Commission, State aid N613/2008 – French Republic, Capital-injection scheme for banks, Brussels, 8. December 2008.
22 Cf. European Commission, State aid N548/08 – French Republic, Scheme for refinancing financial institutions, Brussels, 30. October 2008.

total amount of guarantees which can be granted to the SFEF is limited to 265 bn euro.[23]. All guarantees provided by the French government are unconditional, irrevocable and payable on first demand. The objective of this refinancing scheme is supporting the lending capacity to the economy which has been seen as distorted due to the financial crises.

The SFEF is a company incorporated in France and has an own capital of 50 million euro of which 66 % is held by 7 French banks and 34 % by the French government. Thus the SFEF in general should be considere a private company. However according to its 34 % share the French government has a blocking minority through which important decisions can be prevented. Although the SFEF does not possess a banking licence in order to avoid the application of the Basel solvency rules it is supervised by the French Banking Commission.

Each credit institution carrying out refinancing transactions with the SFEF has to provide eligible collaterals as defined under the law. The collaterals are valued by the SFEF and are also subject to haircuts according to an order from the Minister of Economic Affairs. The haircut varies from 10-40% according to the type of assets provided by the credit institutions.[24] Thus the gross value of the assets provided by the credit institutions as collaterals exceeds the amount of loans under government guarantee provided by the SFEF.

Sector classification of SFEF

The main characteristics of the SFEF are:

- Created during the financial crisis,
- Majority private ownership,
- Timely restricted existence,
- Government guarantee and
- Benefiting banks have to provide eligible collaterals.

In accordance with the Eurostat decision of July 2009 the SFEF should be classified outside the general government sector, because of the special provision concerning units with a majority private ownership. A second point of potential importance is the risk of losses for government, due to the guarantees it provides. However, the risk of losses for government in this case can be assumed negligible, because of the required provision of eligible collaterals by the benefiting bank. In the event that a government guarantee is called, government may use the collateral to avoid or at least substantially reduce the risk of losses. This meets the requirement of the Eurostat division with regard to the small losses for government and allows classifying the SFEF outside the government sector.

Accounting consequences of SFEF

By applying the Eurostat decision of July 2009 the debt of the SFEF is excluded from general government debt. In the extreme case of a full call of the government guarantee (265 bn

[23] European Commission, State aid N548/08 – French Republic, Scheme for refinancing financial institutions, Brussels, 30. October 2008, page 2ff.
[24] European Commission, State aid N548/08 – French Republic, Scheme for refinancing financial institutions, Brussels, 30. October 2008, page 5.

Euro), this would lead to a difference of 14 percentage points in the government sector debt ratio. However, the factual debt increase, which in accordance with the Eurostat decision is dealt with outside general government, is much lower, although not negligible. In 2008 the borrowing of the SFEF amounted to 13 bn Euro and in 2009 to 64 bn Euro. As a consequence, total debt at the end of 2009 added up to 77 bn Euro, representing 4 % of GDP. The development of the total debt is shown in the subsequent table.

Table 3: General Government and SFEF gross debt as percentage of GDP[25]

Year	Debt (% of GDP)	
	General government	SFEF
2007	63,9	0,0
2008	67,9	0,7
2009	78,3	4,0

3.2.2 The National Asset Management Agency (NAMA)

The Irish government implemented several measures to get the consequences of the financial crisis in the banking sector under control and maintain the stability of the financial system. The measures include in particular state guarantees for the deposits, senior debt and subordinated debt of explicitly named Irish credit institutions which was lateron extended to all credit institutions, a recapitalisation programme for credit institutions and the creation of a new unit to acquire land and development loans from banks via the National Asset Management Agency (NAMA).

NAMA has been established on a legal basis under the control of the National Treasury Management Agency (NTMA), which carries out, among others, the borrowing and debt management functions for the Irish Ministry of Finance.[26] NTMA is also a kind of service provider to NAMA which includes information technology, human resources, internal control, financial management etc. The NAMA Board consists of nine members of which six members are directly appointed by the Ministry of Finance. The functions of the Board are setting the strategic objectives and targets for NAMA and ensuring that NAMA meets its strategic objectives by establishing the appropriate systems and procedures. The whole business of NAMA is required to run on a commercial basis.

