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Directorate D: Government Finance Statistics (GFS) and quality

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Subject: The Bank Assets Management Company (BAMC) and its operations

Ref.: Your letter 542-47/2016/1 and its annexes sent by e-mail on 11 February 2016

Dear Ms. Škrlec,

Eurostat has examined the documentation, on the bad bank (BAMC) operations carried out in Slovenia that was provided in your letter dated 11 February 2016, together with data sent and further analyses and clarifications given by e-mails, in the context of the *Request for Clarifications* rounds, as well as in telephone conferences on 21 and 30 March 2016. The issue is complex in terms of statistical recording. We are now in a position to provide an opinion on the appropriate treatment of the BAMC conversion operations in the light of ESA 2010.

1. The accounting issue

The accounting issue under discussion is the appropriate statistical treatment of the conversion into equity or into real estate of BAMC non-performing loans (NPLs), acquired in 2013 and 2014. These conversions carried out in 2014 and 2015 took the form of three kinds of operations:

(1) debt to equity swap, i.e. conversion of claims into equity;
(2) debt to real estate through direct conversion of claim;
(3) debt to real estate through purchase at auction of the collateral.

Aside from these operations, BAMC has also written off claims on a routine basis, including claims subject to conversions or purchases as described above.

The impact on the government deficit (B9) should be determined also taking into consideration other related events: (a) the 2013 recapitalisation (3.6 bill euro) of ten state banks to cover the losses due to NPLs provisions, and (b) the BAMC creation and the

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subsequent transfer of NPLs to BAMC from four of the previous recapitalised banks (NLB, NKBM, Abanka and Banka Celje).

1.1. Description of the case

1.1.1 Background

BAMC was created in 2013 in order to purchase non-performing loans (NPLs) and to gradually recover, restructure or liquidate non-performing loans. As such, BAMC has the features of a government sponsored defeasance structure, which was classified in the government sector according to ESA2010.

In 2013 and 2014, BAMC purchased NPLs, mostly collateralised, from four banks owned by the Republic of Slovenia (NLB, NKBM, Abanka and Banka Celje), in exchange for cash and bonds. These four banks had previously been recapitalised by government for an amount of 3.2 billion euro (out of which 3.1 billion was recorded as capital transfer expenditure in national accounts and 0.1 billion as an increase in equity). The EU Commission approved the state aid commitments involved and related restructuring plans.

The transfer of the NPLs was seemingly conducted at their fair value, estimated at 1.527 billion euro, equal to approximatively 30% of their total nominal value (4.859 billion euro).

The purchase of these NPLs by BAMC was recorded in national accounts as a financial transaction (increase in loans F.4), with no impact on the deficit (B.9). Nonetheless, following ESA2010 para 7.70, the stocks of loans were recorded in the government accounts for their original nominal value of 5 billion euro (following Action Point 22 of the September 2015 EDP mission). As a result, an entry in the revaluation account had to be entered, for 3.5 billion euro, at time of the NPL transfer, following ESA2010 para 6.58.

1.1.2 Conversions

Starting from 2014, BAMC was involved in three types of operations concerning the above NPLs: debt to equity swaps, debt to real estate swaps and proceeds from real estate collateral sales, involving a total of 1 billion claims at nominal value over two years.

Debt to equity swap occurs when a company cannot repay obligations and enters a so-called ‘compulsory settlement’. A compulsory settlement is not a bankruptcy, given that its main goal is to prevent it. A compulsory agreement involves an agreement between creditors and the debtor on how to settle the debt, e.g. by way of debt to equity conversion. The basic criterion applied by BAMC for undertaking the debt to equity option is the assessment that direct ownership (and management of the company) will allow BAMC to recover more than it can otherwise expect. BAMC does not swap debt to equity with companies in bankruptcy proceedings. BAMC values firms using a present value of free cash flow model (Annual Report of the BAMC, page 48). If the present value of free cash flows is calculated to be higher than the amount BAMC expects to receive from outright liquidation/bankruptcy or from taking over the pledged collateral, BAMC decides in favour of a debt to equity swap. If the value is lower, BAMC takes over the collateral or lets the company enter into liquidation/bankruptcy proceedings.

