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Decision of Eurostat on government deficit and debt

The statistical classification of BANIF (Banco Internacional do Funchal, S.A.) residual entity

1. Introduction

This note provides Eurostat's decision on the statistical classification of the residual entity following the resolution process of Banco Internacional do Funchal, S.A., hereinafter referred to as BANIF S.A.

The main issue to be determined is whether the residual entity remaining after the resolution should be classified in the financial corporations sector (S.12) or in the general government sector (S.13).

This decision is made in accordance with the process defined by Article 10.2 of Regulation 479/2009, as amended, and after consultation of the Committee for Monetary, Financial and Balance of Payments Statistics (CMFB). The related CMFB opinion is included in the annex.

2. The issue

BANIF was the seventh largest Portuguese banking group before its resolution took place in December 2015. In the context of the resolution process, BANIF received a capital injection from the Portuguese government amounting to €2,255 million, of which €1,766 million were provided by the State and €489 million by the National Resolution Fund, which is classified in the general government sector.

Also in the context of the resolution, most assets and liabilities of BANIF were sold off. The viable assets and liabilities were sold to the private entity Banco Santander Totta for €150 million (net value). Problematic assets were transferred to Oitante S.A., a newly created asset

management vehicle with the features of a defeasance structure. The remaining assets and liabilities were kept in BANIF S.A., the residual entity object of this decision¹.

After the sale to Banco Santander Totta and the transfer of assets to Oitante S.A., BANIF S.A. became an entity with a very small balance sheet, which decreased from €12.3 billion before the resolution to €438 million. The assets retained by BANIF S.A. consisted mainly of deferred tax assets² (€323 million), equity holdings (€86 million) and deposits in one public commercial bank (€19 million). Its Maastricht liabilities stood at €295 million, consisting mainly of subordinated debts held by private individuals (€250 million). In addition, the balance sheet showed a €489 million liability towards the Portuguese Resolution Fund, related to the amount injected in the context of the resolution process, which was senior to the subordinated debts.

BANIF S.A. was prohibited from taking new deposits and investing funds, as well as from granting new loans, although it still held a banking license and remained included in the ECB list of monetary financial institutions.

In the context of the resolution measure, BANIF S.A. was put into liquidation with the objective of being wound-up.

As the resolution of BANIF was activated before the entry into force of the Single Resolution Mechanism, it took place under the responsibility of the National Resolution Authority (NRA), Banco de Portugal, and it was only possible due to the financial support of the Portuguese government.

Following the €2,255 million capital injection, the Portuguese State became the main shareholder of BANIF S.A. (the residual entity), holding 97.3% of the shares. In addition, as mentioned above, the Portuguese State was the counterpart for the majority of the assets and liabilities in the balance sheet of the residual entity.

3. The decision

Eurostat has decided that the residual entity remaining after the resolution, BANIF S.A. must be classified in the general government sector. BANIF S.A. has features typical of a government-owned defeasance structure as well as of a dependent public captive financial institution.

Eurostat's decision is based on ESA 2010 chapters 2 (paragraphs 2.56 - 2.62 on financial intermediaries and 2.21-2.23 on captive financial institutions) and 20 (paragraphs 20.44,

¹ This decision is limited to the sector classification of the residual entity. An analysis of the whole resolution process is available in Eurostat advice letter on the issue, published in 2016: <https://ec.europa.eu/eurostat/documents/1015035/7142247/Advice-2016-PT-Consultation-stat-record-resolution-process-BANIF.pdf>

² Deferred tax assets are conditional on future profits. Since BANIF will be liquidated, this amount should be deemed unrecoverable.

20.46 and 20.248 on financial defeasance), on chapter 4.5 of the Manual on Government Deficit and Debt (MGDD) relating to financial defeasance, and on the Eurostat guidance note on statistical implications of new resolution legislation, published in 2016.

