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Securisation operations undertaken by general government (Part V)

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Part V

SECURITISATION OPERATIONS UNDERTAKEN BY GENERAL GOVERNMENT

CONTENTS

V.1. Background of the issue

The definition of government debt in the excessive deficit procedure is coherent with the provisions of ESA95 concerning the definition of the government sector and of the financial liabilities (but excluding Other accounts payable and Financial derivatives). However, its valuation differs from ESA95 valuation rules.

1. <u>Securitisation arrangements</u>

Securitisation is not well covered by ESA95, so there is a need for some further guidance.

Securitisation is where a unit, named the originator, transfers the ownership rights over financial or non-financial assets, or the right to receive specific future flows, to another unit named the securitisation unit, that pays the originator from its own sources of financing.

Securitisation units set up specifically for a securitisation are generally called special purpose vehicles (SPV) but existing units can also undertake such arrangements. Securitisations by government sometimes involve an existing public corporation acting as the securitisation unit.

In order to finance the purchase of the financial or non-financial assets, or of the right to receive specific future flows, the securitisation unit borrows on its own account and not on behalf of the originator. Typically it issues bonds called asset backed securities (ABS). The securitisation unit uses income generated by the transferred asset, or sales of the transferred assets, to service its debt. Usually the lenders to the SPV will have a direct and legal claim on those flows in the event of the SPV not paying the interest and capital due.

Until recently, government securitisation was infrequent and included only cases of financial assets such as loans granted by government or arrears in respect of tax or social contribution payments. However since 2000 several new types of securitisation transactions have occurred and more are possible. Some arrangements cover the transfer of future flows not evidenced by an asset such as receipts from sales of specific services or transfers from international bodies.

Private corporations have various reasons to undertake securitisations such as improving capital solvency requirements; source of funding; enhancing financial ratios, or portfolio risk management. Government often has other reasons such as fiscal policy constraints, improvement of public management, rationalisation of government property. As a matter of rule, purposes of transactions are not a criterion for classification.

The chapter also considers the case where a non-government unit securitises a flow of payments to it from government.

In the rest of the chapter, the expression SPV is often used as a generic term for securitisation units, but it does not exclude any other kind of unit involved in the arrangement. It is also assumed that it is government that is transferring an income stream to another unit.

2. The problem for national accounts

The key question for this chapter is how to record a government receipt from a securitisation.

A preliminary question is the sector classification of the SPV. If it is classified to general government then obviously its borrowing would add to general government gross debt.

If the SPV is classified outside general government, the receipt may be the sale of a financial asset, the sale of a non-financial asset (affecting government deficit/surplus B.9[1]) or government borrowing.

Even if it is legally designed as a sale, the classification of the transaction must be based on its economic substance and not on the legal features. Therefore, a sale could be not considered as such in national accounts. The aim of this chapter is to provide clear rules in order to record the real future commitments of government units.

The sale of an asset by government can only be recorded in national accounts when investors in the securitisation unit are bearing risks and hold legal and direct claims on the assets held by the unit, such that government is not committed or expected to service the SPV's debt[2]. This is sometimes called the "true sale" issue.

3. Issues not covered

It is important not to confuse securitisation with leasing contracts, where government uses a capital asset owned and financed by a non-government unit, the asset not previously existing in government balance sheet. Such cases should be handled by applying the distinction between operating leases and financial leases as described in ESA95 annex II and the rules on public infrastructure in part IV of this Manual.

Securitisation is clearly distinguished from the case of "concessions and licences" where government allows an entity to perform a specific activity for a limited period of time, in return for a single initial payment or regular payments during the period. The sale of UMTS licences was a recent example.

An important difference between concessions and securitisation is that, in the case of concessions, the purchasing unit is fully active in producing output, assuming commercial risks, and incurring costs. Usually, this unit is classified as a market producer in the non-financial corporations sector.

[1] "EDPB.9" for the specific purpose of the Excessive Deficit Procedure. See Regulation (EC) N° 2558/2001 of 3 December 2001 and Part V in this Manual.

[2] A similar credit rating for SPV and government debt (and possibly higher in some cases) could indicate in some cases that the SPV's risks are equivalent to government risk. This could be a sign that government is effectively underwriting the SPV's risks. Moreover, under the framework of the New Basel Capital Accord, classification of SPV's debt as banks' sovereign claims, with the agreement of banking supervisory authorities, could be an additional indicator of insufficient risk transfer. However, this criterion should not be considered as a 100% conclusive one. In some cases, the high rating given to the SPV's debt may also reflect the high quality of the securitised assets.

