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Centraal Bureau voor de Statistiek
Mr Gosse van der Veen
Director-General
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The Netherlands

Subject: Recording of IABF Guarantee Fee

Ref: Your letter, ref.: 1308-13-EOC dated 6 May 2013

Dear Mr Van der Veen,

In reply to your request for advice, I am in a position to provide you with Eurostat's observations.

The accounting issue

The statistical authorities of the Netherlands have informed Eurostat of their new insights into the recording of the so-called "guarantee fee" in the context of the ING Illiquid Asset Back-up Facility, asking Eurostat to evaluate their proposal and to express its view on the questions raised.

Documentation provided

Statistics Netherlands have provided a description of the case and proposed the accounting treatment.

Description of the case

In January 2009, the Dutch State and the ING group entered into the so-called ING Illiquid Asset Back-up Facility (further – IABF) transaction. 80% of ING's EUR 27.7 billion portfolio of Alt-A residential mortgage-backed securities (RMBS) was acquired by the Dutch State. The State therefore receives 80% of any results of the portfolio. ING remains the legal owner of the securities involved and will remain exposed to 20% of any results on the portfolio. The State repays 72% of the notional amount of the securities to ING by fixed payments. ING pays to government portfolio cash flows and an annual guarantee fee, while the government pays ING an annual management fee and a funding fee.

After their investigation Statistics Netherlands at the time came to the conclusion that the arrangement involved the transfer of economic ownership from the ING group to government and thus the assets were to be reclassified on government balance sheet. The CBS concluded that the counterpart transaction is a loan from the ING group to government. The management fee was considered to be recorded as intermediate consumption (P.2), while the funding fee was split between

a decrease of the principal of the long term loan (F.42) and interest (D.41). The guarantee fee was considered as a financial asset and recorded as transactions relating to long term securities (F.332) (split into F.332 and an interest element D.41). The time of recording proposed by the CBS was the second quarter of 2009.

Eurostat's letter of March 2010 agreed with these conclusions.

Recently Statistics Netherlands further analysed the recording of the "guarantee fee" at the request of the Dutch Ministry of Finance and ING. Having examined the State aid decision No C10/2009 (ex N138/2009) dated 18 November 2009, and its amendments to the guarantee fee, Statistics Netherlands propose to change the recording of the guarantee fee, considering the dependent nature of the financial asset and the fact that there is no distribution of property income (interest), including it in the ESA95 category Financial derivatives (F.34), instead of the originally chosen Securities other than shares (F.332). Moreover Statistics Netherlands also wanted Eurostat's opinion on the deviation between the valuation of the Alt-A portfolio assets mentioned in the Commission's DG Competition decision of No C10/2009 (ex N138/2009) dated 18 November 2009 (being 87% of the portfolio's nominal value) and the valuation of Statistics Netherlands (having calculated the NPV of the guarantee fee payments, the portfolio value amounting to 83% of the nominal value).

Another question was whether the "management fee" element of the guarantee fee could be recorded as a reduction in the original "management fee" recording.

Applicable accounting rules

Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA 95) in Community Legislation in its entirety and is directly applicable in all Member States.

Eurostat's decision and corresponding guidance note "*The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis*", dated 15 July 2009.

The Commission's DG Competition decision of No C10/2009 (ex N138/2009) dated 18 November 2009 and its letter to the Netherlands on 11 May 2012 (on State aid cases SA.33.305 and SA.29.832) are taken into account. No further rulings on the IABF has been made to date.

Availability of national accounting analysis

In their letter the Dutch authorities argue for a different recording on the basis of the State aid decision No C10/2009 (ex N138/2009) dated 18 November 2009, which amends their original understanding of the guarantee fee, in order to provide a better compensation for the Dutch state, involving increasing the guarantee fee (from 55bp to 137.6bp) through three additional measures:

- 1) decrease of the management fee by 15bp (from 25bp to 10bp)
- 2) revision of the transfer price by 52bp (corresponding to a decrease of the transfer price from 90% to 87%),
- 3) claw back adjustment for the period of 26 January to 25 October 2009 by 15.6bp.

