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Subject: Statistical recording of the 2015 bank recapitalisations
Final view of Eurostat

Ref.: Our letter Ares (2016)1347422 of 17 March 2016

Dear Ms. Stavropoulou,

In the letter dated 17 March 2016, Eurostat provided its preliminary view on the treatment of the bank recapitalisations undertaken by the Hellenic Financial Stability Fund (HFSF) in December 2015. The issue was further discussed in the EDP dialogue visit of 22-24 March 2016.

Eurostat has closely examined the documentation related to this case. Taking into account the arguments put forward in the EDP dialogue visit of 17-19 February (Part I) and 22-24 March 2016 (Part II) and the exchanges during the April 2016 EDP request for clarification rounds, please find below Eurostat's final view on the treatment of the above mentioned transactions. This second letter includes also Eurostat's analysis concerning the capital injected by the social security subsector in Attica Bank in December 2015.

The treatment recommended by Eurostat in accordance with ESA 2010 has been applied by ELSTAT in the data reported in the April 2016 EDP Notification. The data have been validated by Eurostat and released on 21 April 2016.

We take note that the treatment recommended by Eurostat has not been implemented by Bank of Greece (BoG) in the ESA quarterly financial accounts for general government. As a consequence, the data delivered by BoG is not comparable to the non-financial accounts and the data reported in the context of EDP in April 2016. For this reason among others, Eurostat GFS team was not in a position to validate the data reported by BoG in April 2016.

1. THE ACCOUNTING ISSUE

In December 2015, the Hellenic Financial Stability Fund (HFSF) injected capital in the National Bank of Greece (NBG) and in Piraeus Bank for EUR 2,706 mn and EUR 2,720 mn, respectively. Also, in the case of NBG, preference shares subscribed by government in

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2009 and 2011, with a nominal value of EUR 1,350 mn, were mandatorily converted into ordinary shares (received by HFSF) with a nominal value of EUR 391.5 mn.

Furthermore, in December 2015, the social security fund ETAA-TSEMEDE participated in the share capital increase in Attica Bank, by an amount of EUR 384 mn.

The accounting issues under discussion are the statistical treatment of the following:

- the amounts injected by HFSF in NBG and Piraeus Bank (EUR 5,426 mn);
- the mandatory conversion of the preference shares of NBG (EUR 1,350 mn);
- the amounts injected in Attica Bank (EUR 384 mn).

In particular, it should be determined whether the transactions should be treated as capital transfers (impacting government deficit), as financial transactions (with no impact on government deficit), or partitioned, as a combination of both.

1.1. Description of the case

Systemic Banks

One of the pillars of the MoU signed in August 2015 in relation to the Third economic adjustment programme for Greece was the safeguarding of financial stability. The MoU foresaw a recapitalisation process of banks to be completed before the end of 2015.

The 2015 Comprehensive Assessment undertaken by the ECB and the SSM¹ identified the capital shortfall of the four Greek systemic banks (Alpha Bank, Eurobank, Piraeus Bank and National Bank of Greece (NBG)) in a baseline and in an adverse scenario.

On 1st November 2015, the Greek government passed Law 4340/2015, setting the framework to recapitalise the four main banks. On 2 November 2015, the Cabinet Act n36 provided additional information to complement the Law. Following Law 4340/2015, Greek banks might:

- Seek to raise funds from the private sector, in order to cover their capital shortfall under the baseline scenario;
- Raise precautionary recapitalization from the HFSF for any remaining shortfall arising from the adverse scenario.

According to the aforementioned Law, each bank would aim to cover at least its baseline scenario needs from the market, with the remainder, up to the adverse scenario, being covered by HFSF. In case HFSF would be involved in a precautionary recapitalization, it would acquire a combination of common shares (25%) and contingent convertible bonds ('CoCos', 75%) from the banks. If the market would fail to cover the baseline needs, then HFSF would automatically acquire the remaining ordinary shares to reach that limit, thereby providing comfort to the bank and any prospective investor, and then proceed to the

¹ Single Supervisory Mechanism

precautionary part as before. The Cabinet Act n36 sets the framework for HFSF subscribing to CoCos and the basic terms of such instruments.