Securitisation units, particularly those described as SPVs, are passive; they are just the ultimate beneficial recipients of receipts collected by government units. For example, for bank loan securitisation, the effective management of loans often remains with the originator and is not outsourced by the purchaser to specialised non-financial units.

Some securitisation units may be more active. An example could be a sale of real estate to a securitisation unit that manages the assets for a given period of time or outsource the work to a market producer that is not the originator. Some operations could also cover transfer of assets to be used for carrying out a productive activity. As such, these cases would not imply analysing the transaction under different rules. Such cases may be observed for securitisations undertaken with existing non-financial corporations in which the transferred assets are minor part of their balance sheet.

V.2. Rules to be followed

1. Classification of the securitisation unit

A preliminary step in determining the treatment of a securitisation arrangement in national accounts is to consider the general definition of an institutional unit in ESA95. If the SPV is under the influence of government such that it has no autonomy of decision concerning the management or disposal of the transferred assets or concerning its financial liabilities, the SPV should not be considered as a separate institutional unit according to national accounts criteria (as stated in §2.12) and so should be included within government sector. As a result, government debt would be increased.

Examples are full management of the SPV's debt by government[3], or the absence of the right to actively manage the counterpart assets in response to market conditions, such that government unit should approve any significant disposal[4].

If the SPV meets the condition to be considered as a separate unit actively managing the assets and liabilities, and bearing risk, it should be classified as a corporation[5].

2. Securitisation by units not classified to general government

Looking at securitisation arrangements undertaken by non-government units, two features must be examined closely.

1. The kind of receipts transferred by the government unit to the purchaser

To be treated as the sale of an asset, a necessary condition is that the receipts must be derived from a non-financial asset (like revenue from the asset and its further resale) or from a financial asset (like interest and reimbursement of loans) that exists in the government's balance sheet before the arrangement starts. Securitisation of any other future receipts, not attached to pre-existing assets, would imply the classification of the transaction as government borrowing.

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[3] Debt management means that government assumes debt service. It may also imply that government is entitled to take decisions such as early redemption, exchange, etc

[4] In this respect, experience shows that in almost all cases units involved in government securitisation can be considered as institutional units.

[5] The resident securitisation unit would normally be included in the sub-sector " Other financial institutions" S123 except in some cases where non-financial assets are transferred to an existing non-financial corporation for which the securitisation arrangement is a minor part of its whole activity.

2. Transfer of risks

To be treated as a true sale of an asset (and therefore affecting B.9 in case of non-financial assets), the risks associated with the assets must be borne by the purchaser. The main risk here is the variability of the income that the assets generate. The purchaser, not the government, must be allowed to benefit if the income is higher than expected when buying the asset, and must suffer the consequences if the income is lower.

For securitisation by government units, risks would be considered as not having been transferred on the basis of three criteria (separately analysed): the level of the purchase price relative to market value of the asset, the existence of Deferred Purchase Price (DPP) payments (but only under some conditions that are specified in paragraph 3.5), and government guarantees to the acquirer of the assets.

These issues are looked at in more depth in paragraph 2.4.

3. Implementing treatment as government borrowing

If the conditions specified below for risk transfer are not satisfied the transaction is treated as government borrowing. This means that government's receipt is recorded as the acquisition of a financial liability – namely government borrowing from the SPV. The government account continues to record the receipts as if they had not been sold. The government account records payments to the SPV that are classified as interest and redemptions of the financial liability. In general the latter will equate to the interest and loan repayments that the SPV pays to its investors, although there might be some minor adjustments necessary to reflect the SPV's intermediate consumption[6].

4. Evidence of risk transfer

Two questions to consider are:

1. *Is there a clause in the contract stating that the originator unit could possibly receive in the future additional payments from the SPV if it receives more income from the transferred asset than it needs to service its debt?*

   Such a clause is often called "Deferred Purchase Price" (DPP). This arrangement usually exists when the asset is sold for less than its true value. This enables the SPV to finance the purchase by borrowing less than the net present value of the expected future income from the asset. This gives comfort to the SPV's investors[7].

[6] When the securitisation unit is resident, recording as government borrowing generally consists in classifying the unit within government sector. When it is no resident, normally, a loan to government must be imputed.

[7] The DPP clause may not cover all the surplus realised by the SPV that may keep one part but, whatever the concrete arrangement, the very existence of a DPP implies examining the following issues.

If it is the case[8], one has to examine the price at which the initial transaction is carried out.

In order for the transaction to be considered as a sale:

a) the initial price paid must not be lower than 85% of the “true” market price (or "fair value");

b) if there is no organised market to demonstrate a market price, the estimated market price for the calculation above must have been estimated by a body independent from government.

