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Directorate D Government Finance Statistics (GFS)

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Mr Jean-Marc Delporte
Chairman
National Accounts Institute
City Atrium C
Rue du Progrès 50
B-1210 Brussels

Subject: Recapitalisation of the Dexia Group

Ref: your letter dated 29 October 2012
our letter ESTAT/D-2/FL/LFO/JD/jl D(2012)1638407 of 27 November 2012
your letter T/ICN/2012/011169 of 11 December 2012
your letter T/ICN/2012/011520 of 19 December 2012
your letter ICN/2013/000825 of 25 January 2013
our letter ESTAT D/FL/LFO/JD/lj (2013)154284 of 1 February 2013
your letter T/ICN/2013/001296 of 7 February 2013

Dear Mr Delporte,

I would like to inform you herewith of Eurostat's final view on the recent recapitalisation of the Dexia Group. This view is based on the information contained in the correspondence between our services, on Eurostat's previous opinion on the case as communicated to the Belgian authorities, on the rules for the recording of capital injections, on the description of the operation published on the Dexia Group website and on the Eurostat decision of 19 March 2013 on the "Clarification of the criteria to be taken into account for the recording of government capital injections into banks" which followed a CMFB consultation.

1. Background - exchanges between Eurostat and Belgium

On 29 October 2012 Eurostat received from the Belgian National Accounts Institute (NAI)¹ an official "ex-ante" request on the statistical treatment of the recapitalisation of the Dexia Group by the Belgian government (alongside the French government). In its letter, the NAI proposed that the whole injection should be considered as a financial transaction, not impacting the government deficit.

Based on the information which was available at that time, Eurostat sent on 27 November 2012, one month before the capital injection took place, a preliminary advice to the NAI stating that the operation proposed should be recorded, for its entirety, as a non-financial

¹ The NAI is responsible in Belgium for the reporting of government finance statistics.

transaction impacting the deficit. At the specific request of the Belgian authorities, this letter was not published on Eurostat's website.

The recapitalisation was then carried out in the last days of 2012.

On 25 January 2013, the NAI sent to Eurostat a set of additional documentation on the projected future financial performance of Dexia.

On 1 February 2013, based on the fact that the operation had been conducted and its characteristics were fully known, Eurostat transmitted to the NAI a letter which confirmed its view of 27 November 2012, including the conclusion that the deficit of Belgium for 2012 should be impacted by this operation.

On 7 February 2013, the Belgian Federal Government requested Eurostat to consult the CMFB on the recording of this transaction. On 11 February 2013, Eurostat asked the chairman of the Committee on Monetary Financial and Balance of Payments Statistics (CMFB) to organise a consultation on the Dexia case. The consultation ended on 12 March 2013, and the CMFB opinion was released on 19 March 2013.

On the same day, Eurostat published its decision on the “Clarification of the criteria to be taken into account for the recording of government capital injections into banks”.

2. Guidance and documentation

The applicable rules for the recording of government bank recapitalisation operations are to be found in the ESA95 Manual on Government Deficit and Debt (MGDD) part III.2, Capital injections into public corporations, and Eurostat's July 2009 decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis. Both were summarised in a Eurostat guidance note of 18 July 2012 on the impact of bank recapitalisations on government finance statistics during the financial crisis.

The applicable rules were further clarified in Eurostat's decision of 19 March 2013 on the “Clarification of the criteria to be taken into account for the recording of government capital injections into banks”

3. History

The Franco-Belgian Dexia group² significantly developed its activities in the 1990's and 2000's in several countries. It has been going, since the outset of the financial crisis in 2008, through a series of serious difficulties which were worsened by Dexia's business model (long term assets – for a large part credits to local units - financed by shorter term liabilities). A first restructuring plan was implemented in 2008. It already included a recapitalisation by the French and Belgian governments of EUR 5.7 billion (at this time, together with other, private, shareholders)³, and a guarantee of EUR 100 billion by the French, Belgian and Luxembourgish governments. Dexia was then hit by the sovereign debt crisis and could not refinance itself on the markets. A new guarantee from the French, Belgian and Luxembourgish governments was necessary, temporarily approved by the Commission up to September 2012, and extended for the last time up to 31 January 2013.