In an attempt to cover their capital requirements, the four systemic banks did a Reverse Stock Split and took a number of measures involving the private sector: a voluntary Liability Management Exercise (LME) and capital rise through a book building process (and also through public offering in some cases).

By following the above measures, Alpha Bank and Eurobank managed to cover the capital needs identified in the adverse scenario solely through private investors and, therefore, the participation of the Greek government in the recapitalisation was not needed. This was however not the case for Piraeus Bank and NBG, where the participation of private investors was not sufficient to reach the capital needs identified in the adverse scenario and a precautionary recapitalization from HFSF was required.

Following the above Law 4340/2015, prior to the precautionary recapitalization from the HFSF, mandatory measures have to be taken to ensure that the residual amount of any capital shortfall is allocated to existing holders of capital instruments and other creditors, before providing any state aid.

As a result, in the case of NBG, a mandatory conversion of liabilities into shares also took place. In addition to instruments held by the private sector, preference shares subscribed by government in previous years were converted into ordinary shares. The conditions of the mandatory bail-in for each instrument were pre-defined in Cabinet Act n45. The conversion of the instruments held by the Greek government was done by applying a coefficient of 96.667% to the nominal value of the preference shares and multiplying this by the face value of ordinary shares (0.30). Preference shares for a nominal value of EUR 1,350 mn were thus converted into ordinary shares with a nominal value of EUR 392 mn.

Finally, in December 2015, the Greek government provided state aid to the National Bank of Greece (NBG) and Piraeus Bank in order to cover the capital shortfall to reach the adverse scenario. The HFSF injected capital in the form of ESM notes for EUR 2,706 mn in NBG and for EUR 2,720 mn in Piraeus Bank. In both cases, the capital increase was done partly (25%) by subscribing ordinary shares and partly (75%) by subscribing contingent convertible bonds ('CoCos').

Attica Bank

Following the stress tests conducted by the ECB on the Greek systemic banks in October 2015, the Bank of Greece conducted a similar exercise for Attica Bank and identified its capital shortfall in a baseline and in an adverse scenario.

A share capital increase (SCI) trying to cover the needs identified in the adverse scenario was initiated in December 2015. The state owned social security fund ETAA-TSEMEDE contributed to the recapitalization by subscribing EUR 384 mn in the form of ordinary shares. Other investors participated to a minor extent via a public offering. The target identified in the adverse scenario was only partially fulfilled.

Also in this case, the SCI was preceded by a reverse stock split.

1.2. Documentation provided by ELSTAT

- Note provided by ELSTAT before the EDP dialogue visit of February-March 2016 (document 12 of the EDP dialogue visit of February-March 2016);
- Replies provided by HFSF to the questions raised by Eurostat in Part I of the above mission (action point 23 of the EDP dialogue visit of February-March 2016);
- Additional information provided by the BoG², GAO³ and DG Public Property, sent by ELSTAT on 2 March 2016 (action point 23 of the EDP dialogue visit of February-March 2016);
- Cabinet Act n36 establishing the details of the precautionary recapitalization by HFSF;
- No specific documentation has been submitted to Eurostat in relation to Attica Bank. For this case, Eurostat has based its opinion on the documentation publicly available in the site of Attica Bank as well as on the information exchanged in the request for clarification rounds of the April 2016 EDP Notification.

2. METHODOLOGICAL ANALYSIS

2.1. Accounting provisions

- ESA 2010 provisions for capital injections (20.197-20.203).
- MGDD chapter III.2, Capital injections into public corporations.
- Eurostat Guidance note of 2012, "*The impact of bank recapitalisations on government finance*", updated in 2013 by Eurostat Decision on the "*Clarification of the criteria for the recording of government capital injections into banks*".
- Eurostat Decision of 2009, "*The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis*".