2. *Has the originator, or another government unit9, provided guarantees that have the effect of committing government to repay the debt of the SPV in the event of it being unable to do so from its own resources?*

   If so, no true change in ownership is evidenced and the transaction is classified as government borrowing.

   It is worth noting that if a securitisation arrangement does not meet one of the criteria mentioned the transaction must be classified as government borrowing.

   This statement sets up basic principle for assessment of the reality of the transfer of risks. It must apply to any securitisation arrangements undertaken by government units independently of any specific feature.

   Where a securitisation arrangement meets all the criteria to be considered as the sale of an asset, the value of the sale is recorded, in accordance with ESA95 rules, as the amount actually received in the transaction and not as an estimated market value of the asset. The DPP is considered as a further sale of the assets (see 3.5).

5. Securitisation of regular government payments to non-government units

In some cases a non-government unit (perhaps through an SPV) will, for its own purposes, securitise receipts from government. At first sight this would seem to have no consequences for government sector accounts. However the contractual obligations of government must be examined to check whether the substance of the transaction is such that the government has a financial liability to finance the borrowing of the SPV.

The question here is whether the borrowing of the SPV should be recorded as government borrowing from the SPV’s investors. If so, the government accounts would show a capital transfer to the SPV; a loan from the SPV to government of same size; and the future government payments would be recorded as interest and loan repayments to the investors. The computation of the amounts would be similar to the way in which loans are imputed, and regular payments recorded, for finance leases – see ESA95 annex II.

8 Where no DPP clause is observed, the effective price paid to government is not a criterion for classification of the sale as such. However, the difference with market price needs specific consideration (see 3.3.2).

9 For instance, a local authority has written the arrangement and the guarantee is given by central government.

The choice of the treatment again depends on risk transfer. If government takes an obvious commitment (by a formal guarantee or under another form) to pay a sufficient amount to cover specifically the interest and principal debt servicing of the SPV, the operation should be reclassified as government debt according to rules specified in the “ESA95 Manual on government debt and deficit” (special case where guarantee is systematically exercised). The SPV’s borrowing and its expenditure or lending (financed by the securitised borrowing), would be re-routed through government.

If the securitisation by the non-government unit has no impact on the government’s contractual obligations to make the future payments there should be no impact on the government sector accounts. This applies even when the government is contractually obliged to make payments to the non-government unit. Usually certain conditions would have to be met by the non-government unit for the payments to become due. For example the government’s agreement to pay subsidies to a unit might depend on it producing certain outputs. The exception to this is where the government’s commitment is linked to the repayment of the SPV’s debts that effectively amounts to the systematic funding of a government guarantee as mentioned above.

This treatment recognises that government is almost unique in the economy in that it often agrees to make future payments for which government itself receives no goods, services or assets in return, but does so to promote its policy objectives such as relief of poverty or enabling market producers to provide goods and services to the population at prices below the costs of production. Such obligations to make future payments are not financial liabilities (sometimes called “onerous contracts”) because the payments help deliver the government’s policy objectives in those future time periods.

It might be the case that one non-government unit (A) securitises receipts from another non-government unit (B), say for the sale of services, and that unit B receives significant but not all of its income from government through subsidies, investment grants, or social benefits.

In such cases, where the nature of government obligations to make the regular payments does not change, it is not necessary to impute the borrowing of unit A as government borrowing. This is because the existence of unit B between government and unit A, and unit B’s non-government income, implies a break in the contractual link between government and the securitisation unit, and increases the potential risks faced by lenders to unit A.

The situation becomes more complex in cases where unit A securitises a mixture of direct government payments and payments from non-government units who are themselves also recipients of government payments. In such cases there is no need to impute government borrowing provided that:

- a majority of the securitised receipts are from non-government units;

and

- any given guarantees given are not specifically linked to the securitised government payments (except where such guarantees are in respect of the risks of government taking action that affects the value of the securitised assets - see section 3.4.2 on guarantees).

V.3. Rationale, and some further considerations

1. ESA95 references

ESA95, like SNA 1993, provides little guidance on this issue.

Concerning the sector classification of securitisation unit (SPV): paragraph 2.55 f states that they should be classified as "Other financial intermediaries" (S.123), assuming that they are separate institutional units, according to criteria stated in ESA95 2.12.

Concerning the classification of financial corporations: paragraph 2.33 states that "a financial intermediary does not simply act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account".