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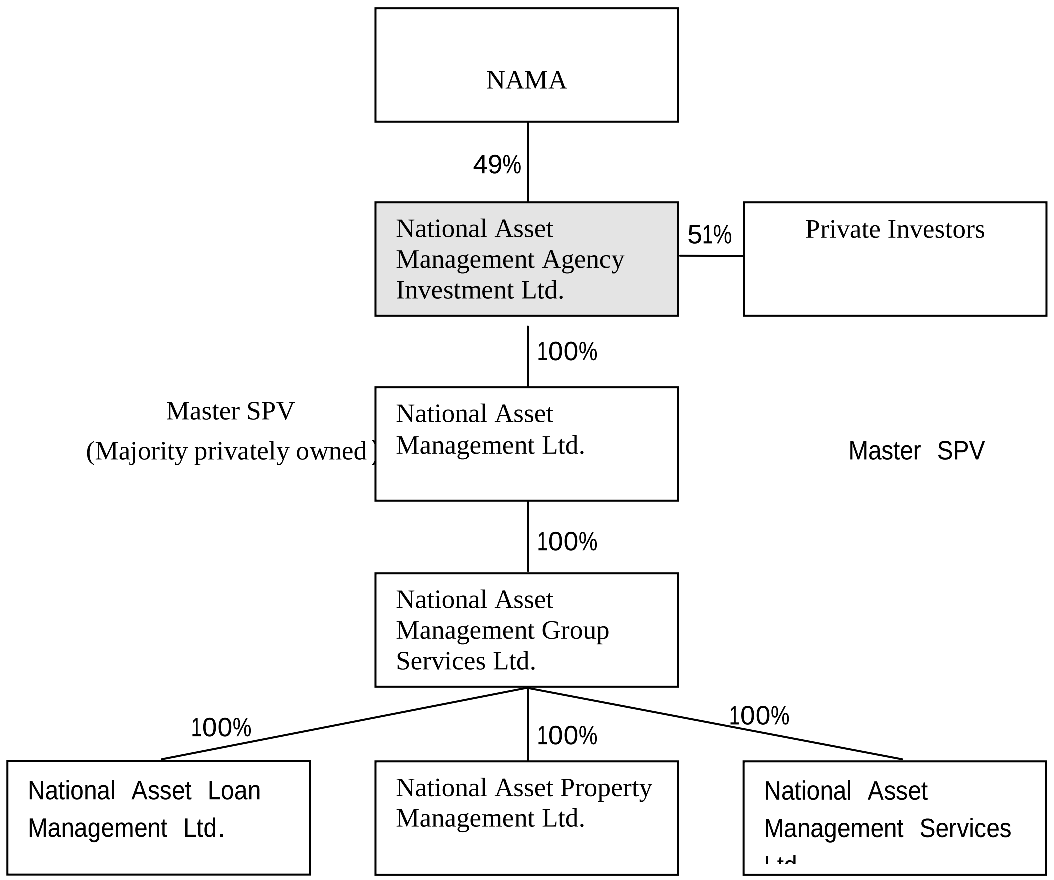
[25] Reporting of Government Deficits and Debt Levels in accordance with Council Regulation (EC) N° 479/2009, as amended and the Statements contained in the Council minutes of 22/11/1993, EDP Notification Tables, April 2011, Institut National de la Statistique et des Etudes Economiques: Notification du deficit et de la dette publics de l'autonomne 2009: Traitement comptable des interventions publiques en faveur du secteur finanicier dans le cadre de la notification du déficit et de la dette publics à la Commission européenne, Le 30 septembre 2009. Mayer Brown, Summary of Government Interventions in Financial Markets, France, 8 September 2009, page 3 ff.