2.2. Eurostat's preliminary analysis

The general principle of reporting economic substance over legal form stated in ESA 2010 20.164 should be applied.

"Reporting the economic reality where it is different from the legal form is a fundamental accounting principle to give consistency and to make sure that transactions of a similar type will produce similar effects on the macroeconomic accounts, irrespectively of the legal arrangements. This is of particular importance for transactions involving the general government."

In line with this ESA statement, it is necessary to consider which role the government is playing in the transaction and apply a recording that recognises the economic substance of the transaction if this differs from its legal form.

² Bank of Greece

³ General Accounting Office of the Ministry of Finance

Concerning the systemic banks, the capital injection with CoCos, the capital injection with ordinary shares and the conversion of preference shares are analysed below. Finally, a brief analysis of the injection in Attica Bank has been included.

Analysis of the CoCos subscribed in the systemic banks

According to the replies provided by HFSF, an 8% interest is due and payable at the sole discretion of the issuer, who has the right to cancel (in whole or in part) any interest payment. The interest decided to be paid is payable either in cash or in shares, once again, at the sole discretion of the issuer. The interest not paid shall be cancelled and shall not accumulate over time. Therefore, it can be concluded that the CoCos injected in NBG and Piraeus Bank have a contingent annually payable rate of return.

Given the contingent return on the CoCos, the general MGDD rules for capital injections in the form of shares and other equity should be applied, as stated in Eurostat's Guidance Note of 2012. The CoCos subscribed by HFSF would have the nature of equity more than the nature of debt instruments and should be treated as equity for statistical analysis. This is also in line with the IFRS recording followed for the CoCos subscribed by HFSF, recorded as equity in the issuer's balance sheet, as confirmed by HFSF.

According to the replies received from HFSF, it seems that the conversion price of the CoCos is fixed (EUR 0.3) and will be equal to the nominal value (and not to the market value) of the ordinary shares. According to Eurostat's Guidance Note of 2012 (footnote 5), any excess of the acquisition price compared to market price is to be recorded as a capital transfer at time of conversion. The fact that any conversion would take place at the nominal value (and not at the market price) is a non-market feature that *prima facie* indicates that the CoCos entail a gift component, which would materialize at the time of the conversion in case the market value would be inferior to the nominal value.

For the rest of the analysis, the statistical treatment of the transaction in CoCos will be identical to the treatment of ordinary shares, being analyzed below.

It should also be noted that MGDD III.2.3.2.2 (paragraphs 41 and 42) state that hybrid instruments (such as CoCos) should normally be recorded as transactions in equity except in cases where the corporation has accumulated significant losses and the bonds are purchased almost exclusively by government (both conditions of losses and exclusive participation by HFSF being met for Piraeus and NBG, as it can be seen below). This would point to a recording of the CoCos as a capital transfer in any case.

Analysis of the ordinary shares subscribed in the systemic banks

For this analysis, it is considered that both Piraeus Bank and NBG are controlled by HFSF in national accounts terms. Before the 2015 injection, the holding of HFSF in Piraeus Bank and NBG was 66.9% and 57.2% respectively. After the 2015 injection and considering the CoCos as equity, HFSF is still the main shareholder of both banks (owning 61.34% and 67.91% respectively).

Even though the CoCos do not have associated voting rights, and, may not constitute, under normal conditions, a tool to exercise effective control, the Relationship Framework Agreements signed between the banks and HFSF in 2013 (and 2015), grant such a large number of rights and significant veto powers to HFSF that the latter should be considered the controlling entity in the light of ESA 2010. As a result, these two banks are to be considered as public corporations since (at least) 2013.