² Formerly Franco-Belgian-Luxembourgish, but the latter is no longer present in the group.

³ This operation was recorded as a financial transaction because of a significant private shareholders' participation.

During 2012, the French and Belgian governments submitted to the European Commission a plan of "orderly resolution" including the sale of some parts of the group⁴ and a plan of resolution for the residual entity. It is to be noted that this entity is meant to progressively and completely withdraw from business, resolving the remaining assets and liabilities on its balance sheet.

According to the plan submitted by the French and Belgian governments, the residual group needed a further recapitalisation from the two governments. At the Extraordinary Shareholders' Meeting of Dexia SA on 21 December 2012, it was decided that a EUR 5.5 billion recapitalisation into the Dexia Group would be undertaken by the Belgian and French governments, without any private participation. EUR 2.915 billion, or 53% of the total, would be provided by Belgium and EUR 2.585 billion, or 47% of the total by France. The recapitalisation occurred at the end of 2012 when Dexia, following the latest losses, was in a situation of negative equity⁵ before the recapitalisation. The orderly resolution plan itself was approved by DG Competition of the European Commission on 28 December 2012. The actual recapitalisation payments by the Belgian and French Governments took place on 31 December 2012.

4. State Aid rules, nature of financial instrument and guarantee of sufficient rate of return

Compliance with State Aid rules

In Eurostat's 2009 decision it is indicated that "*recapitalisations in form of preference shares will be recorded as financial transactions if EU State Aid rules on rates of return are complied with*". The spirit of the use of the State Aid rules in 2009 was that, if complied with, it would give assurance to statisticians that there are sufficient guaranteed market returns. However, the State Aid rules were meant to be used in the context of "fundamentally sound banks", and to ensure that the recapitalisation by government did not give undue competitive advantage to the future business of the bank. In the present case, while the recapitalisation was approved by DG Competition, this was specifically on the basis that "*these aid measures are compatible with EU state aid rules for banks during the financial crisis because the residual group will exit from the market altogether and will no longer exercise any competitive activities*".

Following the CMFB consultation, the Eurostat decision of 19 March 2013 on the "Clarification of the criteria to be taken into account for the recording of government capital injections into banks" clarifies that: "*simple compliance with State Aid rules, although providing some indication, cannot be used as the sole element for the classification of the transaction, especially when the entity will exit the market and not exercise future competitive activity. The essential criterion to be taken into account is whether or not the financial instrument used ensures a sufficient non-contingent rate of return. In the case this criterion is not complied with, the other criteria developed in part*

⁴ Dexia has notably sold retail banking entities in Belgium, Luxembourg, and Turkey. The residual group was reduced essentially to the holding Dexia SA (registered in Belgium) and its principal affiliate in France (Dexia Credit Local), which itself has sold/will sell most of its affiliates.

⁵ This is based on Dexia's press release of 21 February 2013: "Results for the year 2012 and update regarding progress made on the Group's resolution" (page 14)⁵. Total shareholders' equity at the end of December 2012 was reported at EUR 2.852 billion. This leads to the conclusion that just before the recapitalisation of EUR 5.5 billion, Dexia's total shareholders' equity was negative and stood at EUR -2.648 billion.

III.2 of the MGDD (among which the existence or not of participation of private shareholders, and of accumulated net losses) have to be applied.”

This decision fully applies to the case of Dexia, which will exit from the market. Furthermore, in the case of Dexia, any payment of the coupon on the preference shares used for the recapitalisation is strictly conditional on a number of factors:

- 1) On the Dexia Group having profits,
- 2) On explicit decisions of its Shareholders' Meeting to distribute and to pay dividends (if any) to shareholders (as they may also decide to allocate any profits to the reserves instead),
- 3) Moreover, if the dividends do not cover the priority amount attached to the instrument, the missing amounts would be accumulated as priority rights on possible liquidation proceeds,
- 4) However, if the own funds of Dexia would go below the ratio of 6%, such missing amounts will in the future not even be accumulated anymore as priority rights on possible liquidation proceeds,
- 5) Possible liquidation proceeds cannot be guaranteed in advance and could be insufficient.

