EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS)

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The impact of bank recapitalisations on government finance statistics during the financial crisis

1. Relevant statistical rules

The general rules applied by Eurostat for recapitalisations (capital injections) into public corporations, both for non-financial and financial corporations, are described in chapter III.2 of the Eurostat Manual on Government Deficit and Debt (MGDD), 2013 edition[2]. The specific case of capital injections into financial institutions[3] during the current financial crisis was considered in the relevant 2009 Eurostat decision and its associated guidance note[4].

The key issue at stake is then whether or not a capital injection is considered as a capital transfer (increasing the government deficit) or as an acquisition of equity (a financial transaction, which does not impact on the government deficit). Under certain conditions an injection may be split between these categories.

It should be noted that each capital injection into each financial institution must be individually analysed by statisticians.

Capital injections into banks are sometimes associated with the creation of specific entities (sometimes dubbed 'bad banks') which have the objective to separately manage the impaired assets of the recapitalised banks. The statistical treatment of these entities is different from the issue of bank recapitalisation and is summarised in a box in section 3.

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[1] In accordance with Eurostat decision of 19 March 2013 http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/ESTAT-decision-Criteria_for_classif_of_gov_capital_injec.pdf

[2] http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-13-001/EN/KS-RA-13-001-EN.PDF

[3] It is assumed in this document that the financial institutions concerned are not classified to the general government sector, but are classified as financial corporations and therefore the classification of recapitalisations is statistically relevant.

[4] See http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/FT%20-%20Eurostat%20Decision%20-%209%20July%202009%20_3_%20_final_.pdf

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostat_guidance_note_FT_-_10_September_2009.pdf

i) The Eurostat 2009 decision

The statistical treatment in this decision depends on the circumstances of the recapitalisation:

- Where government purchases, without taking control of the financial institution, shares traded on an active market, it is necessary to compare the price paid by the government with the prevailing market price. Any excess of the price paid by the government over the prevailing market price is recorded as a capital transfer.

- Where government injects funds under the form of other instruments such as purchases of preference shares with a non-contingent, sufficient and annually payable rate of return, the recapitalisation is treated for its entirety as a financial transaction.[5] Compliance with EU State Aid rules can be an important element in the assessment of such cases, although not in the case of entities exiting the market and not exercising future competitive activities.

The more challenging cases to be analysed are those where the government's injection is not in the form of traded shares or other above-mentioned instruments, commonly when government injects funds into a private institution without any contribution by private shareholders in the operation, or into a public financial institution (i.e. an institution already under its control) or nationalises a financial institution. For this, the Eurostat decision makes reference to the general rules, as described in the MGDD.

ii) Relevant issues from the general rules of the MGDD as regards public financial institutions

The MGDD specifies that if a capital injection into a public corporation (thus already controlled by government but also in the case where government would acquire a majority of voting rights at that time) is undertaken with the funds being provided without receiving anything of equal value in exchange, OR without expecting a sufficient rate of return, OR with the funds being provided to a corporation that has shown losses in the past[6], the capital injection is recorded fully or partly as a capital transfer. A sufficient rate of return on funds invested would have to be at least equal to the risk adjusted rate of return expected by private investors on similar equity, or to long-term government bond rates.

If there are private shareholders taking a significant share in the equity during the injection - in proportion to their existing shareholding and bearing the same risks and rewards as government - this is an indication that the capital injection could be considered as a financial transaction, since it is assumed that the private investors are seeking a return.

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[5] Such preferred shares (or other specific instruments) may be converted into ordinary shares. The conditions in which such conversion takes place must be closely considered for statistical purposes. Notably, the acquisition price of the new shares purchased by government will be compared to the market price observed at the time the acquisition price was set. Any excess of the acquisition price compared to market price will be recorded as a capital transfer.

[6] The rare case of 'one-off exceptional' losses is treated in the annex to this note.

If this is not the case, and the amount injected exceeds the accumulated losses, some partitioning of the capital injection could be possible, provided that government can provide evidence that the funds in excess will receive a sufficient rate of return or there is a fundamental restructuring of the corporation in order to prevent the occurrence of new losses and to return to sustainable profitability after the complete implementation of a new business plan.

In this respect, the evidence of rate of return will often take the form of a business plan which must be provided to statistical authorities and will usually be the subject of scrutiny by EU competition authorities (see below). The business plan may identify a specific projected rate of return on investments, or may project forward the remaining capital in the business (after the impact of losses) over several years.

2. Similar kinds of government interventions

The concept of recapitalisation refers in the strict sense of the term to increase equity capital, but government could also provide support by other ways which are covered by provisions both in the above-mentioned Guidance note and in the MGDD. For example, loans to loss-making financial institutions (even if subordinated) would be treated as financial transactions if there is no 'documented or other irrefutable evidence' that they will not be repaid. Purchase of assets will give rise to a capital transfer for any purchase price which would be higher than the market (or fair) value, notwithstanding the difficulties to establish the latter in certain cases.