Concerning the classification of new financial assets resulting from the securitisation: paragraph 5.63 states that securities issued by a SPV are to be classified under AF3 "Securities other than shares". ESA95's writers had in mind arrangements carried out by banks. These provisions may not be fully relevant for similar transactions implemented by government units because government might undertake securitisations in different conditions.

Concerning the transfer of risk, as a reminder, according to ESA95 two basic principles exist:

- the change in ownership must be based on an economic point of view (see §7.10 and 7.11 on ownership rights and the definition given in annex II.4 of ESA95), which is implicitly a notion of "true sale" as referred in this chapter,

- whenever securitisation is done through a SPV classified in "other financial intermediaries" S123 (ESA95 2.55 f) this financial unit must "place itself at risk" (ESA95 2.33).

2. Types of securitised assets

2.1 Assets already held in government's balance sheet

Government units may sell financial assets.

In general, similarly to credit institutions, these assets take the form of loans (AF.4), for any purpose, or "other accounts receivable" (AF.7), as tax or social contributions arrears (provided that they have already been fully assessed and, therefore, recognised as a liability by the counterpart agent).

However, it must be stressed that there are no restrictions on the category of financial asset that could be considered as completely transferred to a non-government unit. In addition, some claims/liabilities between government units might also be sold to third parties but, as such, this transaction does not change in the consolidated outstanding amount of debt for the total government sector.

In the case of non-financial assets (mainly buildings), one has to consider the rules established in this Manual (Part II). A transfer of asset would not be considered as a sale where the transaction is undertaken with a public corporation (as defined in ESA95 Chapter 2) and concern assets that mainly continue to be used by government units. It is treated as a reclassification recorded in “other change in volume” with no impact on B.9.

2.2 Flows not attached to a pre-existing asset

Certain types of future income unrelated to any asset recorded on the government’s balance sheet are sometimes the subjects of securitisation arrangements on the market. In national accounts such arrangements are always to be treated as government borrowing.

These arrangements involve the transfer of the entitlement (sometime called “subrogation”) to future government income that does not fit the definition of economic assets in ESA95.

ESA95 specifies that there is an economic asset when “economic benefits may be derived by their owners by holding them or using them over a period of time.” (§7.10) It is added in §7.11 that "economic benefits consist of "primary incomes (operating surplus by using, property income by letting others use) derived from the use of the asset and the value, including possible holding gains/losses, that could be realised by disposing of the asset or terminating it."

Such arrangements do not meet this definition. The SPV is not undertaking an activity where it has to use an asset in order to generate the cash flow needed for the repayment of the debt. Similarly, there would be no sense to think that it could resell the flows to other economic agents.

The flows transferred by government cannot be considered from an “autonomous” view. They exist only if government continues to carry out the underlying activity. They have no independent, “objective”, existence. It is a completely different situation from the case where a SPV holds all the flows linked to financial (interest/principal) or non-financial assets (commercial receipts, rents, and resale on secondary markets). In this case, the SPV management is assumed to be in a position to take decisions in order to face its own commitments towards investors.

Thus, the SPV has absolutely no control over the effective amount of these future flows that are totally the result of government action and will. In fact, under these conditions, government would have no advantage to perform the given activity in the best way or to keep the flows at the required level.

Therefore, the “claim” of the SPV on some specific flows is not linked to the effective amount that would be generated by the underlying activity undertaken by government. It is in fact a contractual liability for government as any other kind of financing process. As a result, in national accounts, the money that the SPV gives to government must be recorded as government borrowing, i.e. a financial transaction that has no impact on deficit, but increases government debt[10].

[10] Under business accounting standards the SPV normally records an asset on its balance sheet that is generally valued as the present value of the sum of the expected flows, and it could be argued that this asset has been recognised by both parties in the transaction, based on "mutual agreement". However, this asset is not recognised as such in national accounts. In addition, accounting rules on the counterpart in a transaction in no way allow for the classification of the transaction in national accounts for government units.

Finally, it must be pointed out that government payments to non-government units can of course be treated as a sale of assets to a third (non-government) party where they are securitised by the receiving units, provided that all above-mentioned conditions related to transfer of risks are fulfilled and notably concerning government obligations (see below).

In this respect, it seems quite obvious that in the case of securitisation by one non-government unit of receipts for sales of services from another non-government unit, the latter receiving current or capital transfers from government, risks are fully transferred to investors as their repayment depends on the capacity of the "originating" unit to perform its activity. Government is not at all involved.

3. The sale price

3.1 Price fixing process

Where government unilaterally fixes the price of an asset transferred to the securitisation unit, it is evidence that government is directly borrowing funds. The transaction should be considered as exclusively financial (AF.3 or AF.4) and the assets would be kept in government unit's balance sheet.