Therefore, in the case of the financial instrument used in the Dexia recapitalisation, Eurostat's view is that these preference shares do not meet the criteria mentioned in the Eurostat decision of 19 March 2013 on the “Clarification of the criteria to be taken into account for the recording of government capital injections into banks”. Their return is fundamentally contingent on profit, similarly to ordinary shares.⁶

On the basis of the above, Eurostat's final view is the same as its preliminary view, i.e. that the situation of Dexia as regards State Aid rules and the nature of the financial instrument used in the case of Dexia are not sufficient to conclude that there is no capital transfer to be recorded and the other criteria mentioned in the MGDD have to be applied. This view has been fully confirmed by the consultation of the CMFB.

5. Other criteria to analyse the recapitalisation

First, it is to be noted that Dexia is a public group. A significant majority of its shares before this last recapitalisation were already held either directly by the two governments, or indirectly via public corporations. After the recapitalisation, the participation of the private shareholders in Dexia's share capital has become negligible. Therefore the MGDD's rules in the part III.2 on capital injections into public corporations are fully applicable.

⁶ It should be noted that Eurostat equally advises other Member States having preference shares with payments contingent on profits, to treat the preference shares as ordinary shares for the benefit of the analysis of the capital injections. On the contrary, cases of injection of capital in the form of preference shares where the payment of a fixed rate of return is not contingent on profits and/or other issues, have been recorded as financial transactions.

Second, the financial situation of Dexia is critical. The Group showed significant losses in both 2011 (EUR -11.6 billion) and 2012 (EUR -2.9 billion). Moreover, just before the recapitalisation, the Group recorded a negative equity position of EUR -2.6 billion (see footnote 5). In addition, as even shown in the most optimistic scenario circulated by the Belgian authorities, there are expected losses of EUR 929 million for 2013 and 340 million for 2014. Overall the capital injection of EUR 5.5 billion is significantly smaller than the total of losses incurred and to be incurred between 2011 and 2014.

According to the MGDD part III.2.2.2.1, a capital injection undertaken by government in a public corporation (such as Dexia) without the participation of private shareholders, where the company has accumulated losses, is to be treated as a non-financial transaction. These losses cannot be considered as exceptional in the sense of the Eurostat guidance note of 18 July 2012, because they do not 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*". The losses incurred by Dexia are on the contrary, linked to the business strategy of the group, such as its loan and investment policies.

Moreover Eurostat has analysed whether only part of the injection could be recorded as a capital transfer. The fact that the injection is significantly smaller than the losses amongst other, does not justify such a recording.

6. Conclusions

Eurostat considers that the general accounting rules related to capital injections, as described in the Eurostat MGDD part III.2 and recalled in the guidance notes mentioned above, are applicable in the case of Dexia. Based on these rules and on the characteristics of the recapitalisation, Eurostat considers that the capital injection into the Dexia Group is to be recorded as a capital transfer. This conclusion was confirmed by a large majority of CMFB members during the recent consultation on the issue in February and March 2013.

Based on the sequence of events that have occurred, with a final decision on the injection as such at the Extraordinary Shareholders' Meeting of Dexia SA on 21 December 2012, the approval of the orderly resolution plan by DG COMP on 28 December 2012 and the injection taking place on 31 December 2012, the capital transfer has to be recorded in the 2012 government accounts of Belgium and France.

Overall, Dexia is considered by Eurostat as an exemplary case. No other shareholder, besides the French and Belgian governments, is providing additional capital. The company recorded a negative equity position just before the recapitalisation. It is a company that incurred heavy losses and is exiting from the market altogether. All of this confirms that this injection is not motivated by seeking market returns, as a private investor would do, but by the preservation of the stability of the banking system in Belgium and France.

7. Procedure

Eurostat expects that the Belgian statistical authorities include the capital transfer (EUR 2.915 billion) related to the recapitalisation of the Dexia Group in the government deficit for 2012, which will be notified before 1 April 2013. A similar recommendation is addressed in parallel to the French statistical authorities.

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, as amended.

This is Eurostat's final view on the statistical treatment of the recapitalisation of the Dexia Group. Eurostat will publish this view immediately after reception by Belgium of the present letter.

A handwritten signature in black ink, consisting of several overlapping loops and strokes, positioned above the printed name and title.

François Lequiller
Director