Following the above, the rules for capital injections in public corporations as defined in ESA 2010 and in the MGDD are fully applicable. According to the general principle defined in the MGDD (III.2.2.1, paragraph 11), a case-by-case analysis should be undertaken and the following key questions must be examined:

- 1) Accumulation of net losses during the years prior to the capital injection
- 2) Participation of private shareholders under the same conditions as government
- 3) Likelihood of a sufficient rate of return⁴

Accumulation of past losses

As concerns the accumulation of past losses, both Piraeus Bank and NBG incurred losses in the years prior to the capital injection. The losses⁵ for the period 2013-2015 are the following, as compared to the capital injection:

- Piraeus Bank posted accumulated losses of 8,007 mn over the period 2013-2015, against a capital injection of 2,720 mn.

- NBG posted accumulated losses of 5,583 mn over the period 2013-2015, against a capital injection of 2,706 mn.

In order to undertake the capital injection test, accumulated past losses should be compared to the amount of capital injected. However, it would be debatable whether the whole amount of losses should be attributed to HFSF, given the fact that part of the shareholders of both Piraeus and NBG were (and are) private.

It should also be taken into account that significant capital injections were already undertaken by the Greek government in year 2013 in the four systemic banks. HFSF injected around EUR 25.5 bn⁶ in the four banks. The private sector participated for smaller amounts. Part of the injections undertaken by HFSF at the time were treated as financial transactions and part as non-financial⁷. HFSF became the main shareholder in the four banks in 2013.

While EUR 15.7 bn were injected in Piraeus Bank and NBG in 2013, the sum of the share capital of the two entities was EUR 2.9 bn before the additional injections undertaken in December 2015. This means that most of the capital injected by government in the two

⁴ It should be recalled that this criteria is usually checked in case of no existence of accumulated past losses. However, in case of significant losses accumulated over the past, its application is less relevant.

⁵ For the calculation of the losses, the information used in this letter has been obtained from the publicly available consolidated group IFRS quarterly accounts. Because of the contingencies of deferred taxation, the profit/loss has been used before tax. The figures for Piraeus Bank have been adjusted to disregard the negative goodwill reported.

⁶ Out of which around EUR 7 bn were injected in Piraeus Bank and EUR 8.7 bn in NBG.

⁷ In the case of Piraeus Bank, out of the EUR 7 bn, EUR 3.6 bn were recorded as a financial transaction with no impact on government deficit. In the case of NBG, out of the EUR 8.7 bn, EUR 4.7 bn were recorded as a financial transaction.

entities in 2013 was lost (even if EUR 8.3 bn of the injections undertaken in Piraeus Bank and NBG were recorded as financial transactions at the time).

Given that the 8.3 bn injection recorded as a financial transaction in 2013 has been largely lost by now without an impact on the deficit, it would be difficult to justify that the addition capital injection undertaken in 2015 be again recorded without any impact on the deficit. Box 1 in MGDD chapter III.2 (capital injections into public corporations) states that "*A pattern of repetitive payments would be an indication and presumption of unrequited transfers, and therefore lead to record a capital transfer*".

Therefore, based on the above elements, Eurostat considers it a legitimate method that the capital injections are compared to the losses borne by HFSF as apportioned according to the relevant ownership in each period.

Following this approach, only the losses from the third quarter of 2013 onwards are taken into account, as before June 2013, HFSF did not hold ordinary shares of the two systemic banks under analysis. The accumulated losses borne by HFSF, as correctly apportioned, were the following for the period 2013Q3-2015Q4 according to Eurostat's calculations:

- around EUR 4,792 mn for Piraeus Bank (against a capital injection of 2,720 mn)
- around EUR 3,745 mn for NBG (against a capital injection of 2,706 mn)

In both cases, the accumulated losses assumed to be borne by HFSF are significantly higher than the amount of capital injected.

Participation of private shareholders

Although it is sometimes believed that private shareholders' participation by convention entails an automatic financial recording for the capital injection of government, this is in fact not the case.