In addition, where government fully imposes the price on the SPV, there would be strong doubt as to the autonomy of decision of the SPV, in which case it should be classified within the government sector, as it would not be recognised as an institutional unit in national accounts.

This is why, where the assets are not quoted on an organised market, it is important to check whether the value of the transaction is "marked-to- market"(for assets where comparable prices can be observed) or "market-oriented" in other cases where it would be difficult to find a close market reference for this valuation.

The sale price can be considered a genuine market price when judged by a body fully autonomous in the function of fixing the price independently of its sector classification. A major point is that it must be the main activity of the unit, or a K.A.U., that performs the valuation, and the results must be publicly available[11].

In cases where the asset cannot be valued according to usual expert criteria, because of having unique features or aspects on which no value can be placed, the valuation methods should be closely examined (notably where these are very specific or untried), together with other contractual features. For example, in some cases it is likely that the very existence of DPP would be evidence of insufficient transfer of risks and the transaction should be considered in national accounts as government borrowing.

[11] Government may also base the valuation on competitive process between different specialised units. However, each of them must meet the independence condition.

3.2 Value of the transaction

For a securitisation receipt to be classified as a sale of an asset, the price paid to government must be close to the market price, either observed where quotation is available, for the same or comparable assets, or estimated through market criteria in other cases.

However, it is not realistic to consider it possible to get a unique and unquestionable market price. Actual market prices can frequently vary because of general economic conditions, and different methodologies generally give quite a range of estimates. The period covered by the securitisation is also a factor of uncertainty that should be taken into account[12].

Factors like normal market volatility and, in the case of resale of assets, difficulties in absorption by the market, could be taken into account. But only small margins can be seen as acceptable. Although it is rather difficult to fix a general rule concerning their amount, intuitively (based on experience in evaluating some government assets) such spreads should be restricted by convention to a maximum of 15%.

<u>If the price paid by the securitisation unit to general government is higher than market price</u>, and if government enters into a legal commitment to make future payments to investors in order to compensate them for the high price, the difference between the market price and the initial price paid must be classified as a loan to government irrespective of whether the rest of the receipt is classified as an asset sale or government borrowing. This applies even if the government payments depend on the performance of the asset sold.

<u>If the price paid by the securitisation unit to general government is lower than the market price</u> of the assets acquired, it is likely that either:

a) The securitisation contract provides government with compensation for the shortfall in initial receipts through a series of future payments from the SPV to government depending on the future performance of the securitised asset. This is often referred to as Deferred Purchase Payments (DPP).

b) No possible compensations are foreseen.

<u>If a) is the case</u>, the existence of further payments (but beyond the above-mentioned conventional threshold fixed at 15% of the market price of the assets[13]) means that the SPV is fully covered for the risks related to its debt service. It will always receive all the necessary income because the securitised assets have a higher net present value than the SPV borrowing.

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[12] In addition, in the case of assets quoted on an organised market, due to volatility, the price might be an average of different quotations, provided that it follows observed market practice (like for instance in case of wholesale transactions).

[13] In accordance to the conceptual rationale, the DPP must result from the "performance" of the assets. Under these conditions, a DPP paid by anticipation, without any reference to the occurring performance of the assets should be classified as government borrowing, redeemed by the effective occurrence of revenues from the assets. A DPP could instead be recorded as a further sale of assets in case the following conditions are fulfilled: the receipts allowing the SPV to reimburse its debt have already been collected or the time lag between payments to government and future revenues from the assets would be very short (within the same current year), whereas the amount of DPP is evidenced by a new, higher, valuation of the level of debt which can be issued at the same rating level as the original notes and attributed by the same independent agency/ies which valued it at inception, allowing the SPV to issue new bonds and, thus, to transfer to the market further risk attached to the assets.

It is likely that the SPV's investors have accepted the DPP because the value of the assets supporting the investors' lending exceeds the amount lent. In effect, government funds the debt.

Those cases should be treated as government borrowing[14].

Sometimes it is difficult to estimate the market value of an asset because it has very specific features. The asset is sold for what everybody agrees is the most accurate estimate of the market price at that time but subsequent performance shows that this was too low. To allow government to benefit from a better than expected performance, the sale contract may be written so that government shares in the windfall by receiving additional payments from the purchaser at a later date under certain conditions.

Such a contract does not have to mean classification as borrowing provided that the original price was the best estimate of market value at that time and the additional payments are strictly limited to unexpected windfalls[15].