[26] NATIONAL ASSET MANAGEMENT AGENCY BILL 2009

NAMA acquires the land and development loans at a discount since the underlying property collaterals have lost value in comparison to the issue date of the loans. The haircut for the first tranche of loans acquired by NAMA amounted on average to 50% with a range between 35 % and 58% in relation to the five participating credit institutions. Thus the loans acquired by NAMA are not recorded with their book value on its balance sheet which is a basic difference compared to the German approach in dealing with the risky assets where the book value is recorded on balance sheets of the liquidation sub-agencies. Whereas the haircut assures that NAMA probably will not make any losses through the acquired assets, the Irish banks transferring the assets have to bear the full effects of the haircuts.

Chart 3: NAMA corporate structure



NAMA makes use of several Special Purpose Vehicles (SPVs) and subsidiaries to carry out all tasks and operations in connection with the valuation, purchase or repurchase etc. of the impaired loans. The National Asset Management Limited (Master SPV) plays a key role in the established group structure since it is responsible for issuing the government guarantee securities with which the loans are acquired from the credit institutions. The Master SPV itself has also created three subsidiaries and one SPV which

- are responsible for the purchase, holding, management and disposal of the loan assets from the participating institutions,
- take ownership of real property assets if acquired,
- are responsible for administration and banking affairs.[27]

The holding company of the Master SPV is the National Asset Management Agency Investment Limited which was established to permit the participation of private investors in the Master SPV (see chart 1).[28]

According to the implemented holding structure the Master SPV is majority privately owned unit, where private investors are holding 51% and the public owned NAMA holds 49% of the capital. Despite the fact that the private investors have de facto the majority of the ownership NAMA retained a veto right over all operations carried out by the Master SPV. Furthermore a special provision in the legal arrangements in connection with the creation of the Master SPV put a ceiling on the possible annual return to private investors. The annual return to private investors is "linked to the Irish government 10 year bond yield at the time it is declared with the potential upside of 10% of capital invested to be paid at maturity."[29] All additional profit or loss will be distributed to NAMA.

According to the fourth quarter 2010 report, NAMA respectively the Master SPV, had acquired around 71 bn euro in loans from the five participating credit institutions, for which NAMA has paid around 30 bn euro. Thus the haircut for all loans transferred to NAMA average out to 58% up to now. In general NAMA could finance the purchase of the loans either through government securities or NAMA government guaranteed securities. Using directly government securities would have an immediate impact in the government gross debt whereas the debt impact of NAMA government guaranteed securities is depending on the sector classification of NAMA which will be discussed in more detail below. The credit institutions can use the securities obtained in exchange for the loans disposed of to NAMA as collateral in capital market or central bank transactions in order to receive liquidity.

Sector classification of NAMA

For the classification of the NAMA and its Master SPV, the Central Statistics Office of Ireland requested Eurostat for an advice[30] on their sector classification. According to the Eurostat Advice which is based on the Eurostat decision of 15 July 2009 on the statistical treatment of public interventions to support financial the following classification results: NAMA is to be classified to the general government sector (S.13) and the Master SPV has to be classified in the Financial Corporations sector (S.12).

For NAMA the Eurostat advice is very short but it could be concluded that Eurostat considers NAMA not as institutional unit since only in this case the sector classification for publicly owned units is clear.

27 NAMA QUARTERLY REPORT (Section 55 NAMA Act 2009) 31st of December 2010, page 8.
[28] Cf. National Asset Management Agency, NAMA BUSINESS PLAN, 30th June 2010, Appendix D.

[29] Cf. National Asset Management Agency, NAMA BUSINESS PLAN, 30th June 2010, page 15f.
30 European Commission (Eurostat) Preliminary view on the ESA 95 accounting treatment of the National Asset Management Agency (NAMA) and related majority privately owned SPV, 16. October 2009.

In the case of the Master SPV the Eurostat advice considers three elements as essential for the classification: The (1) purpose and the (2) duration of the Master SPV and (3) the possible expected losses for general government as a result of its activities.