In their analysis, the Dutch authorities examine these four parts (the original guarantee fee plus the above mentioned three elements) separately.

For the first part, which aims to reduce the management fee, the proposal is to deduct this element from the original "management fee", recorded as intermediate consumption (P.2).

Concerning the other three parts (the original guarantee fee plus elements 2 and 3 as presented above), Statistics Netherlands conclude that these are financial assets, and in this case, the most appropriate ESA95 category to classify them would be financial derivatives (F.34). According to their reasoning, this category is the closest, because of “*the dependent nature of the financial asset*” and the “*fact that there is no distribution of property income*”. However, they also explain that the guarantee fee is not tradable nor can it be offset on the market, both being key criteria for a classification as financial derivatives according to ESA95.

Statistics Netherlands also provided to Eurostat its model for calculating the net present value of the guarantee fee.

Analysis

This section follows the questions posed by the Dutch authorities in their letter.

1) The management fee element of the guarantee fee

Eurostat agrees with Statistics Netherlands on this issue of recording the management fee element, offsetting these 15bp against the original 25bp, recording therefore only 10bp as intermediate consumption (P.2).

2) The transfer price

See answer for question 4.

3) Guarantee fee as financial asset

Eurostat agrees with Statistics Netherlands that the guarantee fee should be recognized as a financial asset in the system of national accounts.

ESA95 paragraph 7.10 defines assets, saying that these are “*entities functioning as a store of value over which ownership rights are enforced by institutional units.. and from which economic benefits may be derived by their owners by holding them or using them over a period of time*”. ESA95 paragraph 7.20 further defines financial assets in national accounts, which are “*economic assets, comprising means of payment, financial claims and economic assets which are close to financial claims in nature*”. The guarantee fee element of the IABF is in this sense a financial asset, as it “*stores a value*”, provides economic benefit to the Dutch state and, incorporates a financial claim on ING. Therefore it must be recorded in the system of national accounts.

According to ESA95 paragraph 7.22 “*contingent assets are contractual arrangements between institutional units.. which must specify one or more conditions which must be fulfilled before a financial transaction takes place*”. Payment of the guarantee fee is on the other hand automatic; no other condition must be fulfilled by the Dutch state in order to receive this payment. Thus the guarantee fee cannot be considered as a contingent asset.

4) Recording the guarantee fee as financial derivatives (F.34)

Eurostat does not endorse the recording of the remaining elements of the guarantee fee (original guarantee fee plus elements 2 and 3) as financial derivatives (F.34). Financial derivatives, as also mentioned by the Dutch authorities, according to ESA95 paragraph 5.66 have to be tradable or can be offset on the market, in order to be classified in the category F.34.

Moreover, their value must be based on or derived from a different underlying instrument. In order to meet this criterion, the guarantee fee has to be based on the evolving value of the assets (whether fair value or market value). However, according to the “Amended and restated illiquid assets back-up facility agreement”, dated 13 November 2012¹, these parts of the guarantee fee are calculated based on the “*current par value of the securities as per the 26th of January immediately preceding such state payment date*” (point 5.2.b and 5.3). This means that the basis for the calculation of the guarantee fee is not the market (or fair) value of the portfolio but the remaining par value of the portfolio, which is independent of the fluctuation of the fair or market price of the portfolio. In this situation, the only uncertainties over the guarantee fee to be received relate to the possibility that the facility is cancelled before its expected end-date, either through sale of the assets or withdrawal of the guarantee, and the redemption process of the underlying mortgages, but not their actual market value.

