

Directorate C: National and European Accounts

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Mr Réginald Massant
President
Institut des Comptes Nationaux
City Atrium C, Rue du Progrès, 50
B-1210 Bruxelles

Subject: Recording in national accounts / EDP of early redemption by KBC of government aid

Ref.: Your letter T/ICN/2010/010219 dated 3 September 2010

Dear Mr Massant,

Following your above-mentioned letter, I am in a position to reply to the question you have asked on the appropriate statistical treatment of the case you have presented.

The case

The issue for which an opinion is being sought is the appropriate recording in national accounts / EDP of "premium" flows to government resulting from the anticipative reimbursement by the bank KBC of the financial aid granted by government in end-2008 / beginning-2009. The KBC case was subject of the state aid decision of the Commission and was considered in conformity with the Treaty¹.

Documentation provided

Together with its letter, the Belgian National Accounts Institute (ICN/INR) provided to Eurostat their national accounts analysis of the case, analysing two possible options of the recording of the flows in question, following the provisions of the ESA95 Manual on government deficit and debt (MGDD): as holding gains/losses without impact on government net lending / net borrowing, or as interest with impact on government net lending / net borrowing.

Description of the case

In total, a 7.0 billion EUR recapitalisation of core Tier-1 capital was provided to KBC by the Belgian Federal government and the Flemish regional government in return for hybrid financial instruments with a unitary price of EUR 29.5. As a holder of these instruments,

¹ Commission Decision of 18 November 2009 on the State aid C 18/09 implemented by Belgium for KBC (OJ L 188, 21.7.2010, p. 24).

government has the right to payments from KBC of the higher amount of either: (i) an annual EUR 2.51 per unit, or (ii) 110% of the dividend on ordinary KBC shares for 2008, 120% of the dividend for 2009, and then 125% of the dividend for 2010 and for the later years. However, any payments from KBC to government on these hybrid instruments are conditional on the distribution by KBC of dividends on its ordinary shares. According to the base scenario, KBC's redemptions of the hybrid instruments would start in 2012 and finish in 2020.

In 2008, ICN/INR classified these hybrid instruments in national accounts as securities other than shares (F.3). Recently, ICN/INR has been reassessing the classification of these instruments and currently considers that it is more appropriate to classify them as loans (F.4) due to the fact that government does not have the right to sell them without the agreement of KBC and the Belgian Banking Finance and Insurance Commission (CBFA).

Possible early redemption by KBC of the instruments held by government is foreseen according to two scenarios; in both cases on the initiative of KBC:

- (i) Until December 2011, the instruments held by government can be repurchased by KBC at the fixed price of EUR 44.25, including any accrued interest,
- (ii) After December 2011, KBC can require conversion of the hybrid instruments into ordinary shares on a one-for-one basis. However, instead of conversion, the government has the right to require KBC redeem the instruments at a unit value between 115% and 150% of the issue price, depending on the timing of the activation of the underlying conversion option.

Methodological analysis by Eurostat

After an examination of the provided documentation, Eurostat has reached the following provisional views.

Applicable accounting rules

European system of accounts 1995 (ESA95) paragraphs 4.53, 5.50, 5.69-70, 5.77-79, 5.86, 5.90, 5.94, and 6.36, are applicable in this case.

Availability of national accounting analysis

In their letter of 3 September 2010, ICN/INR considers two options for the recording of premiums resulting from the possible early repayment to government of financial aid received by KBC. However, the ICN/INR does not identify its preferred option.

Analysis

After an examination of the background documentation provided by the Belgian statistical authorities, Eurostat has reached the following views.

Considering the classification in national accounts of the hybrid instruments issued by KBC and subscribed by government, Eurostat notes that (i) they are de facto perpetual in nature, i.e. without a fixed maturity and interest, and that (ii) they can not be effectively sold by their owner, since this requires the consent of the issuer (KBC).