Debt to real estate swap occurs either if a company has an unused asset for sale or is bankrupt, and the underlying loan has real estate as collateral. In both cases, BAMC assumes there is no prospective buyer on the market. The basic criterion for BAMC in

taking the decision to swap debt for real estate is an assessment on whether direct ownership and management of the real estate will allow BAMC to recover something in future. Typically, a company has an asset (serving as collateral for the loan) which it cannot sell on the market and it offers it to BAMC. BAMC buys the asset and closes the loan for an amount called 'conversion value'. As a result, if the value of the asset is not enough to redeem the whole claim, BAMC only reduces the loan amount for the value of the assets acquired.

Purchases of real estate collateral during (or proceeds from) a sale process occur when real estate that was a collateral for the loan is sold on the market, as part of the deleveraging process of the company or of the bankruptcy proceedings. Also in this case, the BAMC basic criterion is whether direct ownership and management of the real estate will allow it to optimize recoveries. Most of the loans transferred to BAMC had real estate as collateral. This collateral is not included in the government accounts. When the company is bankrupt or is deleveraging, the company or the bankruptcy trustees may sell real estate at auction according to the following ways: a. the bankruptcy trustee or the debtor company sells real estate and BAMC is repaid by the proceeds; b. alternatively, BAMC may decide to buy itself the real estate at auction, for later resale. BAMC's loan is then repaid by the bankruptcy trustee or the debtor company with the auction proceeds. If the redeemed amount is lower than the whole amount of the loan, the debtor company is still liable to return the remainder of the loan. If the bankruptcy proceedings are not yet finished, the loan is not written off.

In addition, BAMC routinely write-off claims. Debt write-off is an internal accounting decision of BAMC to partially or totally cancel the claim against a company. Over 2014-2015, BAMC has made full or partial write-offs of claims, which had an aggregated nominal value of 1.6 billion euro, including 0.6 billion euro that were involved in the conversions described in previous paragraphs.

1.2. Documentation provided by SORS

- the letter no. 542-47/2016/1 including a description of the case, the actual and proposed recording in the government accounts (and its annexes), the new draft BAMC law and the 2014 BAMC annual report; these documents were sent by e-mail on 11 February 2016 at the recommendation of Eurostat during the ECFIN MIP mission on January 2016;

- the data provided by SORS in several e-mails in March 2016, at Eurostat's request, including the financial statements of companies involved in the D/E swap for the last 5 years, details on individual transactions of 2014 and 2015 (detailing the nominal value of the loan, the ‘transfer value’, the fair value of the equity stakes acquired taking into consideration past losses, the fair value of the real estate collateral, and the ‘conversion value’ defined by SORS as being the converted part of the nominal claims);

- the clarifications given by SORS in the telephone conferences with Eurostat on 21 and 30 March 2016 and further new data and details transmitted by SORS during the April 2016 EDP notification rounds (8/14/15 March 2016).

2. METHODOLOGICAL ANALYSIS

2.1. Applicable accounting rules

- ESA2010 chapter 6 Other flows, ESA2010 chapter 7 Balance sheet, section Debt operations of ESA2010 chapter 20 The government accounts;

- MGDD (2016 edition) chapter IV.5 Financial defeasance

2.2. Availability of national accounting analysis – SORS' analysis

SORS initially proposed to Eurostat the following deficit impact, based on the approach used for the October 2015 notification.

Actual recording (October 2015 EDP notification)	2013	2014	2015
million euro			(estimates)
Other capital transfers (debt to equity swap)	0.0	61.2	109.5
Purchases in the real estate collateral sale process	0.0	23.1	8.7
Debt to real estate conversion	0.0	31.1	16.7
Total	**0.0**	**115.4**	**134.9**

2.2.1 Cap on the overall impact of the conversion (SORS' analysis)

SORS notes that debt to equity or real estate conversions had the potential to distort the deficit of general government over the long term if an expenditure was to be accounted twice for the same amount, resulting in the cumulated deficit to end-up even higher than the amount originally paid out for the claim.

