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Directorate D: Government Finance Statistics (GFS) and quality

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**Subject: Recording of the winding down of Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A.**

**Ref.: Your letter ref. n. 860371/17 of 4 August 2017 and your emails of 31 October 2017, of 12 December 2017 and two emails of 28 March 2018**

Dear Mr Oneto,

Following your letter of 4 August 2017 and subsequent exchanges, Eurostat would like to provide you with its opinion on the recording of transactions related to the orderly liquidation of Banca Popolare di Vicenza and Veneto Banca in national accounts.

## **1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED**

The issue for which an opinion is being sought is the appropriate recording in national accounts of the operation relating to the winding down of Veneto Banca S.p.A and Banca Popolare di Vicenza S.p.A., and the sector classification of the Liquidator managing the assets of residual entities in liquidation.

### **1.1 Documentation provided**

The Italian statistical office (Istat) in its letter of 4 August 2017 clarified the background of the crisis of the two banks that resulted in the decision on their liquidation and described the content of the Decree Law n.99/2017 that regulates the disposal of 'good assets' of the two banks to a third party and the liquidation of the remaining assets in residual entities.

In its analysis, Istat proposed three recording options having different impacts on the government deficit and debt. As concerns the sector classification of the Liquidator, Istat briefly described the basic features of the entity, without providing a final view on its sector classification.

## 1.2 Description of the case

Veneto Banca S.p.A. and Banca Popolare di Vicenza S.p.A. are two small Italian commercial banks, located in the Veneto region. In the past, both banks had already received liquidity support from government. After several years of continuous deterioration of financial performance, in June 2017 the SSM/ECB concluded that both banks are "failing or likely to fail" and Italy notified to the Commission an orderly liquidation of the Veneto Banca and the Banca Popolare di Vicenza. The orderly winding down of the two banks and related operations were regulated by the Decree Law no.99/2017, which was converted to Law in July 2017.

In the first phase of the winding down procedure, assets and liabilities of both banks were transferred to the Liquidator that was established according to the Decree Law and pursuant to the compulsory liquidation process ('liquidazione coatta amministrativa'). The Liquidator sold 'good' assets and most liabilities of these two banks to Intesa Sanpaolo S.p.A. (a commercial bank classified in S.12). The 'bad' assets and selected liabilities remained on the Liquidator's balance sheet, i.e. non-performing loans (NPLs) for the nominal value of 18.9 billion EUR and equities (1.7 billion EUR) on the asset side, and shareholders' equity (4.0 billion EUR), subordinated debt (1.2 billion EUR) and other liabilities (1.0 billion EUR) on the liability side. The Liquidator also incurred an obligation for an amount of 5.4 billion EUR, later on revised to 6.4 billion EUR towards the Intesa Sanpaolo which originated from the negative net value of the assets and liabilities taken over by Intesa Sanpaolo<sup>1</sup>. This obligation is guaranteed by government up to the maximum amount of 6.4 billion EUR.

To cover costs relating to the restructuring of acquired activities and capital needs, the Italian government provided to Intesa Sanpaolo two capital injections in cash for an amount of 3.5 billion EUR and 1.3 billion EUR. In addition to the cash injections, government granted to the Intesa Sanpaolo a guarantee on the possibility to return, within the following two years, any high risk loans belonging to the asset portfolio transferred to Intesa Sanpaolo, currently still not classified as NPLs, for a maximum amount of 4.0 billion EUR. For the benefit of the Liquidator, the government provided a guarantee to cover potential legal risks and violations or noncompliance of banks' previous commitments up to a maximum amount of 2.0 billion EUR.

The Italian government acquired a senior claim towards the Liquidator for an amount of 4.8 billion EUR which is supposed to be paid from the NPLs' recoveries or sales of the remaining assets. In their note, the Italian authorities declared that the NPLs are to be recovered over 10 years, of which 80% within five years and 97% within eight years. According to the seniority stipulated by the Decree Law, the government claim is to be repaid after the claim of the Intesa Sanpaolo and before claims of other remaining creditors.

In accordance with the 2013 Banking Communication, claims of the banks' shareholders and subordinated creditors were written down (burden-sharing principle) prior to the capital injections provided by government. According to the Decree Law, junior bondholders, i.e. individuals, entrepreneurs, farmers owning junior bonds, can apply for compensation of losses which is to be paid by the Solidarity Fund, managed by the Fondo Interbancario di Tutela dei Depositi (FITD).