Since the Master SPV is majority-privately owned operates like a market unit, is established for a short temporary duration and has a sole purpose to address the financial crisis and the exposure of government to losses is small (haircuts), the master SPV is classified in the financial corporations sector.

Accounting Consequences of NAMA

Because of the allocation of the Master SPV to the financial corporations sector no direct general government deficit and debt effects occur through the operations of this unit. However indirect deficit and debt effects are resulting from the necessary recapitalisation of the transferring banks due to problems with regulatory capital requirements since the haircuts involve a destruction of own capital.

Table 4: General Government and NAMA gross debt as percentage of GDP

Year	Debt (% of GDP)	
	General government	NAMA (Master SPV)
2008	44,4	0,0
2009	65,6	0,0
2010	96,2	18,6

Data source: EDP Notification Tables, April 2011, Supplementary tables on financial turmoil April 2011, own calculations.

4. Impact assessment of alternative rescue concepts

4.1 Bad banks: NAMA versus liquidation sub-agencies

Due to the classification of the Master-SPV outside the government sector, there was no initial impact of its operations on general government's deficit and debt. In comparison to the German liquidation sub-agencies, the Irish NAMA solution may therefore be considered more advantageous. But in addition to the initial impact the longer-term repercussions have to be taken into account as well. An important point in this respect is the valuation of the impaired assets. The Master-SPV did not take over the impaired assets at their (original) book value, but at a substantially reduced value by applying so-called haircuts (see above). This at the same time implies for the banks selling the impaired assets that they had to bear substantial losses and balance sheet depreciations. To meet the international equity standards, this in turn required substantial government capital injections into the banks concerned. These government capital injections do have an impact on general government's deficit and debt, in addition to the fact that they burden the actual budget. From the longer-run perspective the initial zero impact of the Irish NAMA solution was to a large extent reduced by later government payments.

In comparison, the German liquidation sub-agencies are included in general government, implying that particularly government debt was increased in the beginning. This impact was reinforced by the fact that the impaired assets were taken over with a value close to their book values. On the other hand, given that book values were used when transferring the impaired assets to the liquidation sub-agencies, the banks concerned did not have to bear big losses and additional capital injections from general government were not required. The impact on government deficit was restricted due to the uncertainty about the market value. Instead, mostly the so-called real economic values from the state aid decisions were used. However, since these real economic values usually are higher than the market values (at the time of transfer), there may be an impact on the German government deficit in the following years as well. This is different in the case of the Irish NAMA solution, where the deficit impact is concentrated in the initial period. The reason is that the Eurostat decision requires comparing the sales proceeds with the original transfer values. If there is a negative difference, i. e. lower sales proceeds, the difference is to be included in government deficit (of the period of sale)[31].
When the assets are kept until maturity the potential gain or loss is treated as holding gain or loss. The basic idea of the German liquidation sub-agency solution is to play on time and bet on better market conditions for the sale of the impaired assets. This strategy has to accept an increased debt level in the transfer period and a potential deficit impact during the following years. It seems useful to mention, that this solution does not cause an actual budgetary burden in the beginning.

4.2 The refinancing company SFEF

Assessing the characteristics of the SFEF on the basis of the classification rules of ESA-1995 (instead of the provisions of the Eurostat decision of July 2009), it seems doubtful whether this unit can be classified outside the government sector. For instance, the ratio of own capital (50 mill. Euro) to potential debts of the unit (265 bn Euro) is extraordinarily high. This can only work because of government guarantees. In addition, general government has a veto-right in the case of essential decisions and has the right to nominate the chair of the board although its share in voting rights only amounts to 34% (and that of the private owners to 66 %). Furthermore, government by legal provisions specifies essential parts of the SFEF activities in advance. This concerns for instance the conditions for collaterals to be provided by the benefiting banks or the haircuts to be applied by the SFEF. Moreover, one could argue, that the activity carried out by the SFEF is not a market activity since the main purpose of providing the financial support is to stabilize the French financial market which is in the interest of the general public.