ESA 20.248 states that *“If a public institutional unit is created by government with its only task being to assume management of the bailout, the unit should be classified in the general government sector.”* This would be applicable to BANIF S.A. The fact that BANIF S.A. is not “created” to assume the management of the bailout but is, instead, the legacy unit, would not prevent this ESA paragraph to be applicable, because, in application of the substance over form principle, the classification in national accounts should not be unduly influenced by the way the rescue is formalistically organized. Oitante S.A., which hosts another part of the former BANIF assets not sold out to the private sector, is already classified inside government.

BANIF S.A. has no power anymore to take deposits or to grant loans and is barred from competing on the financial market. Its activity has been intentionally limited to the winding-up of its assets, and notably to the sale of its equity holdings. BANIF S.A.’s main assets relate to deferred taxes that are deemed unrecoverable (as they are conditional on future profits). BANIF S.A. cannot be considered a financial intermediary as defined in ESA 2010 2.56-2.62, as the entity is not allowed to acquire assets, and its incurrence of liabilities (if any) would be limited to the refinancing of existing loans or the management of existing assets. The fact that it keeps in its balance sheet some legacy assets and liabilities incurred before the resolution and that it may transact in those, does not sufficiently evidence the provision of financial intermediation services.

In support of this analysis, ESA 20.248 indeed indicates that *“Units that purchase financial assets from distressed financial corporations with the objective of selling them in an orderly manner cannot be considered financial intermediaries because they do not place themselves at risk. They are classified in the general government sector.”*

In addition, to assume the risks associated with any presumed financial intermediation activity, sufficiently positive equity would normally be required and the equity of BANIF is substantially negative.

BANIF S.A. does not meet the definition of a deposit-taking corporation (S.122), as it can no longer receive deposits nor grant loans. The fact that it kept its banking license after the resolution is not relevant when deciding the sector classification in national accounts in the S.13 or the S.12 sector, that is, when deciding whether the unit is market or non-market. A banking license can be a determinant factor for deciding only the sub-sector in which a unit that is considered a market financial corporation (in S.12), should be classified.

BANIF S.A. is neither a money market fund (S.123) nor a non-money market fund investment fund (S.124), as it does not issue investment funds shares. The possibility of refinancing existing loans is not sufficient to conclude that the entity is engaging in financial intermediation and does not justify its classification as other financial intermediary (S.125). The activity of BANIF S.A. does not fit in any of the activities listed in ESA 2.88-2.94 for

other financial intermediaries: securitization transactions, derivative dealing, leasing, factoring, etc.

BANIF S.A. is controlled by the Portuguese government, which is its major shareholder and holds the largest claim against BANIF S.A., arising from the financial support provided under the resolution measure. Under a liquidation process, the role of the management appointed for the residual entity is merely instrumental. Besides, if the controlling entity would be considered to be the NRA, as stated in the MGDD (section 1.5 paragraph 17), when the NRA is organized as part of the Central Bank (as it is the case in Portugal) or another public financial regulator classified outside government, the latter would be conducting tasks on behalf of government, and, accordingly, national accounts would recognise the principal party of the transaction to be government.

The above analysis is reinforced by analyzing the risks: BANIF S.A. should in any case be classified in S.13, as government is exposed to most risks and rewards related to BANIF S.A. assets. According to ESA 20.46, a defeasance structure that does not place itself at risk is classified in the general government sector, and the degree of risks assumed must consider the degree of financial support of government. The defeasance structure does not place itself at risk when the restructuring agency benefits from “*the direct or indirect financial support of government*”, as “*its activities result in redistribution of national income and wealth*”.

In the case of BANIF S.A., the degree of financial support of the government appears high. It manifested itself through an intervention of 489 million by the Resolution Fund, and the resulting claim originating from the latter. Because of this claim, and taking into account that the deferred tax assets is not of meaningful value, it is government that is de facto mostly exposed to the BANIF S.A. portfolio. As explained in the Eurostat guidance note on statistical implications of new resolution legislation “*the existence of risks to government does not require any risk for a future outflow of resource of other government unit. The risks exist from the possibility of a lower return of resources than implied by the fair value of the assets transferred at time of transfer.*” In the same vein, according to MGDD section 4.5.2.1 paragraph 11, if the main source of financing is from the public sector, government is de facto assuming all or the majority of risks and rewards and the entity would be classified in the general government sector, because the likelihood that subordinated creditors may get any proceeds would be virtually zero.