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<sup>1</sup> The preliminary estimate of the negative net value of 5.4 billion EUR, i.e. assets 45.9 billion EUR minus liabilities 51.3 billion EUR (Bank of Italy source), was later on revised to 6.4 billion EUR calculated as a difference between the value of assets 43.3 billion EUR and liabilities 50.2 billion EUR and taking into account deferred tax assets of 425 million EUR (Due Diligence report, p.115).

The Decree Law specifies that the Liquidator assigns the NPLs to a government controlled entity - the Società per la Gestione delle Attività (SGA, classified outside S.13), which is to be involved in management and administration tasks. Eurostat understands that SGA is not exposed to risks and rewards on this portfolio, operating on an agent basis.

## **2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT**

### **2.1 Applicable accounting rules**

The following accounting guidance is relevant for this case:

- ESA 2010 paragraph 4.164 on other capital transfers, paragraph 20.46 on the classification of entities, paragraph 20.223 on the debt assumption and cancellation, paragraphs 20.244-20.247 on defeasances and bailouts and paragraphs 20.256-20.257 on one-off guarantees;
- MGDD Chapter IV Financial defeasance;
- Eurostat Guidance note of 2009 *"The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis"* and Guidance note of 2012 *"The impact of bank recapitalisations on government finance"*, updated in 2013 by Eurostat Decision on the *"Clarification of the criteria for the recording of government capital injections into banks"*.

### **2.2 Availability of national accounting analysis by Istat**

Istat provided in its analysis three recording options which have a different impact on the government deficit and debt, also depending on the sector classification of the Liquidator.

Following Eurostat's request, Istat provided an updated analysis that took into account the recording of the operation on a net impact basis, i.e. the expected cash outflows relating to cash transfer of government and the estimated guarantee calls, minus the expected cash inflows from recoveries of bad assets. To quantify the amount of expected recoveries, Istat used the historical recovery rates compiled by Bank of Italy, published on its website in 2017.

Concerning the sector classification of the Liquidator, Istat provided a brief analysis of the basic features of the Liquidator without having a final view on its sector classification.

As regards the compensation measures to junior bondholders, no impact on government accounts was foreseen by Istat. According to the Decree Law, possible compensation will be provided by the Solidarity Fund, which is managed by the FITD, classified outside S.13.

### **2.3 Eurostat's analysis**

#### Classification of the Liquidator

The winding down procedure for both banks was stipulated by the Decree Law that also appointed the Liquidator responsible for the management and future disposal of the bad assets and the settlement of remaining liabilities. In particular, the bad assets concerned the NPLs, shares and equity which remained in the residual entities, after the "good" part of the assets was sold to Intesa Sanpaolo.

ESA 2010 paragraph 20.46 defines the defeasance structures or the bad banks dealing with impaired assets that may be set up in banking or other financial crisis. Such defeasance structures should be *"classified according to the degree of risk it assumes, considering the degree of financial support of the government."*

In the case of Veneto Banca and Banca Popolare di Vicenza, there was no specific defeasance structure set up by government, but the impaired assets remained in the residual entities controlled by the Liquidator. In this context, the MGDD Part IV.5.2 paragraph 10 (2)b is relevant: *"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 generally the main shareholder, directly or indirectly through other public bodies)."*

The Liquidator has an obligation towards Intesa Sanpaolo for an amount of 6.4 billion EUR that resulted from a negative value of the "good" part of the assets net of liabilities transferred by the two banks in liquidation. The claim of Intesa Sanpaolo will be repaid from NPLs proceeds in the future and, according to the seniority rule, it is senior to the government claim (4.8 billion EUR). In addition, the claim of Intesa Sanpaolo is covered by a government guarantee up to the maximum amount of 6.4 billion EUR.

The MGDD Part IV.5.2 paragraph (11) foresees that *"When there is evidence that government is assuming all or the majority of the risks and rewards associated with the activities of a government-controlled defeasance structure, as described above, this structure is classified in the general government sector, whatever its legal status. For instance, government is committed to cover the majority of the expected losses from the assets, through providing guarantees on the financing of the entity holding the problematic assets and the guarantee fee is not in line with the risks involved, or that the main source of financing is from the public sector."*

Following the analysis above, government is materially exposed to the risks associated with the residual value of the portfolio managed by the Liquidator, including recovering NPLs proceeds in the future to pay out the Intesa Sanpaolo's claim. On this basis, Eurostat considers that the Liquidator and/or its Portfolio (should the Liquidator be seen as a mere auxiliary/agent) are to be classified inside the general government sector.