<u>If b) is the case</u> the classification of the securitisation unit needs to be examined closely because a reason for the government's generosity could be that the unit is part of government.

If the unit is classified within government sector, its debt is part of government debt.

If, for national accounts, the SPV is judged to be an institutional unit in the corporations sector, private or owned by government, and the transaction is treated as a sale the low price would reflect a clear decision of government to support the corporation.

In this case the estimated market price should be recorded as value of the transaction in assets (negative GFCF) with a partial offset by a capital transfer. The final effect on B.9 would still be equal to the amount paid to government.

4. Guidance related to guarantees

4.1 Guarantees and reality of the sale of assets

As a "basic rule", guarantees given by government for different purposes are not included in government debt, nor should the issuance of a guarantee be recorded as a government transaction, except where there is strong evidence that the guarantee would be called automatically[16].

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[14] It is worth noting that in cases of issuance of tranches of debt with different features related to DPP, the assessment of the sale price should be based on a global approach as assets were transferred under the form of a package.

[15] "Windfall payments" may of course also occur in case of improvement in market conditions, meaning that DPP could be higher than the above-mentioned 15% margin.

[16] Another specific case is where legislation states that government would take in charge repayment of the debt. See, in this Manual, Part II.4.

There would be a strong contradiction in national accounts recognising a securitisation arrangement as sale, implying a complete transfer of risk, where guarantees would give the effect of hedging investors' risks. Therefore, specific consideration must be given to cases where government provides guarantees for the debt issued by the securitisation unit in order to finance the purchase of assets[17]. It is an indication of insufficient transfer of risks.

From a conceptual point of view, granting guarantees to a securitisation unit covering risk borne by the SPV means that the transfer would not be considered as a "true sale". Such guarantees are evidence that the government unit has kept the ownership of the asset in the sense of national accounts. In addition, the fact that the securitisation unit could pay to government some fees in counterpart of the guarantee does not matter at all.

In this respect, it is not important knowing whether there is a high or low likelihood that the guarantee would be called. The main point is that government is on one hand transferring property rights on assets but, on the other, assuming the coverage of risks attached to the assets because of possible insufficient future receipts from them. In fact, the transaction may occur only because the purchaser is not bearing all the risks linked to his apparent property rights. This case must of course be clearly distinguished from guarantees given to third parties for transactions where it is not directly involved[18].

As a result, the securitisation transaction is to be treated as government borrowing[19].

A specific case to be examined is where a non-government unit securitises subsidies, investment grants, or other amounts received from general government.

If government takes in addition a commitment (by a formal guarantee or under another form as a firm obligation to transfer some identified receipts) to pay a sufficient amount to cover interest and principal debt service of the non-government unit, the debt of the SPV involved in this transaction should be reclassified as government debt because government is clearly assuming directly the repayment of the debt.

Where the government decides to stop subsidising or giving grants to the receiving unit, the guarantee would be called so that government would finally assume the repayment of the debt to investors. In this respect, investors would consider holding an unquestionable claim on government.

4.2 Cases where government guarantees may be admitted

The decision rule allows guarantees where, under the condition that the guaranteed amount does not exceed the value of the transaction, it would be difficult to get similar guarantees or contract insurance at a reasonable price on the market.

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[17] As aforementioned in 2.4, another unit within government sector may provide the guarantee. It is of course at the sector level that the assessment must be carried out. In addition, government involvement may take the form of "counter-guarantee". Where the latter covers specifically the assets transferred to SPV (and is generally "at first call") the rules on guarantees fully apply.

[18] In the case of the sale of an asset of high quality one should assume that government would not add a guarantee in the contract.

[19] In practice, a guarantee would not mean an insufficient transfer of risks where the guarantee would cover a limited lower performance of the transferred assets such that the "15% margin rule" would be respected.

Only limited external events (like natural disaster, terrorism, and war) could be covered by such a government guarantee and the latter should not have been designed for the sole purpose of the SPV but be offered to other units for similar events[20].

The decision rule also specifies that the above-mentioned provisions do not apply to guarantees given to protect against the risk of government changing the law or taking other action that reduces the value of the securitised assets.

The rationale is that in the absence of such clauses, one can assume that investors could easily claim some compensation, as the government would have changed the initial expectations of the investors. However, such guarantees would not be restricted to a change in conditions related to the specific assets transferred to the securitisation unit but would have a larger impact, similar to coverage of exceptional events.

4.3 Other provisions

The restrictive provisions about guarantees would also apply to financial derivatives that would have a comparable effect to "plain-vanilla" guarantees. Although financial derivatives are generally designed for risk management, in some conditions, using these financial instruments in the framework of a securitisation transaction shows that the original government owner is still bearing risks for the benefit of the counterpart in the transaction.

