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Directorate C: National and European Accounts

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Ms Aija Žīgure
President
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LATVIA

Subject: Accounting treatment of the Joint Stock Company Parex Banka takeover
Your letter dated 17 July 2009

Dear Ms Žīgure,

In reply to your request for advice on the statistical recording of a takeover of Joint Stock Company Parex Banka, I am in a position to inform you of Eurostat's observations.

The accounting issue

The issue for which an opinion is being sought concerns the correct accounting treatment of the takeover by government of the Joint Stock Company (JSC) Parex banka.

Eurostat opinion is being sought on what would be the appropriate recording of the takeover operations as well as on the nature and classification of certain financial transactions.

Documentation provided

A note from Statistics Latvia describing the takeover operation (letter dated 17 July 2009).

Description of the case

The Latvian statistical authorities informed Eurostat that in November 2008 the state owned Latvija Hipotēku un zemes banka (Mortgage and Land bank of Latvia) took over 51% of shares of JSC Parex Banka for a nominal price 2 LVL in total. In December 2008, the Mortgage and Land bank took over all the shares owned by the former major shareholders (without changing the total purchase value of shares). The former shareholders in Parex Bank were not further compensated. The Mortgage and Land bank owned at this stage 84.83% of Parex shares while 15.17% were in possession of minority shareholders. In the period November – December 2008, the State Treasury has made "deposits" into Parex on a rolling basis. In total nine separate agreements were signed. The total value of "deposits" was 673.9 million LVL. The State received Parex assets (part of its loan portfolio) equal to 866 million LVL as collateral.

In the beginning of 2009 the Mortgage and Land bank took over the shares of one minority shareholder and became the owner of 85.15% of Parex shares. The amount paid for the transaction was 1 euro cent. In February 2009, the Mortgage and Land bank sold all Parex

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shares to the JSC Privatisation Agency for 2 LVL and 0.01 euro. In May 2009, the European Commission authorised an increase in capital of Parex by 140 million LVL and to issue 50.3 million LVL of subordinated debt. The increase of Parex capital was carried out through capitalising a part of the resources previously provided by the Treasury, thus reducing the amount of Treasury "deposits" in Parex. In April 2009, the Privatisation Agency signed an agreement with the European Bank for Reconstruction and Development (EBRD). According to the agreement EBRD will purchase 25% of Parex share capital plus one share, paying for this 57.5 million LVL, and also issue 15.5 million of subordinated debt.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA 95) in Community Legislation in its entirety and directly applicable in all Member States.

Relevant ESA1995 paragraphs are 5.05, 5.136, 5.74. The ESA95 Manual on government deficit and debt chapters on capital injections and recording of guarantees are relevant.

Eurostat's decision and corresponding guidance note *"The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis"*, dated 15 July 2009 (hereinafter – "Eurostat decision" and "Guidance note").

Analysis

Takeover by the Mortgage bank

Regarding the Parex takeover operation undertaken in November 2008, the Joint stock company Mortgage and Land bank purchased a 51% stake in Parex Bank for a nominal LVL 2 in total. As discussed in the EDP dialogue visit in Latvia during February 2009, the operation was recorded by the Mortgage bank as an acquisition of shares, the takeover having thus no impact on government deficit.

Classification of the financial transaction -Loan or deposit

On the first question raised by Latvian statistical authorities in their letter on how to classify Treasury "deposits" in Parex, Eurostat has the following views. The fact that Government received collateral for those so called deposits speaks in favour of the classification of the transaction as a loan.

We take note that ESA paragraph 5.75 foresees that *"short-term loans granted to monetary financial institutions ... are normally classified in one of the deposit sub-categories"*. However the fact that government investments into Parex, first placed in November 2008, are of rolling-over nature and in fact were prolonged nine times or so, raises doubts about their "short-term" nature.

In addition ESA paragraph 5.74 reads: *"The distinction between transactions in loans (F.4) and transactions in deposits (F.22, F.29) may often be based on the criterion who is taking the initiative for the transaction. In cases where the initiative is taken by a borrower, the transaction is to classify in the category loans. In cases where the initiative is taken by a lender, the transaction is to classify in one of the deposit sub-categories."* The letter of the Latvian authorities does not explicitly mention who took the initiative. Nevertheless the documents attached to the letter, namely *Overview of JSC Parex Banka takeover* on 15 of May 2009 by Financial and Capital market Commission and *AS Parex Banka Annual Report* *for the year ended 31 December 2008*, suggest that it was Parex who took the initiative for this transaction: "*Parex in its letter to the MoF requested to place 300 million euro from the State Treasury into Parex as a deposit...*" and "*Parex bank was forced to apply for the State support*".