SORS emphasised the two following points:

1. The transfer of the impaired assets to BAMC and the recapitalisation of the banks should not be seen as separate operations, but should instead be viewed as one operation;
2. The maximum cumulated impact on the deficit should not exceed the value paid for the original claim.

SORS considers that there are indicators that those two events are connected. Government was the owner of all banks for which a capital shortfall was detected by the stress tests conducted by Bank of Slovenia. In order to maintain the capital adequacy ratio, government had to recapitalise these banks. To this effect, ZUKSB's (art. 2, par. 2) measures envisaged the transfer of assets and the recapitalisation of the banks at the same time. Also, the joint press release from Bank of Slovenia and government about the results of the comprehensive review of the banking sector clearly mentions together the amount of recapitalisation and the transfer of impaired assets to BAMC. As a result, SORS's view is that the recapitalisation of the banks and the transfer of the impaired assets to BAMC are closely connected events.

SORS agreed to record government recapitalisation as a capital transfer expenditure, impacting the deficit. As a result, in SORS's view, any further transactions potentially influencing the deficit should be analysed against the *'transfer value'* and not the original nominal value. Separately, SORS nonetheless agreed that the loans which were taken over by BAMC were to be recorded in the government balance sheet at their nominal value.

SORS argues that a capital transfer to cover the same kind of losses should not be recorded twice in government account, that is, in the BAMC case: once when the injection effectively took place, and a second time when the NPLs (recorded at nominal value in the ESA balance sheet of government) would be converted into equity or into collateral.

To the limit, assuming that the value of impaired assets had been zero at time of transfer, then government would have first recorded in the deficit an amount of 5 billion euro. Subsequent further write-offs or cancellations of the acquired claims should be without deficit impact. The maximum deficit of the government should be 5 billion, and no more. SORS notes such view is consistent with MGDD (IV.5.3.4, par. 35): *'Moreover, if, among the transferred assets, there is reliable information leading to think that some loans will in fact never be repaid, the capital transfer to the financial institution disposing of them must be accounted for the full value of these loans. Afterwards, they should be removed (written-off) from the acquiring defeasance unit's balance sheet under the conditions mentioned above. This is recorded in the other changes in volume of assets account of the financial institutions.'*

2.2.2 Write-offs and debtors in liquidation (SORS' analysis)

SORS believes that SNA 2008 and ESA 2010 prescribes that write-offs should be recorded in other changes in volume of assets account (SNA2008 12.40 and ESA2010 6.14b).

SORS also refers to the MGDD 2014 (7th edition) VII.2.2.2.3 (par. 12, 13) and VII.2.3.2 (par. 25) suggesting that write-offs cannot be regarded as transactions. In addition, SORS refers to the MGDD chapter on financial defeasance, notably section IV.5.2.5 b. para 22 "*For loans, if they are not finally repaid at redemption at the principal value that has been recorded by the purchasing government unit, they may be subject to two possible procedures: a cancellation implying a capital transfer if the debtor still exist, or, in very exceptional cases a write-off to be recorded in the other changes in volume of assets account if the debtor does not exist anymore and the debt cannot be reimbursed by a pledging unit.*"

In SORS opinion, in case of bankruptcy, write-offs should be recorded in the other changes in volume account, without government deficit impact, in all cases.

2.2.3 Proposal of recording for conversions (SORS' analysis)

Debt to equity swap (conversion of claims into equity)

When BAMC decides in favour of a debt to equity swap, there are two configurations, with two different recording. If a subsequent disposal of the equity acquired is completed within one year, then this transaction is recorded in F.5 (MGDD 2014 page 146). If the equity is held for a longer period, then a capital injection test is to be performed using traditional methods, starting with checking the accumulated losses over the past years. When the accumulated losses exceed *the amount of conversion*, a capital transfer D.99 is recorded. When the accumulated losses are lower than *the amount of conversion*, SORS checks the business plan of the company. If the company has a positive perspective of future profits, then the difference between the amount of conversion and accumulated losses is to be recorded as a financial transaction (F.5, as an equity injection) with no impact on the deficit (B.9).