#### Recording of the government interventions

In the context of the liquidation of both banks, the Italian government undertook the following measures:

- cash transfer (3.5 billion EUR) to cover capital needs of Intesa Sanpaolo and a cash transfer (1.3 billion EUR) to cover the cost of restructuring measures, both provided to Intesa Sanpaolo;
- government guarantee (6.4 billion EUR) to Intesa Sanpaolo to cover the negative difference between assets and liabilities acquired from the two banks in liquidation;
- government guarantee (4.0 billion EUR) to Intesa Sanpaolo in relation to the asset protection scheme;

- government guarantees on ongoing legal disputes taken over by Intesa Sanpaolo (491 million EUR) and on other legal risks (1.5 billion EUR).

Eurostat considers that the government interventions relating to the winding down of Veneto Banca and Banca Popolare di Vicenza are to be recorded in accordance with the net impact approach. The net impact approach consists in recording as capital transfer the difference between the consideration (cash, debt assumed, fair value of guarantees granted...) provided to third parties in the context of a defeasance structure and the expected recoveries (mostly on the portfolio of impaired assets acquired). This approach is supported by ESA 20.223, 20.244, 20.245, 20.247, 20.256 and 20.257.

ESA 20.244 indicates that a bail out can take place through creating specific bodies to manage assets, through purchasing assets, or through providing guarantees.

ESA 20.245 indicates that such guarantees lead to a capital transfer at inception, as if called at inception (ESA 20.256), for the expected loss of government in case a reliable estimate is available. Otherwise, a capital transfer for the full amount of the guarantee is to be recorded.

ESA 20.247 indicates that the purchase of loans leads to a capital transfer corresponding to the difference between the purchase value and their market value. When there is no reliable information (or information that the loans are all or mostly unrecoverable) a full capital transfer is to be recorded.

ESA 20.223 indicates that, on a debt assumption, a claim is recorded for the amount expected to be recovered, and the difference with the debt assumed is a capital transfer. Finally, ESA 20.257 indicates that the activation of one-off guarantees is treated in the same way as debt assumptions.

This approach is also consistent with the 2009 Guidance note in point 6, step 6 (released under ESA 1995): *"Where the statistician concludes that the original valuation was unsoundly based and was too high, a capital transfer, equivalent to the sale value minus the original purchase price, is recorded at the time of sale from government to the unit which sold the assets to government. A capital transfer to government should not be recorded if the value at which the asset is sold by government is higher than the value at which it was purchased by government."*

Thus, the impact on the government deficit is to reflect, at the time of government intervention, the difference between the expected inflows from bad assets recoveries (mainly NPLs) and the expected government outflows relating, apart from the cash transfer, to the expected cash calls of guarantees.

#### Estimation of cash inflows

Expected cash inflows concern future recoveries of the assets remaining in the residual entities. In particular, those are the NPLs for an amount of 18.9 billion EUR that mainly consist of "bad loans" ("sofferenze") for 10.0 billion EUR and of "unlikely-to-pay (UTPs) loans" for 8.4 billion EUR, and shares and other equity (1.7 billion EUR). As concerns the sales of impaired loans, the existing market is considered rather undeveloped due to a limited number of transactions and, therefore, the Italian authorities decided to maximise recoveries by following a so-called "patient approach", i.e. extending the recovery period over a ten years' horizon. The recovery rates used in the calculation by the Italian authorities in the updated note are consistent with this approach.

In its communication, Eurostat stressed that the precondition for the net impact approach is the availability of a reliable and conservative estimate of recovery rates, made by an independent body. The recovery rates provided by Istat resulted from a Bank of Italy's analysis of the data from the Central Credit Register over 2006-2015, excluding foreign bank subsidiaries, financial companies and banks specialised in leasing or in recovery activities, and institutions under resolution or in comparable situation. Due to the non-availability of actually recovered amounts, the analysis used, as a proxy, the difference between the gross value of the exposure and the accumulated losses. Eurostat considered these recovery rates as not prudent enough. In addition, recovery rates need in general to be established by independent parties.

The net impact approach uses the concept of market value and the real economic value (REV) where the latter one is defined in the Impaired Asset Communication<sup>2</sup> as follows: *"To ensure consistency in the assessment of the compatibility of aid, the Commission would consider underlying long-term economic value (the 'real economic value') of the assets, on the basis of underlying cash flows and broader time horizons, an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary."* As the market value does not seem to reflect all elements in this particular case, mainly due to the dysfunctional market with NPLs, Eurostat considers that the REV can be used.