Eurostat is more of the view that the original argument of the CBS presented in their note sent to Eurostat on 8 December 2009, that “*The “guarantee fees” are in effect a discount on the value of the securities, that ING supplements over the lifespan of the contract on the cash streams that the Dutch state receives from the securities*” (page 3, last paragraph) is more convincing, even with the new elements introduced in the analysis.

Therefore Eurostat would still consider that the most appropriate ESA95 category remains Securities other than shares (F.332).

Concerning *the transfer price* of the Alt-A portfolio, the Dutch authorities enquire, whether they should change the current value used for ESA purposes (83% of the face value of Alt-A securities) to the judgement of DG Competition (87% of the face value of Alt-A securities).

Regarding the portfolio valuation differences between the EU’s DG Competition and that of the CBS, it has to be noted that these are not based on the same theoretical background.

The value accepted by DG Competition (under EU State aid rules) was based on the understanding that market values are temporarily distressed and that the real long-term economic value (REV) of an asset or portfolio may be higher. Therefore, the value of the impaired asset transfers might be above the market value but not above the REV. The REV was calculated in the ING case at 87%.

In national accounts the valuation rules are different. Loans are recorded on nominal value, therefore, the Dutch authorities recorded the synthetized loan to ING at 90% of its par value. Securities other than shares are however valued at their market value.

Following the above conclusions on the recording of the guarantee fee, the real value of the portfolio (Securities other than shares (F.332)) can only be calculated as the difference between the value of the loan and the net present value of the guarantee fee. According to the calculation of the CBS presented to Eurostat, the difference between these two is 83%, corresponding to the transaction value of the Securities other than shares (portfolio).

5) *Not applicable.*

6) *Cancellation of the guarantee fee*

Statistics Netherlands asked Eurostat how the cancellation of the guarantee fee should be recorded in case there is no compensation paid by ING to the state or is a compensation but it is below the Net Present Value?

¹ <http://www.ing.com/web/file?uuid=b57634e8-0e1a-4be3-af9f-8c90d6baaa31&owner=b03bc017-e0db-4b5d-abbf-003b12934429&contentid=23242>

Since, in Eurostat's opinion, the current recording of the guarantee fee as Securities other than shares (F.332) remains the best option, meaning that the government holds a financial asset, a cancellation without any compensation or a compensation that is below the Net Present Value of the asset, would require the recording of a capital transfer from the government to ING.

Conclusion

Eurostat acknowledges the very detailed and comprehensive work done by the Statistics Netherlands in order to correctly record the IABF in national accounts. Eurostat retains its opinion about the recording of the acquisition of securities as F.332 Securities other than shares as assets, and by a Loan (F.42), as liabilities valued at the Guaranteed Value (90% of the nominal value). Similarly, no changes are foreseen to the ESA categories of the funding fee (split between a decrease of the principal of the long term Loan (F.42) and Interest (D.41)). For the management fee (recorded as Intermediate Consumption (P.2)), Eurostat agrees with Statistics Netherlands that the element of the guarantee fee aimed at decreasing the management fee should be deducted directly from the management fee.

Regarding the other parts of the guarantee fee, Eurostat argues that the current recording as Securities other than shares (F.332) fits more the transaction, rather than financial derivatives (F.34), as these assets are not tradable nor can be offset on the market. Moreover, their value is not based on underlying market/fair value of the assets, but simply the par value, which does not change with the fluctuations of the market/fair value.

Eurostat supports the evaluation of the portfolio as presented by Statistics Netherlands, valuing the portfolio at 83% of the par value after deducting the net present value of the guarantee fee from the Guaranteed value of 90%.

Concerning the cancellation of the guarantee fee without any compensation or a compensation that is below the Net Present Value of the asset, Eurostat thinks that it would require recording a capital transfer from the government to ING.

Procedure

This preliminary view of Eurostat is based on the information provided by the country authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, 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, 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 is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on the Eurostat website. In case you have objections concerning this specific case, we would appreciate if you let us know before 8 July 2013.

Yours Sincerely,



Walter Radermacher