For instance a put option could give the right to sell back to government assets in some occasions ("non-performing" assets, no possibility of resale). Other kinds of financial derivatives would also be covered by this provision, such as "credit default swaps" where government is "seller of protection" for assets previously transferred to a specific entity or, more simply, under the form of a swap contract in which government would pay or receive the difference of the initial price of an asset and the price at which it would be realised by the securitisation unit.

In any case, where the government originator (or another government unit) enters into a derivative contract such that it could possibly bear final risks on behalf of the securitisation unit, the transaction should be classified as government borrowing.

A more specific case could be the use by the SPV, for hedging purposes, of "tailor-made" credit derivatives where government would be the main counterpart. As a general principle, any evidenced "circular" risk exchange arrangement would result in a reclassification of the SPV's debt as government debt.

Finally, arrangements where government would guarantee only the repayment of principal of the SPV's debt but not of interest or where the opposite coverage of risks is observed, would result in classifying the debt of the SPV as government borrowing.

[20] In the specific case mentioned in 2.5, involving two non-government units, a guarantee given by government to the "originator" (unit A) would also be treated as a contingent liability and would not be reclassified as government debt. Again, government is not directly financing the repayment of unit A's debt.

5. <u>Treatment of "Deferred Purchase Price"</u>

The issue related to the "Deferred Purchase Price" must not be confused with arrangements where parties agree on a sequence of settlements, fully known at inception. In this case, government holds a claim recorded under AF.79, as a time-lag adjustment. If in later periods effective cash payments were below the nominal value of the government claim, a capital transfer to the SPV would be recorded (debt cancellation or, in some cases, writing-off with no capital transfer).

At the time of the securitisation transaction, the sale of the asset must be recorded only for the value of the cash payment received in counterpart of the transfer of the asset. This is in accordance with ESA95 rules of valuation of flows as the amount of cash exchanged by parties, either immediately or according to a schedule agreed by parties at inception, which is obviously not the case for DPP[21].

Where securitisation contracts include possible future payments to government as compensation for a "marginally" lower initial payment, but for an amount not known with certainty at inception, no recording as F.7 can occur.

<u>In cases where all or part of the initial securitisation receipt is treated as government borrowing,</u> because no complete transfer of risks was evidenced, the compensation payments should be classified as interest and repayment of borrowing, as for a finance lease.

<u>Cases of additional payments where the initial receipt is recorded as a sale of an asset are discussed below</u>.

A strong distinction must be made between two cases:

1. The first one is where <u>government holds equity</u> in the securitisation unit, whatever the form (founders' shares, "golden shares", etc.).

   According to debt and deficit principles, payments are considered as dividends (see in this Manual, Part II.5) only if they stem from an operating surplus. On the contrary, where they take the form of holding gains (or streams of flows higher than the purchasing price), they must be recorded as a withdrawal of equity (notably if they occur at the time the SPV is liquidated), with no impact on B.9.

   If government received proceeds of resale of the transferred assets exceeding its share in the SPV's equity, the difference should be partly treated as in the second case below. In any case, withdrawal of equity should always be recorded before any other transaction.

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[21] One could also refer to §5.136: "in concept, the transaction value is to be clearly distinguished from a value based on a price quoted in the market, a fair market price."

2. The second case, more frequent, covers securitisation units in which government holds no property rights.

   Following the initial transaction government does not hold the assets anymore, as all rewards and risks are transferred to the SPV. However, the SPV cannot be considered as the final owner and is, by construction, a temporarily owner of the assets, either through an intended resale in the future or because of specific rights attached to the assets, as it is for repayment loans.

   Under these conditions, the initial transfer should not prevent further payments to government by the SPV where it is agreed in a contractual clause. Through the latter the SPV is committed to repay to government all or part of additional revenue stemming from the assets transferred at inception. This payment fully occurs under the framework of the transfer of assets. It is in fact a direct consequence of the initial transaction as the DPP depends both on the existence of an initial transfer of assets and on the price of the transaction.

   The DPP must be analysed as the "re-routing" of proceeds from the revenue of the assets perceived by the SPV (as resale, recovery of loans, etc.)[22]. From a conceptual point of view, it would not be appropriate to consider it as an unrequited transaction[23].

   Therefore, a DDP must be recorded, at the time it is effectively paid to government, under the same conditions as the initial transaction. As a result, in the case of a non-financial asset, there is again an impact on government deficit/surplus.