Taking into account all of the above, it is our view that the financial transaction in question in national accounts is to be treated as government loan (F.4) and not as Currency and deposits (F.2).

Takeover by the Privatisation agency

In March 2009 the JSC Privatisation agency purchased the Parex shares owned by the Mortgage bank – in total 85.15% of Parex shares- for the total price of 2 LVL plus 0.01 euro cent. We take note that Parex shares were not quoted on the market, thus the market price could not be easily determined. We take note that Eurostat chapter 3 of the "Guidance note" dealing with recapitalisation operations reads: "*... any government payment above the prevailing market price of the equity, or an equivalent valuation..., would require the recording of government expenditure (capital transfer) – for the difference – to the unit selling equity.* " Chapter 6 of the "Guidance note" provides steps to determine the market price of the financial assets. In this context it is our understanding that there was no market adequately operating, the transaction was undertaken not in a way to determine a market value (i.e. via auction), the price paid was exactly the same as in the business accounts of a seller – i. e. in the Annual Financial Report of Mortgage bank and the price paid could not be compared to the average price in adequately operating market for similar securities. Therefore the price paid could be considered to be a market value of the acquired asset.

Equity injection and subordinated loan

In May 2009 the Latvian government increased Parex capital by 140.8 million LVL in the form of ordinary shares and issued subordinated debt of 50.3 million LVL. These amounts and in particular the proportion between Tier 1 and Tier 2 capital were approved by DG Competition (Commission decision of 11 May 2009 in case N 189/2009).

Chapter 3 of the Eurostat "Guidance note" reads: "*Recapitalisation in the form of ordinary shares will be examined to determine if they are made in line with prevailing market price... Any government payment above the prevailing market price of the equity, or an equivalent valuation ..., would require the recording of government expenditure (capital transfer) – for the difference- to the unit selling the equity.*" In their analysis DG Competition notes that "*Parex shares are not tradable on the market, market price of its shares is not established*", thus "*Net Assets Value (NAV) per share could be used as an estimate of their market value*". Following DG Competition estimations "*The NAV of Parex prior to the capital injection exceeds the total share capital. Hence the NAV per share exceeds the nominal price of the share.*" In other words "*the State receives a discount of 29% from NAV i.e. the real underlying value of the shares*". Taking into account this analysis it would seem that the requirement of chapter 3 of "Guidance note" is fulfilled, thus a financial transaction for the full amount of equity injection could be recorded.

Guarantees

The Latvian government issued guaranties on the remaining syndicated loans of Parex (the amounts involved are 542.5 million Euro). According to the Chapter 5 of the Eurostat "Guidance note" "*Guarantees are contingent instruments with no direct impact on government accounts when they are granted unless there is written or other irrefutable evidence that they will be called.*"

In addition we would like to remind you that fees for guarantees are to be recorded as payment for service, unless such fees are compulsory. Also following the "Guidance note", the fees are to be recorded on an accrual basis across the period for which the guarantees are in operation.

Open issues

We would like to draw your attention to the fact that following the "Eurostat decision" chapters 4 and 5, the Latvian statistical authorities should investigate whether there is written or other irrefutable evidence that loans will not be repaid or that the guarantee will be called. If this is found to be the case, government expenditure (capital transfer) is to be recorded at inception.

It is our understanding that the DG Competition decisions apply for the Parex rescue phase ending on 11 May. DG Competition has opened an in-depth investigation into the aid package (restructuring plan) for JSC Parex Banka, notified by the Latvian authorities on 11 May 2009. The Latvian authorities are asked to inform Eurostat on the outcome of the aforementioned investigation, as any identified state aid might have statistical implications.

Conclusion

On the basis of the above considerations, it is Eurostat's view that Government investments into JSC Parex Banka have the features of long term loans and should be classified as such in national accounts and for EDP purposes and not as transactions in currency and deposits.

From the information provided to us on the other government operations related to Parex – takeover operations and recapitalisation measures – it seems that those will not have impact on government deficit/surplus.

Procedure

This preliminary view of Eurostat is based on the information provided by the country 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.

In this context, 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 the amended Council Regulation 3605/93 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat is therefore publishing 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 15 October 2009.

Yours sincerely,

Helena Figueira

Maria Helena Figueira
Acting Director