

The Director General

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Bundesministerium der Finanzen
Dr Hans Bernhard Beus
Staatssekretär
Wilhelmstrasse 97
10117 Berlin
Germany

Subject: Sector classification of the Erste Abwicklungsanstalt (EAA)

Ref.: Letter from the Bundesministerium der Finanzen dated 26 March 2010 -GZ VII
A6 -WK 7220/08/10005-04, DDK 2010/0217900
Letter from the Statistisches Bundesamt dated 10 June 2010

Dear Dr Beus,

I would like to inform you that the analysis requested from the German statistical authorities on the classification of the Erste Abwicklungsanstalt has now reached Eurostat.

After a detailed examination of the issue, Eurostat is now in the position to provide its preliminary opinion on the classification of this body.

The case

The issue concerns the classification of a unit established on 11 December 2009, the Erste Abwicklungsanstalt (here referred to as EAA), in order to take from commercial banks (here Landesbanken held by the Länder) some assets. This covers essentially loans, structured securities and negotiable securities. These have been transferred from the bank to EAA that will manage them until maturity.

Documentation provided

The letter of request for the opinion of Eurostat coming from the Ministry of Finance and the analysis accompanying this letter.

The analysis sent on request of Eurostat by Destatis.

Description of the case

a) activities in the Liquidation Institution Model (AidAs)

To deal with the financial crisis in Germany, the *Gesetz zur Fortentwicklung der Finanzmarktstabilisierung* has added further tools to the risk stabilisation measures (guarantee, recapitalisation and the assumption of risk) previously provided for under the

Finanzmarktstabilisierungsfondsgesetz [Financial Market Stabilisation Fund Act] (FMStFG). The extension of the scope of the Act is now enabling banks to set up special entities to which impaired assets or strategically unnecessary activities can be transferred. This will enable banks to reduce their assets without time pressure and to realign their business. The Act specifically refers to two models: the special purpose vehicle model and the liquidation institution model, the second having been developed mainly for *Landesbanken* and is the subject of the present analysis.

The liquidation institution model (AidA) permits a bank to transfer to a liquidation institution its activities that are no longer strategically necessary. An AidA is an institution under public law with partial legal capacity within the *Bundesanstalt für Finanzmarktstabilisierung* (FMSA). The owners of the bank have the same share in the AidA as they have in the core bank and are liable for its losses.

According to the information received, the function of a liquidation institution is to organise activities that are no longer strategically necessary, and also risk positions, in order to reduce them in the medium to long term along commercial lines. In this context, AidAs will undertake an optimum realisation of the transferred assets, operate in such a way as to generate profit and actively manage its loans portfolio. However, AidAs will not receive funds from the public (e.g. deposits), as it will receive as a counterpart of the transfer of assets existing liabilities, of which a large part are guaranteed. The financial institutions will have only a limited banking licence and limited capital requirements (in your note: point 2.2.6 "*An AidA is not formally considered to be a bank within the meaning of the KWG and the European Banking directive. This is designed to exempt the AidAs from the capital liquidity requirement of the KGW.*")

b) characteristics of the Erste Abwicklungsanstalt – First Liquidation Agency (EAA)

Generally, the owners of the AidAs are the same as of the original bank. In the case of the first AidA, EAA, the owners are two public banks (Sparkassenverband Westfalen-Lippe, and Rheinische Sparkassen- und Giroverband, having 25.03234% share each, classified as financial institutions), one state government (Nordrhein-Westfalen) and two associations, both classified in state government. Therefore the EAA is a public entity.

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 benefits first of all from the guarantee of its owners (up to 4.5bn euro) but also, above this amount from the guarantee of the state Nordrhein-Westfalen and of the Financial Market Stabilisation Fund.

c) diverging opinions about the classification of EAA

The Ministry of Finance considers that the First Liquidation Agency (EAA) should be classified outside the general government sector and asked Eurostat to provide its opinion on it. Eurostat, according to the existing regulations, asked the analysis of Destatis on the issue.

Destatis concluded in their analysis that "*Erste Abwicklungsanstalt does not have sufficient capital resources to bear the risks associated with the assets that have been transferred. In addition, the providers of outside capital are released from liability by the owners' guarantee, for example. It is highly probable that if it had been valued on a market basis, Erste Abwicklungsanstalt would have been over-indebted at the time of its foundation, which would have deprived it of any basis for*

classification as a financial intermediary. Although the activities of Erste Abwicklungsanstalt are similar to the activities of a financial intermediary, the way it was set up and the types of measures taken mean that its activities resemble the activities of a financial defeasance body for the purposes of the Manual on government deficit and debt. The Federal Statistical Office therefore considers that this unit should be classified as belonging to the general government sector (S.13). Within this sector, it should be allocated to the Land sub-sector (S.1312), since the form taken by the loss compensation arrangements means that the Land of North Rhine-Westphalia bears most of the risks."

Destatis also points out however: *"The valuations obtained in the EU State aid proceedings may cast light on the value of the assets and liabilities transferred and therefore on the capacity to bear risk of Erste Abwicklungsanstalt. This might then make it necessary to reconsider the sector classification of Erste Abwicklungsanstalt being proposed here."*

Methodological analysis by Eurostat

After examination of the provided documentation and after careful consideration of your position, Eurostat has reached these preliminary conclusions.