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[22] The DPP is not recognised as an asset as such, as the amount is not certain and depends on the occurrence of a given event (better "performance" of the asset). It is a contingent liability for the SPV even for the 15% margin where the initial price is lower than the market price because the existence of the margin recognises limited uncertainty over the market price. By convention, the "performance profits" repaid to government by the SPV are made through a kind of "rerouting" as mentioned in ESA95 1.39 for some transactions. Therefore, the realised profits are recorded in the revaluation accounts of government.

[23] The provision on redistribution of realised capital gains in ESA95 4.165g does not cover the case of additional payments to the seller of an asset but is related to cases where the beneficiaries are holders of equity. In addition, for financial assets such solution would have the effect of recording differently the initial transaction and the DPP.

V.4. Accounting examples

Example 1

A government sells buildings to an SPV that intends to resell them on the market over the following few years. The buildings are estimated to be worth 100. Government receives 90 immediately for the sale of the buildings and also has a DPP agreement such that, if the SPV receives more than 90 for the resale of the buildings, the receipts above 90 shall be given to government up to a maximum of 25. The SPV issues bonds to the value of 90. The buildings are resold for 120. The government receives an additional payment of 25 in DPP and the SPV makes a profit of 5 after repaying its borrowing. The transaction is judged to be a genuine sale because much of the risk has been transferred and because the sale price is more than 85% of the market value of the sold asset. Risk is transferred because the SPV would make a loss if the buildings were sold for less than 90, and a profit if sold for more than 115.

YEAR t

General government				**SPV (NFC)**			

Opening balance sheet (before the transaction)

A		L		A		L	
AN.11	100						

Capital account

A		L		A		L	
P.51	-90			P.51	+90		
B.9	+90			B.9	-90		

Financial account

A		L		A		L	
F.2	+90			F.2	0 (+90-90)	F3	+90
		B.9	+90			B.9	-90

Revaluation account

A		L		A		L	
AN.11	-10			AN.11	+10		

Closing balance sheet

A		L		A		L	
				AN.11	100		
AF.2	90					AF.3	90

YEAR t+3

General government	SPV (NFC)

Opening balance sheet

General government

A		L	
AF.2	90		

SPV (NFC)

A		L	
AN.11	100	AF.3	90

Revaluation account

General government

A		L	
AN.11	+25		

SPV (NFC)

A		L	
AN.11	-5		

Capital account

General government

• A		• L	
P.51	-25		
B.9	+25		

SPV (NFC)

• A		• L	
P.51	-95		
B.9	+95		

Financial account

General government

• A		• L	
F.2	+25		
		B.9	+25

SPV (NFC)

• A		• L	
F.2	+5		
		F.3	- 90
		B.9	+ 95

Closing balance sheet

General government

A		L	
AF.2	115		

SPV (NFC)

A		L	
AF.2	5		

Example 2

A government unit sells five years of future receipts to an existing market unit. The market unit has market activities other than just the securitisation. The receipts are expected to be 100 per year resulting from sales of services. The price of the transaction is 450, equal to SPV's borrowing. Debt principal of 90 is repaid each year. Interest is 5 each year (in order to simplify, there is only the initial transaction in the first year). Under the terms of the sale contract, the market unit has to return to government all receipts exceeding those needed to repay its debt. In the second year the receipts are 120 rather than the expected 100.

The market unit cannot be included within government sector, but the transaction is judged <u>not</u> to be a true sale so is to be recorded as government borrowing. The accounts show government borrowing from the market unit and government still receiving the income from sales of services.

YEAR t
(year of transfer, assume no sales of services till following year)

General government | **Market unit**

Financial account

General government:

• A		• L	
F.2	+450	F.4	+450
		B.9	0

Market unit:

• A		• L	
F.2	0 (+450-450)	F.3	+450
F.4	+450	B.9	0

Closing balance sheet

General government:

A		L	
AF.2	450	AF.4	450

Market unit:

A		L	
AF.4	450	AF.3	450

YEAR t+1

General government				Market unit			

Opening balance sheet

A			L	A			L
AF.2	450	AF.4	450	AF.4	450	AF.3	450

Current and Capital account

U and • A		R and • L		U and • A		R and • L	
D41	+5	P11	+120	D41	+5	D41	+5
		B.9	+115			B9	0

Financial account

• A		• L		• A		• L	
F.2 +25 (+120-90-5)		F.4	-90	F.2 0(+90-90+5-5)			
				F.4	-90	F.3	-90
		B.9	+115			B.9	0

Closing balance sheet

A			L	A			L
AF.2	475	AF.4	360	AF.4	360	AF.3	360