The risks and rewards analysis implies the classification of BANIF S.A. inside government even if the latter would not be considered a defeasance structure, in case the DTA assets should not be neglected. Under this view, BANIF S.A. can be seen as a dedicated entity managing a portfolio of illiquid, though not necessarily impaired, assets to which government is mostly exposed. BANIF S.A. can thus alternatively be seen as a dependent public financial captive in the meaning of ESA 2.22 and 2.23 or simply as a portfolio of government assets, in both cases to be classified inside government.

To summarize, BANIF S.A. does not carry out financial intermediation activities, its main activity consists of the management of certain assets in a liquidation scenario (entailing a limited lifetime) and is controlled by government. To the extent that most of the assets of the

entity are non-viable, as they relate to deferred taxes assets that are deemed unrecoverable, BANIF S.A. has undisputedly the features of a government controlled financial defeasance structure as defined in the MGDD (section 4.5.2.1 paragraph 9) and, therefore, should be classified in the general government sector. Alternatively, in case BANIF S.A. would not be seen as primarily hosting impaired assets but mainly illiquid assets, the analysis of risks and rewards of BANIF S.A. portfolio would also imply the classification of the entity inside government.


Annex



CMFB opinion

on the statistical classification of BANIF (Banco Internacional do Funchal, S.A.)

1. Pursuant to Article 9(1) of Regulation 549/2013 EU on the European system of national and regional accounts in the European Union, the National Central Bank of Portugal requested the opinion of the CMFB on the statistical classification of BANIF, now a residual entity after a bank resolution process in December 2015. The National Central Bank as well as the National Statistical Institute of Portugal provided the CMFB with in-depth documentation, supporting their respective views on the matter. The Chair of the CMFB, assisted by the Executive Body, launched afterwards a consultation within the CMFB. The deadline for replies was 23 September 2016. Twenty-seven (27) national statistical institutes as well as twenty-seven (27) national central banks returned the questionnaire within the specified time. Eurostat and the ECB also expressed their opinion. A total of fifty-six (56) institutions provided therefore their opinion.
2. The request for an opinion of the CMFB came after a reclassification of BANIF residual entity in the General Government sector that was made by the Portuguese NSI with the approval of Eurostat.
3. In the CMFB consultation, the respondents were provided with two options for the statistical classification of BANIF.
4. Under Option 1, the residual entity is considered as providing financial intermediation services, albeit on a limited scale, while no more taking deposits, hence meeting the ESA definition of a public 'Other Financial Intermediary' (ESA 2010 category S12501).
5. Under Option 2, the residual entity is considered as a government controlled defeasance structure which would warrant a statistical classification in the General Government Sector (ESA 2010 category S13).
6. Five (5) votes being 'no opinion' were not counted for the outcome of the consultation pursuant to the CMFB Rules of Procedures.
7. The option for classification in S13 received the majority vote (27). The members who supported this option mainly argued that BANIF cannot take deposits or grant new loans and therefore is not placing itself at risk. Its main activity is the management of problematic assets in a liquidation scenario under the control of government via the National Resolution Fund (which is itself part of the General Government Sector).
8. A significant minority (24) supported a statistical classification in S12501. These respondents mainly argued that BANIF still carries out financial intermediation as defined by the ESA Regulation while being no more a Monetary Financial Institution, that its controlling authority is the National Central Bank of Portugal and that potential liquidation losses will, under the Portuguese Law, weigh on BANIF's own funds and diverse creditors such as other commercial banks, in the latter case for very limited amounts.
9. Based on the outcome of the consultation, the CMFB expresses the opinion that the BANIF residual entity should be classified in the General Government Sector (S13).
10. In addition to the publication of this opinion, all the anonymised answers to the questionnaire will be transmitted to the CMFB Members and will be kept in the records of the CMFB secretariat.



Jacques Fournier
CMFB Chairman

Paris, 30 September 2016