Following a Eurostat request for two independent audits for BAMC's evaluation of assets acquired, SORS indicated this to be too expensive and burdensome for BAMC. SORS proposed the using of a value called 'conversion value' instead.

Debt to real estate conversion
In the case when the value of the asset acquired by BAMC is higher than the 'transfer value', then the loan is recorded as redeemed, and the difference between the asset value and the nominal value enters the revaluation account. If the value of the asset acquired by BAMC is lower than the 'transfer value', then the difference should be recorded as capital transfer. The acquisition of the real estate should be included in the GFCF in the amount of the 'transfer value'. Imposing two independent audits for the valuation of the equity on the BAMC would be for SORS too expensive and burdensome.

When the company is in bankruptcy proceedings and there is no demand for the real estate assets on the market, it is impossible to sell them, and BAMC may decide to repossess those and close its claims against the debtor, because bankruptcy proceedings are finished. In that case, SORS considers that an acquisition of real estate should be included in the GFCF for the amount of the 'transfer value', with a counterpart as debt redemption, and the difference between the 'transfer value' and the nominal value is to be treated as a debt write-off, in the other economic flow.

Purchases in the real estate collateral sale process
When real estate is sold at auction with more than one bidder, SORS considers that the price achieved is a close approximation of the market price. As a result, no capital transfer is recorded. Also, if the loan is not repaid for its full amount, the difference remains in the books of BAMC as the process of bankruptcy or deleveraging is not yet finished. If the company ceases to exist (bankruptcy) at a later date, the difference should be treated as a write-off in the other change in volume.

2.2.4 Apportionment of the claim (SORS' analysis)

SORS pointed out that a given claim may be subject to a succession of conversion events, for instance when more than one asset is held as collateral, or when an equity swap follows a first real estate swap. More generally, a first conversion will often not extinguish all prospects of further recoveries under the loan contract itself.

This creates a difficulty for identifying the part of the claim that is concerned by any conversion event, so to be able to appropriately apportion the 'transfer value'. To alleviate this problem, SORS uses a 'conversion value' compiled by BAMC, without being able to justify, at this stage, the basis of this calculation. SORS nonetheless believes that, despite this uncertainty, the 'conversion value' is more appropriate to avoid excessively impacting the deficit.

An alternative approach proposed by SORS is to revise the 2013 and 2014 data, recording the full deficit impact at the time of the transfer to the BAMC of the NPLs.

2.3. Eurostat's analysis

2.3.1 Cap to overall deficit impact (Eurostat's analysis)

Eurostat concurs with the general point raised by SORS that the overall cumulated deficit impact cannot exceed the amount effectively paid out by government for acquiring the

claim. As a result, when the initial transaction has been partitioned between a financial part and a nonfinancial part (with a capital transfer impacting the deficit recorded at inception for the latter amount), any subsequent write-off or cancellation of claims leads to a capital transfer only up to the former amount of acquired claim.

This is still the case even where the loan remained valued, in ESA balance sheet, at the original nominal value and not at the transfer price. In this case, the removal of the claim leads to an 'other economic flow' for the difference between the original nominal value and the 'transfer value'. In this case, a net capital transfer expenditure is to be recorded only for any positive difference between the transfer price and the fair value of the asset acquired (case of conversion).

Eurostat can also accept the point of SORS that the recapitalisation event (2013) and subsequent BAMC purchases of loans (part of the NPLs considered in the 2013 assessment) could constitute one unique operation, to be assessed as a whole.

2.3.2 Write-offs and bankruptcies (Eurostat's analysis)

Write-off

Eurostat recalls that business accounting 'write-off' cannot be transposed in national accounts directly or exclusively into an 'other change in volume' (OCV), as SORS seemed to assume. While some SNA2008 as well as ESA2010 references quoted may give such an impression, ESA2010 paragraphs 20.233 to 20.235 are very clear and explicit in this respect: 'write-offs' (as well as 'write-downs') are accounting actions internal to the creditor unit, which may occur in the context of a bilateral agreement or unilaterally. In turn, a write-off can lead to either a capital transfer or an OCV. This is particularly clear with para 20.235 ("*…debt write-offs lead to the removal of the asset from the creditor balance sheet by way of an other change in volume for the amount existing – the principal value for loan, a market value for securities, unless the write-off reflects a debt cancelation event")* or para 20.234 *("write-downs and write-offs are internal accounting actions by the creditor and are often not carried out by mutual agreement.").*

These three paragraphs, being a dedicated section of ESA2010 specialised on this specific issue, must supersede any other references, at least for events involving government entities. In addition, ESA2010 is an EU regulation, while SNA2008 is not.