Applicable accounting rules

- Manual on Government deficit and debt (MGDD), 2nd edition, Part II.5 *"Financial defeasance"*
- Revised Manual on Government deficit and debt (MGDD) chapter IV.5 on Financial Defeasance,
- Eurostat decision of 15 July 2009 *"The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis"*, http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/FT%20-%20Eurostat%20Decision%20-%2009%20July%202009%203%20final.pdf

Analysis by Eurostat

The Eurostat decision of 15 July 2009 specifically mentions the classification of certain new bodies, which were created to address specific aspects of the financial turmoil.

The decision says that government-owned special purpose entities, which have as their purpose to conduct specific government policies *with no autonomy of decision*, are to be classified in the general government sector.

As an exception, the decision mentions that majority privately-owned special purpose entities, which are established for a short temporary duration and have as sole purpose to address the financial crisis, even if they receive a government guarantee, are to be recorded outside the general government sector.

However, the EAA is not a majority privately owned unit, *therefore this exception does not apply to its classification*.

As far as the question of whether EAA is an institutional unit is concerned, Eurostat has taken note that according to Destatis, the EAA can possibly grant new loans and issue new debt, if necessary. Effectively, the fact that EAA has the mission to *"optimise"* such liquidation means that it would not act passively, but on the opposite could perform an active management with a relatively high degree of independence.

According to the analysis of Destatis, it seems that the EAA merits to be an institutional unit, as it keeps a complete set of accounts and is *considered to have autonomy of decision* (even if "bound by the liquidation plan", the agency has the possibility of take economic decisions, is able to incur liabilities and obligations, and is entitled to own goods and assets in its own right).

In the absence of the liquidation plan, Eurostat is not in the position to judge whether the EAA is an institutional unit or not, nevertheless Eurostat provisionally accepts the analysis of Destatis that the EAA is to be considered as an institutional unit.

Therefore, as concluded by Destatis, it does not seem that the decision of 15 July 2009 can be fully applied when deciding about the classification of the First Liquidation Agency.

On the contrary, the specific case of removing bad assets from a financial institutions' balance sheet is specifically dealt with in the Manual on Government deficit and debt (MGDD) chapter II.5 (new edition chapter IV.5) on Financial Defeasance. This chapter deals with the cases where government is involved, directly or indirectly, in the rescue process of financial institutions, facilitating the financing of the rescue, at least through the granting of guarantees. In this (revised) chapter, paragraph 8 says: *"..where the management of assets are allocated to another entity (not created by government), the sector classification inside or outside the general government sector 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, typically through providing guarantees to the newly created entity, a special purpose vehicle for instance, this would imply that the rescuing entity is "acting on behalf" of the government "*

Consequently, the characteristics of a financial intermediary and the degree of government sponsoring have to be evaluated. (The liquidation agency can not be considered as financial auxiliary, as it does not comply with ESA95 par 2.39).

A financial intermediary *"places itself at risk by acquiring financial assets and incurring liabilities on its own account"* (ESA95 par 2.33). In the case of the EAA (and all other AidAs) it has to be evaluated whether it is placing itself at risk completely or whether on the contrary, this would somehow be limited, because of the undercapitalisation or because of the existence of an extensive government guarantee.

From the analyses of Destatis, Eurostat understands that *"it seems probable that Erste Abwicklungsanstalt does not have sufficient capital resources to bear the risks associated with the assets that have been transferred"*, as a result of the analysis of *"the information supplied concerning book values, the book-keeping system used, the timing of the transactions, the underlying values of the transactions and the assessments of the EU Commission in the EU State aid procedure."* In addition: *"it is highly probable that if it had been valued on a market basis, Erste Abwicklungsanstalt would have been over-indebted at the time of its foundation, which would have deprived it of any basis for classification as a financial intermediary"*(quotes from the analysis of Destatis).

Eurostat is fully aware of the difficulties to assess the "fair" value of the assets that have been transferred but according to Destatis there is strong evidence that these assets have been entered in the balance sheet at a value that is higher than the expected realisation value. Eurostat also agrees that the amount of expected losses is a crucial point to be considered. Eurostat understands that Destatis considers that these will be rather significant, notwithstanding the uncertainty attached to such exercise, and in all cases by far superior to the existing capital of EAA.

In addition, two main shareholders (the two public banks) would be released from their liability of the owners' guarantee as the State government assumes liability in the event of the default of these

two banks. In normal circumstances the owner would have to cover these losses but, according to the analysis of Destatis, in this case the regional commercial banks would have only a limited involvement, so that, finally, the possible losses would be very likely born by the guarantying State Government.

Therefore, Eurostat agrees with Destatis, that EAA cannot be considered, at this stage, as a financial intermediary because it does not place itself fully at risk that is a crucial criterion according to ESA95.

However, as mentioned by Destatis, Eurostat also agrees that further investigations in the on-going State aid procedure and more detailed knowledge on the market value of the assets and liabilities transferred might make it necessary to reconsider the classification of this agency at a later stage.

Conclusions

Eurostat shares the opinion of the Statistisches Bundesamt that the *Erste Abwicklungsanstalt* (EAA) should be classified within the general government sector, allocated to the state sub-sector, S.1312.

However, as mentioned by Destatis, Eurostat also agrees that further investigations in the on-going State aid procedure and more detailed knowledge in the future on the market value of the assets and liabilities transferred might make it necessary to reconsider the classification of this agency at a future stage.

Open issues

Eurostat would like to be informed of any new information, notably as regards the fair or market value of the assets, which would be made available in the future. If possible, Eurostat would like to receive the liquidation plan of EAA.

Procedure

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 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. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than **26 July 2010**.

Yours sincerely,



Walter Radermacher

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