In the absence of an independent and reliable estimate, Eurostat has used the source data provided by the Italian authorities to the European Commission (DG Competition) for the purpose of the assessment of state aid measures in the same case. Following the valuation criteria of the Impaired Asset Communication, the portfolio of UTPs sold to Intesa Sanpaolo, covered by the asset protection scheme, is estimated to have a REV of 43% of the gross book value and a market value of 30-36%. Following the previous arguments, Eurostat considers that the expected inflows from the recoveries of both the UTPs transferred to liquidation and the UTPs transferred by Intesa Sanpaolo within the asset protection scheme, have to be calculated based on this REV of 43%.

As concerns the bad loans, Eurostat takes note that the REV was neither determined nor examined by DG Competition, due to the fact that the portfolio of bad loans remained in the residual entities. For this purpose, Eurostat decided to refer to the precautionary recapitalisation of Monte dei Paschi<sup>3</sup> that took place in June 2017. In that case, a portfolio of bad loans was transferred to a newly created securitisation vehicle for a price of 21% of their gross book value in June 2017, i.e. a date close to the decision on the liquidation of the two banks. It is assumed that the features of this portfolio are comparable to the portfolio of bad loans owned by Veneto Banca and Banca Popolare di Vicenza, and that the market value of 21% can be accepted as a technical hypothesis for the current estimation. By applying the same ratio of REV-to-market value<sup>4</sup>, observed for the category of UTPs, to the category of bad loans, the REV estimated for bad loans is 27.4%. Eurostat considers that the estimated REV 27.4% is to be applied to calculate the expected cash inflows from the bad loans' recoveries.

In its updated note, Istat assumes that the shares and other equity from the liquidation portfolio will be sold at their carrying amounts, i.e. 1.7 billion EUR. The portfolio includes several companies, mainly from the financial sector, including one quoted in the market. Eurostat can agree with the evaluation of Istat that the equity and shares remaining in the

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<sup>2</sup> [http://ec.europa.eu/competition/state\\_aid/legislation/impaired\\_assets.pdf](http://ec.europa.eu/competition/state_aid/legislation/impaired_assets.pdf)

<sup>3</sup> [http://ec.europa.eu/competition/state\\_aid/cases/270037/270037\\_1951496\\_149\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/270037/270037_1951496_149_2.pdf)

<sup>4</sup> Market value in this formula is calculated as an average of the estimated bid and ask.

residual entities will be recovered for their full amounts. A number of transactions have already taken place for values close to the estimated value.

Using the market value, rather than REV, for the estimation of the net impact on the deficit at inception, would imply the recording of holding gains or holding losses in the future in case recoveries would turn out different from those expected at the time of the rescue operation. However, when using the REV, future losses could be recorded as expenditure at the time of realisation, or revised backwards<sup>5</sup>.

#### Estimation of cash outflows

Eurostat agrees that the two cash transfers provided by government to Intesa Sanpaolo to cover the capital needs (3.5 billion EUR) and the cost of the restructuring measures (1.3 billion EUR) are to be considered as impacting negatively the government B.9. This is also consistent with ESA 4.164: "*... transfers other than investment grants and capital taxes which do not themselves redistribute income but redistribute saving or wealth among the different sectors or subsectors of the economy or the rest of the world. They can be made in cash or kind (cases of debt assumption or debt cancellation) and correspond to voluntary transfers of wealth.*"

The Italian government provided a set of guarantees to Intesa Sanpaolo in the context of the liquidation of the two banks. ESA 20.245 foresees that "*Government guarantees during a bailout are treated as one-off guarantees to entities in financial distress. An example is where the entity is not able or has substantial difficulties to meet its obligations since its cash generating abilities are limited or the tradability of its assets is severely limited due to exceptional events. This will normally lead to recording a capital transfer at inception, as if the guarantee were called, for the entirety of the granted guarantee or, in case a reliable estimation is available, for the amount of the expected call, which is the expected loss of government.*" On this basis, Istat provided an evaluation of the impact of expected guarantee calls.

First, the claim of Intesa Sanpaolo (5.4 billion EUR) resulting from the negative value of the difference between the assets and liabilities acquired from two liquidated banks in June 2017, was guaranteed by government up to a maximum amount of 6.4 billion EUR. The first estimation of the value was revised upwards to 6.4 billion EUR, following a due diligence exercised according to the Decree Law in February 2018. Therefore, Eurostat agrees with the estimation of Istat that the guarantee will be called for the maximum amount, i.e. 6.4 billion EUR, having a negative impact on government deficit in 2017.