According to ESA 2010 20.198 (b), in case there is participation of private shareholders on similar terms, the injection is "*likely*" to be acquisition of equity⁸. This implies that, ESA 2010 does not automatically prescribe a treatment as acquisition of equity in every case, and instead capital transfers may be appropriate under some circumstances. In fact, the other criteria as stated in ESA and the MGDD should also be analyzed.

While private investors have participated in the capital increase in Piraeus Bank and NBG seemingly simultaneously, it is however arguable whether they have done so under the same conditions as government.

- Law 4340/2015 approved on 1st November ensured that any capital shortfall in the adverse scenario, not covered by private investors, would be covered by the Greek government (HFSF). This law was approved before the measures to be applied in each bank (to attract private investors) were decided in the respective Extraordinary General Meetings. Therefore, private investors participated with the absolute certainty

⁸ That is, under normal circumstances in standard capital injection operations, where government participates with the main objective of making a profit and not because of legal obligations or due to specific circumstances.

that any potential capital shortfall would be covered by government, as stated in the law.

- The amounts subscribed by government were significantly higher than those subscribed by private investors and the instruments used were different, as the CoCos were subscribed exclusively by HFSF.
- As stated above, the design of the CoCos may entail a gift component. In addition the CoCos are not freely tradable. It should be noted that, the MGDD III.2.2.3.2 refers to cases where private shareholders participate in a capital injection and for the shares acquired to be recorded as a financial transaction, only if the shares acquired could be immediately re-sellable for the price paid. This is not the case for the CoCos, which shall only be transferable with the consent of the credit institution and the consent of the Regulator.

Sufficient rate of return

Although this feature would not be determinant in case of accumulated past losses, it could also be assessed whether it is likely that government will receive a sufficient rate of return on its investment. The banks concerned have not paid out dividends in the past years (amongst other, because they were loss making). The NPL⁹ rate is quite high (40% by September 2015), the deposit base needs to be rebuilt and the deposit outflow needs to be stopped. The reliance on the Eurosystem financing is still very high and the return on assets is quite low (-82 bps by September 2015). Based on these elements, the corporations' future profitability and their ability to pay dividends would not seem likely.

Additional considerations

Safeguarding financial stability was one of the pillars of the MoU signed by the Greek Government in the framework of the third economic adjustment programme. The Greek authorities committed to finalize a comprehensive strategy for the financial system focused on restoring financial stability and improving bank viability by: (i) normalising liquidity and payment conditions and strengthening bank capital; (ii) enhancing governance; and (iii) addressing NPLs. A buffer of up to EUR 25 bn was envisaged under the Programme to address potential bank recapitalisation needs of viable banks and resolution costs of non-viable banks, in full compliance with EU competition and state aid rules. Following a forward-looking assessment of the four core banks' capital needs by the ECB and the submission of capital plans by the banks, any remaining identified capital shortfalls would have to be addressed fully by end-2015 at the latest.

Given the commitments in the MoU and the subsequent Law enacted on 1st November for bank recapitalization, it can be concluded that the capital injections by government in the two systemic banks were not undertaken with the main objective of earning a sufficient or attractive rate of return, but instead for pure public policy purpose, in cases where private capital was not available to cover the capital shortfall identified in the adverse scenario.

⁹ Non-Performing Loan.

It should also be noted that the capital injection provided by HFSF has been considered as State Aid¹⁰ by the European Commission. According to the general MGDD rules, "*the flows deemed to be State aids have to be recorded as capital transfers*".

Analysis of the conversion of NBG preference shares subscribed in 2009-2011

According to the information provided, preference shares for a nominal value of EUR 1,350 mn were mandatorily converted into ordinary shares for a nominal value of EUR 392 mn in December 2015, thus involving a large write-down. Given the recording of the transaction as a financial instrument in the past, Eurostat considers that the haircut in the conversion (EUR 958 mn) should be recorded as the cancellation of a claim (and therefore, as a capital transfer). This capital transfer recording, rather than a holding loss, is appropriate also because the instrument in question is a hybrid one (with some of the features of a debt instrument) and not a normal share.