As for the first feature, it would thus seem that the instruments issued by KBC do not fall under the category of loans, as suggested by ICN/INR in their letter, as described in ESA95 paragraph 5.70: "*Generally loans are characterized by the following features: (...) (c) (...) has to be repaid at maturity and which is interest-bearing.*"

The second above-listed feature indicates that the hybrid instruments in question are de facto non-negotiable, thus not falling under the definition of securities other than shares in ESA95 paragraph 5.50: "*(...) financial assets which are bearer instruments, are usually negotiable and traded on secondary markets or can be offset on the market, and do not grant the holder any ownership rights in the institutional unit issuing them.*"

It would seem that these hybrid instruments, as described by the Belgian statistical authorities, have rather the economic features of shares and other equity, as stated in ESA95 paragraph 5.86: "*(...) financial assets which represent property rights on corporations or quasi-corporations. These financial assets generally entitle the holders to a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation financial assets*", in particular falling under sub-category of instruments of unquoted shares (F.512) or other equity (F.513).

In this context, Eurostat notes that the instruments issued by KBC in exchange for the government aid were incorporated in Tier-1 capital, which generally comprises equity or instruments whose features are close to equity. In addition, redemption of the instruments in question is conditional on the initiative of the issuer (KBC) and not of the holder (government). Finally, any remuneration payments from KBC to government on these instruments are linked to payments of dividends on regular shares, thus indicating that they effectively entitle government to a share in KBC's profits, as described in the above-mentioned ESA95 paragraph 5.86. As a consequence, regular remuneration payments from KBC on these hybrid instruments would need to be recorded in government accounts as dividends.

As far as recording in national accounts of flows linked to the early redemption of the government aid is concerned, two possible approaches are foreseen in the agreement between the government and KBC after 2009, both on the bank's initiative:

- (i) Conversion into ordinary shares on a one-for-one basis.
- (ii) Cash repayment linked to the issue price of the instrument, at the value between 115% and 150% of the price paid, depending when the conversion option would be activated.

Taking into account that the underlying hybrid instruments seem to have the economic nature of shares and other equity in the meaning of ESA95, Eurostat considers that in both possible cases of an early redemption described above, a difference between the issue price and the value of the liquidation represents a change in the value of the instrument. Consequently, this difference would need to be recorded in revaluation accounts, as nominal holding gains/losses (K.11), following ESA95 paragraph 6.36 "*The nominal holding gain (K.11) on a given quantity of an asset is defined as the change in value for the owner of that asset as a result of a change in its price. The nominal holding gain on a liability is defined as the change in value of that liability as a result of a change in its price, but with the sign reversed.*"

In the case of a cash repayment, the transaction will be simultaneously recorded in financial accounts of general government as an increase in currency and deposits and a reduction in shares (the value of which in the balance sheet before the transaction will include the revaluation effect).

Conclusion

Eurostat's view is that the hybrid financial instruments received by government in return for the financial aid to KBC seem to have the economic nature of shares and other equity in the meaning of ESA95, principally due to the rights conferred on government to participate in the profit of KBC, noting also that they were included in Tier-1 capital of the bank. Consequently, regular remuneration received from KBC by government on these shares would need to be recorded in government accounts as dividends (D.421).

The flows of indemnity due to the early redemption by KBC of these instruments held by government are to be treated as the realisation of nominal holding gains/losses (K.11) and recorded in revaluation accounts (and as financial transactions if cash is paid) without an impact on general government net lending / net borrowing.


Procedure

There is no explicit Community legislation which governs a procedure by which Eurostat gives its views on operations which have not yet been enforced. Nevertheless, Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it is in possession of all of the necessary background information. This preliminary view is given in accordance with the guidelines for ex-ante advice published on the Eurostat website.

This preliminary view of Eurostat is based on the information provided by the Belgian authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view. To this end Eurostat could request to be informed of the final details of the operation (contract and accompanying papers where relevant) when they are available, or (should this be the case) information that the planned operation has been abandoned.

In this context, we would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with the Council Regulation (EC) No 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat publishes all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat website. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than 24 November 2010.

Yours sincerely,


François Lequiller
Director