Second, within the asset protection scheme guaranteed by government, Intesa Sanpaolo has a right to transfer back to the Liquidator any loans which turned out to be UTPs within a certain time period. In this case, Intesa Sanpaolo would share 15% of losses. Eurostat agrees with the prudent estimation of Istat that, in accordance with the risk sharing mechanism, 85% of the total guarantee, i.e. 3.4 billion EUR is expected to be called and recorded in the deficit in 2017.

Third, as regards the remaining guarantees which relate to legal and other risks, Istat provided an estimation of the Italian authorities presented in the Technical Note accompanying the Decree Law that expects the amounts of 24 million EUR and 100 million EUR respectively,

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<sup>5</sup> The issue is at present being discussed in the Excessive Deficit Procedure Statistics Working Group.

to be called. Eurostat can agree with Istat that the estimated amount of cash calls is also to be recorded in the government deficit for 2017.

### Deficit and debt impact in 2017

As concerns the impact on deficit in 2017, the total expected outflows can be estimated to be 14.7 billion EUR while the total expected recoveries are estimated to be 10.0 billion EUR. As a result, a negative net impact on B.9 should be recorded for an amount of 4.7 billion EUR.

It should be noted that the maximum net outflow could reach 17.2 billion EUR, in the purely hypothetical and totally unlikely case where all guarantees would be called and no recovery proceeds would be collected on the portfolio (some amounts have already been collected).

In relation to debt, Eurostat considers that the Liquidator's obligation of 6.4 billion towards Intesa Sanpaolo constitutes a loan liability (F.4). Taking into account the funding need for the 4.8 billion in cash paid to Intesa Sanpaolo, the debt impact, both direct and indirect, is 11.2 billion EUR.

### Recording of the compensation paid to junior bondholders

The Decree Law defined the compensation scheme that allowed certain groups of junior bond holders to claim compensation from the two banks in liquidation. For this purpose, the Solidarity Fund was established in the past by the Decree no.59/2016 and it is managed by Fondo Interbancario di Tutela dei Depositi (FITD). The FITD is a non-statutory private scheme classified by Istat outside general government (S.12). However, due to its compulsory nature, the statutory part of the guarantee scheme, i.e. contributions received from banks and interventions, is rerouted through government accounts.

Eurostat took note that the Solidarity Fund is managed and also financed by the FITD. According to the Annual Report 2016 of the FITD, the total amount of contributions by the member banks for 2016 was established, also considering the need to replenish resources used for interventions and to finance the Solidarity Fund. In the case of the two banks in liquidation, it was a decision of government (stipulated by the Decree 59/2016) to use funds of the Solidarity Fund for the compensation of junior bond holders.

Based on the considerations above, contributions paid to the Solidarity Fund and its interventions in banks are to be rerouted via government accounts. In the October 2017 EDP notification, the Italian statistical authorities notified to Eurostat that the statutory part of the deposit guarantee scheme, including the Solidarity Fund, was rerouted via government accounts.

## **3. CONCLUSION**

In the view of the analysis above, Eurostat considers that the Liquidator and/or its portfolio have to be classified inside the general government sector.

Concerning the government interventions related to the orderly liquidation of Veneto Banca and Banca Popolare di Vicenza, the operation is to be recorded on a 'net impact' basis, i.e. reflecting, at the time of government intervention, the difference between the expected proceeds from bad assets recoveries (mainly NPLs) and the consideration provided in exchange. The latter comprise government outflows relating, aside from the cash transfer, to



the expected cash calls on the guarantees provided. To estimate the expected revenue, the REV for the categories of UTPs and bad loans can be applied.

On this basis, in 2017 the net impact on B.9 is estimated to amount to 4.7 billion EUR. The direct and indirect debt impact at inception is 11.2 billion EUR.

As regards the recording of the compensation paid to junior bondholders, all flows relating to the Solidarity Fund are to be rerouted through government accounts.

#### **4. PROCEDURE**

This view of Eurostat is based on the information provided so far by the Italian authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, or there may be inaccuracies in the assessment due to the translation risk, Eurostat reserves the right to reconsider its view.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat therefore publishes all official methodological advice given to Member States on its website.

Yours sincerely,

*(e-Signed)*  
Luca Ascoli  
Acting Director