The statistical treatment of 'defeasance structures'

Capital injections into banks are sometimes associated with the creation of specific entities (sometimes dubbed 'bad banks') which have the objective is to separately manage the impaired assets of the recapitalised banks. The statistical treatment of defeasance structures is technically different from the issue of bank recapitalisation and is explained in MGDD chapter IV.5. In statistics, when such an entity has substantial problematic assets, that its principal activity is the resolution of these assets, and is not classified as a financial intermediary, it is called a 'defeasance structure'. Publicly controlled defeasance structures, for which there is evidence that the government is assuming the majority of the risks, are to be classified inside the general government sector. Should this be the case, the balance sheet of the defeasance structure is consolidated with that of government, and in particular its liabilities would increase Maastricht debt. If on the contrary this unit is mostly privately owned, the exact involvement of government will be closely examined with a view to determine whether government takes on most of the risks and rewards attached to some problematic assets or if government is covering the losses of the problematic assets through a guarantee mechanism. It is only in this case that some impaired assets would be recorded on the balance sheet of government with imputed corresponding liabilities which would increase Maastricht debt.

It may happen, as observed in some Member States, that the building up of these entities is organised by buying the problematic assets of other banks at fair or market value (and thus below their book value), the latter thus bearing the losses and therefore requiring a recapitalisation. These recapitalisations will then be recorded as explained in the main part of this guidance note.

3. State aid considerations

In most cases, recapitalisations of banks by government are submitted to the approval of the EU Commission in order to check whether they would not result in distortion in competition. This may provide, in normal circumstances, some indications (notwith-standing the general methodological provisions to be still applied) about the nature of the operations and the possible splitting of the capital injection between equity and capital transfer elements.

4. The financing of government capitalisations of financial institutions

In general, Member State governments will look to their own resources for the financing of recapitalisations, which leads inter alia to a rise in government debt and the incurrence of debt servicing costs which impact the deficit.

However, following an explicit request and the signature of a Memorandum of Understanding, some Member States may receive funds from the specific bodies set up from 2010 onwards in the context of the financial crisis (the European Financial Stability Facility - EFSF – and the European Stability Mechanism - ESM) which are specifically earmarked for recapitalisation of financial institutions. The statistical treatment of EFSF and ESM operations differ as regards the impact on the Maastricht debt of Member States contributing to these entities. In the case of EFSF, the operations are rerouted to the guarantor Member States. Thus, when EFSF borrows/lends, the debts of guarantor Member States increase. On the contrary, when ESM will borrow/lend, the debt of Member States participating in ESM are not impacted.[7] It is only in the case when the ESM would record a loss in one of its support operations, whether recapitalisation of financial institutions or lending and would require to compensate this loss by a call in capital, that this called in capital could be recorded as a capital transfer from shareholder Member States to ESM as explained in the Eurostat decision on ESM[8].

It was agreed in the European Summit of Heads of States and Governments on 29 June 2012 that, when an effective single supervisory mechanism is established for banks in the euro area, the ESM could have the possibility to recapitalize banks directly. This would rely on appropriate conditionality, including compliance with state aid rules, which should be institution specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding. In this case, this direct recapitalisation would have no impact on the Member States' government debt (and on the deficit for the debt servicing costs), provided that the government concerned would not incur any direct or indirect obligations towards the ESM as regards the recapitalisation operation, i.e. there

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[7] The reasons for this difference are explained in the Eurostat decision on 27 January 2011 related to EFSF and the Eurostat 'preliminary view' on ESM of 12 April 2011.

http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-27012011-AP/EN/2-27012011-AP-EN.PDF

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostats_preliminary_view_on_the_recording_of_the_futu.pdf

[8] See

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostat_Decision_on_ESM.pdf

would be no possible involvement of government in the recovery of any claim held by the ESM on the banks.

Appendix: Definition of 'one-off exceptional' losses

The 2009 Eurostat decision and guidance note on the recording of public interventions during the financial crisis, introduced a distinction between 'exceptional' or 'one-off' losses and other losses incurred by banks, when assessing whether or not to record an impact on government deficit (capital transfer), in the case of public financial institutions.

'Where a government makes an injection into a financial institution which has shown losses over more than one accounting period, the injection should be considered as a capital transfer (expenditure of government). However a one-off exceptional loss should not be considered, in the context of the financial turmoil, as being statistically relevant for the classification of a capital injection.'

For Eurostat, losses may be considered as exceptional only if they result from unforeseen events which are, by evidence, beyond the responsibility of the financial institutions which incurs them, such as an unanticipated shock on markets under the form of disappearance of significant market counterparts and/or a sudden rise in costs of financing for all financial institutions. This case is extremely rare, even in the financial crisis.

On the contrary, losses directly linked to the line of business of the institutions, such as their loans or investment policies should not be considered as exceptional.

As far as recapitalisations of banks by government are concerned, by increase in equity or through hybrid instruments (generally accounting for Tier 1 under Basel requirements), in order to restore an appropriate level of own funds for those financial institutions which had previously been profitable and which would occur losses only because of an exceptional event, as described above, there would be normally no impact on government deficit and the operations would be recorded as financial transactions.

On the contrary, where a recapitalisation would take place to the benefit of public financial institutions which were, before an exceptional event took place, already in a difficult position for structural reasons (business model) resulting from an inappropriate strategy, any support by government should be recorded as a capital transfer.

Such financial institutions would usually have already reported losses and/or recorded provisions 'in usually high proportions compared to normal practice', as mentioned in MGDD section IV.5. In other words, the financial institutions would hold an important amount of non-performing (problematic) assets, frequently already written down for a non-negligible proportion or to be written down in the future as the market or fair value of some assets is by evidence lower than the current book value still recorded in their balance sheet.