In a first assessment the SFEF had been classified inside the general government sector[32]. This classification was fully justified by the results of a consultation among the experts of the Committee of Monetary, Finance and Balance of Payments Statistics (CMFB). The consultation was launched by Eurostat well before its decision of July 2009 with the intention to develop harmonized accounting rules for supporting measures used by governments in times of the global financial crisis. With regard to the classification of units it was the opinion of the CMFB that a majority privately owned unit should be allocated to the government sector when

1. the unit primarily carries out or finances non-market activities for the benefit of the society as a whole or

[31] One should add, that in case of a surplus (e. higher sales proceeds), this is not to be included in the government deficit but dealt with as holding gains (asymmetric treatment)
[32] Cf. Institut national de la statistique et des études économiques: Notification du deficit et de la dette publics de l'autonomne 2009: Traitement comptable des interventions publiques en faveur du secteur finanicier dans le cadre de la notification du déficit et de la dette publics à la Commission européenne, Le 30 septembre 2009.

2. general government determines the activities of the unit **and** at the same time assumes the major part of the risks accruing from the unit's activity for instance by providing a guarantee.[33]

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Applying this to the French SFEF, both points offer a basis to include it inside general government. In the end the SFEF is in charge to provide banks with liquidity, to overcome the credit crunch of the different economic agents (at conditions which possibly no market unit would have regarded as profitable or acceptable). One could argue that the goal of the SFEF activities was to avoid further damage from the French economy to the benefit of the society as a whole.

In addition, the activities of the SFEF are to a large extent pre-determined, for instance with regard to the quality of the collaterals or the haircuts (cf. above). Such types of obligation mainly concern the current business operations. Moreover, the state guarantee has to be taken into account, which enables an extraordinary relationship between own funds (50 mill. Euro) and potential debts (250 bn Euro).

As a .result, it seems justified to state that the classification of the SFEF differs depending on the rules which are applied. On the basis of the results of the CMFB consultation as well as according to the general provision of ESA-1995 the SFEF should have been classified within the government sector, whereas the Eurostat decision of July 2009 allows classifying it outside general government.

A further question is, whether the type of activity carried out by the respective unit may justify a different accounting treatment. In comparison to the German liquidation sub-agencies, the SFEF seems not to buy impaired assets but provides loans to banks (against collaterals) in order to overcome the re-financing difficulties caused by the financial crisis. However, if the activity carried out has an impact on the sector classification, on cannot explain, why German bad banks are treated different than the Irish NAMA. By contrast, one could also stress the similarities of the units considered. In this respect it seems obvious that all units are under the control of the respective general government, that the equity of all units is not sufficient to bear the risks of the financial activities and that therefore all units considered benefit from comprehensive state guarantees.

5. Conclusions

1. Due to the legal requirement of EU Member-States to transmit each half year (before 1 April and before 1 October) accurate and comparable data on government deficit and debt for the purpose of the budgetary surveillance under the European Stability and Growth Pact, Eurostat developed provisions to deal with a completely new situation, i.e. the consequences of the global financial crisis. Among others, in July 2009 Eurostat took a decision on the classification of units created by several governments to carry out rescue operations

2. As a consequence of the Eurostat decision, which introduced ownership as a criterion for the sector classification, comparable rescue units can be treated in different ways. This seems obvious in the case of the German liquidation sub-agency, which is within the government sector and the Irish NAMA, which is outside the government sector, although both can be considered as a so-called bad bank acquiring impaired assets and benefiting from comprehensive state guaranties.

[33] CMFB opinion concerning statistical accounting consequences for government of the financial turmoil, 18 March 2009.

3. As a consequence of the sector classification according to the Eurostat decision differences in the deficit and debt data of general governments occur. The differences have an impact not only on the initial amounts to be included in government deficit and debt, but may also have repercussions on deficit and debt data in later periods. Under certain circumstances, there can be compensating effects.

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