It should also be recognised that while the treatment of write-offs as OCV is probably generally appropriate for claims that originate from commercial transactions, following national accounts general principles, this is not necessarily the case when there is an original intention to convey a benefit within a transaction. In the case of defeasance structures, or more generally in the context of financial rescues, governments intend to provide a benefit, although the beneficiary may not be the initial borrower, but the bank or its depositors. As a result, it appears most appropriate that the loss of government, eventually crystallised by the write-off, gives rise to a capital transfer expenditure.

In general, although ESA2010 explicitly refers to the need for a bilateral agreement to recognise a transaction, it is sometimes appropriate to presume the bilateral agreement, also having in mind that the recipient of a gift has generally few reasons to refuse. In the case of governments' financial rescues, the original intention to provide support is a reasonable basis to presume bilateral agreement.

Eurostat also recalls that the reference in the MGDD to write-offs recorded as OCV explicitly refers to "exceptional" cases.

Entities in bankruptcy

Where the borrower was already bankrupt at the time of rescue, a capital transfer in full should be imputed, and any recoveries later on would be recognised as a capital transfer revenue. When the borrower enters bankruptcy after the rescue, government is often de facto in control of the bankruptcy, or generally with some influence on it. It would then appear artificial to treat a write-off differently according to whether this internal accounting action occurred just before, or just after, bankruptcy proceedings. Under a simple and prudent approach, a final capital transfer expenditure should be recorded (for the 'transfer value') at time of entry into bankruptcy. Alternatively, the capital transfer can wait the moment of write-off, following ESA2010 conventions.

Overall, no specific treatment must be envisaged for claims against companies entering into bankruptcy/liquidation procedure. The same treatment (as described in section 2.3.3) should therefore be applied in the three cases of conversion, irrespective of whether a write-off has been undertaken or whether the debtor is in liquidation.

2.3.3 Recording of conversions (Eurostat's analysis)

General recording

As a matter of generality, for the three cases submitted (1. debt equity swap, 2. debt to real estate conversion, 3. auction), a capital transfer, with an impact on the deficit, has to be recorded in the government accounts for an amount equal to the difference between the original BAMC transaction value (i.e. the 'transfer value') of the NPL at time of financial rescue (net of any reimbursement to date) and a reliable fair value estimate of the recoverable assets – irrespective of the situation of the debtor.

In case the estimated fair value is higher than the 'transfer price', the difference enters the revaluation account.

In the case of real estate acquisition, the deficit impact is further increased by the amount of fixed capital formation, at time of conversion, with a compensation later on, at time of resale of buildings (reducing then the deficit).

Specific guidance for the three cases

Following the above, and taking into accounts SORS proposals of treatment for the three separate types of BAMC operations and the further SORS comments, Eurostat concludes that there seems to generally be an agreement for the following.

Debt to equity conversion

Cases of conversion of loans into equity arise when the company is viable but cannot repay its obligations to BAMC, and enters into 'compulsory settlement'. Eurostat considers that a capital transfer has to be imputed for the difference between the 'transfer value' and the fair value of the equity acquired, based on independent experts (unquoted equity).

In the absence of estimation by (two) independent experts, Eurostat may accept the BAMC value as a basis of the estimate. However, in this case, this amount is to be appropriately

‘capital injection tested’. When a privatisation is completed within 1 year, part of the amount can be recorded as a financial transaction (F5), up to the privatisation proceeds. Otherwise, the pattern of past losses, as well as the expectations of future profits should be considered, in order to partition this amount in a (second) capital transfer component and a transaction in equity.