Following the general MGDD rules for capital injections into public corporations, the remaining EUR 392 mn should be capital injection tested. Taking into account the prevailing market price, a capital transfer of EUR 63 mn should be recorded for the difference between the closing share price (EUR 0.252) and the price paid (EUR 0.30). The remaining amount, EUR 329 mn, should be compared with the accumulated past losses.

Following the above analysis for ordinary shares and the existence of losses in the period 2013-2015 (higher¹¹ than the remaining EUR 329 mn), Eurostat is of the view that the whole amount should be recorded as a capital transfer impacting government deficit.

Analysis of the ordinary shares subscribed in Attica Bank

ETAA-TSEMEDE owns more than 50% of the shares of Attica Bank, which can also be considered as a public financial corporation in the light of ESA 2010, even before 2013. Therefore, the same rules as stated above for the injection of ordinary shares in the systemic banks apply. One of the differences with the systemic banks is that social security was already the main shareholder of Attica Bank before the financial crisis.

Attica Bank had also accumulated losses in the years prior to the capital injection. Following the reasoning above, the accumulated losses borne by the social security fund ETAA-TSEMEDE in the period 2013Q1-2015Q4, as correctly apportioned according to ownership were, according to Eurostat's calculation, around EUR 430 mn. This amount is higher than the EUR 384 mn capital injection undertaken by the social security fund.

3. CONCLUSION

Concerning the recapitalization of NBG and Piraeus Bank, based on all the elements above, and, in particular, taking into account the following elements:

¹⁰ Compliant with EU state aid rules.

¹¹ The accumulated apportioned losses considered to be borne by NBG are 3,745 mn, which is higher than the 3,035 resulting of adding 2,706 mn and 329 mn).

- That the capital injected in 2013 has been largely lost;
- That the accumulated losses borne by HFSF in the period 2013Q3-2015Q4, as apportioned according to shareholding, are in both cases higher than the capital injection by HFSF;
- That government did not undertake the capital injection motivated by an expectation for future profits and a sufficient rate of return, but rather for public policy purpose;
- That for a number of reasons, it cannot be considered that the private investors and government participated in the same conditions in the capital injection:
 - The private shareholders participated with the assurance that government would cover the capital shortfall up to the adverse scenario.
 - The CoCos do not seem to be subscribed in commercial terms due to the fact that the conversion price is fixed to the nominal value of the common shares.
 - The CoCos have been subscribed exclusively by HFSF.
- That the capital injections by HFSF have been considered State Aid.

Eurostat considers that, following the economic substance of the transaction, the full capital injection undertaken by HFSF in Piraeus Bank and NBG for an amount of EUR 5,426 mn should be treated as a capital transfer, impacting government deficit of year 2015. Eurostat also considers that an additional capital transfer of EUR 1,350 mn is to be recorded in relation to the conversion of preference shares of NBG into ordinary shares.

As regards the recapitalization of Attica Bank, the accumulated losses borne by social security in the period 2013Q1-2015Q4, as apportioned according to shareholding, are higher than the capital injection, leading to the recording of the full injection of EUR 384 mn as a capital transfer.

This treatment recommended by Eurostat in accordance with ESA 2010 has been correctly applied by ELSTAT in the 2015 EDP data reported in the April 2016 Notification, leading to an increase in the deficit of year 2015 by EUR 7,160 mn (around 4.1% of GDP).

4. PROCEDURE

This view of Eurostat is based on the information provided by the Greek authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented and the assumptions made above, 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 Council Regulation 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 is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website. In case you have objections concerning the publication of this specific case, we would appreciate if you could let us know before 23 May 2016.

Yours sincerely,

(e-Signed)

Eduardo Barredo Capelot
Director