In practice, the recording in the government accounts will imply a capital transfer expenditure (D.9) equal to the ‘transfer value’ of the loan if the accumulated losses of the company exceed the ‘transfer value’. If the accumulated losses are smaller than the ‘transfer value’, a capital transfer expenditure equal to the accumulated losses is to be recorded, together with a financial transaction (F.5) for the difference with the ‘transfer value’.

Debt to real estate conversion

A capital transfer expenditure has to be recorded for the difference between the ‘transfer value’ and the fair value of the real estate acquired. The overall deficit impact is however equal to the full ‘transfer value’, owing to the recording of a gross fixed capital formation expenditure at time of conversion.

A practical way to present the transaction, in the absence of detailed data, is to report, on the one hand, a capital transfer expenditure for the full amount value of the ‘transfer value’. On the other hand, a gross fixed capital formation expenditure offset by a capital transfer revenue (for the same amount) should be recorded for the fair value of the asset converted. The valuation of the gross fixed capital formation is neutral for the deficit.

Further proceeds resulting from the sale of the real asset, later on, are treated as revenue (net) for government.

Proceeds from the real estate collateral sale process ('purchases in real estate')

A capital transfer is again to be recorded for the difference between the ‘transfer value’ and the proceeds obtained at auction. When BAMC is itself the successful bidder of the auction, an amount for gross fixed capital formation is in addition recorded, similarly to the case of debt to real estate conversion.

2.3.4 Apportionment of the claim (Eurostat's analysis)

Eurostat considers that the preferred solution, should the necessary data be available, is to properly apportion the ‘transfer value’ as needed, for instance for each separate non-financial asset being held as collateral (possibly to be converted in several steps). This means that a capital transfer expenditure (D.9) is to be calculated as the difference between the appropriate part of the ‘transfer value’ related only to each conversion and the fair value of the asset acquired, with an impact on the deficit (B.9) of government.

Any gain resulting from the sale of the real asset would then be treated as holding gain. The deficit impact corresponds however to the sale proceeds (negative gross capital formation) at time of resale. This would be the best solution when the data on the ‘transfer value’ of each claim and each of the assets as collateral (and not on each debtor as a whole) are available.

In the absence of data or of plausible estimates, a second solution consists in taking into account the entire claim at the moment of first conversion, that is: to record a capital transfer expenditure for the full ‘transfer value’ of the NPL. When further recoveries take

place, whatever they may be, a government revenue is to be recorded, positively impacting the deficit/surplus (B.9) of the government, at the moment of these recoveries.

Eurostat do not agree with an alternative proposal by SORS to go back and revise the recording in 2013 and 2014 related to the purchase of NPLs. Such revisions should not be done ex-post. The recording in 2013/2014 was based on the information available at that time.

2.3.5 Data implication

The impact on the government deficit of BAMC conversion operations was 301 million euro over two years (115 million in 2014 and 186 million in 2015) using SORS approach. Using Eurostat's recommendation, the deficit impact reaches 540 million euro over two years (148 million in 2014 and 391 million in 2015).

It is important to note that this deficit impact does not only result from capital transfer expenditure (net of revenue), but also results from significant real estate purchases. The latter score in the deficit (defined as the ESA2010 net lending/net borrowing) at time of conversion, but will later on reduce the deficit when assets will be sold off.

3. CONCLUSION

Based on all the elements above, and, in particular, taking into account the available data, Eurostat and SORS agreed, during the April 2016 clarification period, on the following practical solution that SORS implemented in the data reported in the April 2016 EDP Notification: to record the full impact (transfer value) when the claim is converted for the first time, as a one-off, and then record revenue in the future when the amounts are known.

4. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the SORS. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information currently available and the assumptions made above, 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 and the note on ex-ante advice. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States on its website. In case you have objections to the publication of this specific case, we would appreciate if you would let Eurostat know *before 17th May 2016*.

Yours sincerely,

(e-Signed)

Eduardo Barredo Capelot
Director

Electronically signed on 03/05/2016 13:25 (UTC+02) in accordance with article 4.2 (Validity of electronic documents) of Commission Decision 2004/563