EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

Luxembourg,
ESTAT/D-2/EBC/LFO/LA/PdR/RJ/pb/(2018)

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Subject: Recapitalization of Caixa Geral de Depósitos

Ref.: Your note on Action Point 14 from the November 2016 EDP dialogue visit, dated 31 May 2017;
Our email dated 15 June 2017; your reply dated 12 July 2017
Our letter dated 5 September 2017;
Your note on AP 14, dated 15 September 2017,
Our letter dated 25 October 2017, Your note on AP 14 dated 16 November 2017

Dear Mr. Oliveira,

In the note dated 31 May 2017, INE has provided a description and statistical analysis of the recapitalisation operation of *Caixa Geral de Depósitos* (CGD). A Eurostat early response and view on the statistical implications of the CGD recapitalization operation was provided to INE on 5 September 2017. This reply was followed by further clarifications and arguments from both Eurostat and INE. Please find Eurostat's elaborated and final view on the statistical implications of the CGD recapitalization operation, taking the additional elements provided by INE into account.

The accounting issue

The issue for which an opinion is being sought is the statistical treatment of the CGD recapitalization operation. Namely, whether following the existing rules on capital injections, recapitalization measures undertaken by the Portuguese government should be recorded as equity injections (with no impact on government deficit), as capital transfers (impacting government deficit), or as a combination of financial and non-financial transactions in national accounts.

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Documentation provided

Following up on the Action Point 14 of the November 2016 EDP dialogue visit to Portugal, INE has provided the above mentioned note analysing the CGD recapitalization operation, as well as some additional supporting information.

Description of the case

The CGD is a bank fully owned by the Portuguese State. Back in 2012, the Bank was not able to meet regulatory capital ratios and the Government subscribed for 1.65 billion EUR of capital: 750 million in a form of ordinary shares and 900 million EUR in a form of hybrid financial instruments (CoCos).

The Bank continued to incur losses over the period 2012-2016 and this resulted in a need for a new recapitalisation plan. The 2017 recapitalization foresees several stages:

- A capital injection in kind by transferring 49% of Parcaixa SGPS S.A. shares (499 million EUR) held by the State via the public holding company Parpublica.
- Conversion of CoCos held by Government in CGD (900 million EUR plus accrued interest of 45 million).
- Issuance of Additional Tier 1 (AT1) subordinated debt instruments for the subscription of private investors (500 million EUR), within a 18 months period, followed by a second tranche of AT1 securities of 430 million EUR.
- A cash capital injection of 2,5 billion EUR by the Portuguese State.

The total contribution of the State in this recapitalization amounts to 3944 million EUR.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

- 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's Decision on the "*Clarification of the criteria for the recording of government capital injections into banks*".

Availability of national accounting analysis

The Portuguese statistical authorities consider two accounting options in their note.

Following the MGDD decision tree for capital injections INE arrives at a conclusion that the "*great part if not all of General Government capital injection on CGD would have to be registered as capital transfers*". The Portuguese statistical authorities also raise questions on the practical application of the capital injection rules. A question is also asked whether the DTAs should be taken into account while analysing the losses.

The Portuguese statistical authorities also consider a second recording option – as a financial transaction. The reasoning for such recording option is focusing on the fact that the government intervention in its entirety was considered as not constituting state aid[1]. That is, injections into CGD were undertaken in a similar way in which they would have been carried out for private banks, and notably with a sufficient rate of return expected for the owner. Some other aspects that according to the Portuguese statistical authorities point towards recording a financial transaction are: CGD is an entity that is operating in a competitive market and is seeking profit maximisation; the losses registered in the last six years are not specific to CGD, and similar situations are observable in other financial institutions in Portugal; the recapitalization involves private investors, who are willing to take risks.

In their second note of 15 September 2017, the Portuguese statistical authorities emphasized a number of points, notably the importance of using the conclusions made by DG COMP for state aid purposes, in deciding on the statistical classification of the transaction. Also, questions were raised on whether the accounts of the CGD Group would be more appropriate for the analysis, rather than focusing on the results of the CGD Bank only. The Portuguese statistical authorities also asked for further clarification why DTAs recognised in the company's accounts were not considered in Eurostat's initial analysis.

Eurostat's analysis

Eurostat has closely examined the documentation related to this case, also taking into account the arguments put forward by the Portuguese statistical authorities.

The role of the State aid decision

The Portuguese statistical authorities, in their analysis, emphasize the fact that the whole recapitalization operation undertaken by Government was considered by DG COMP as not constituting state aid, and want to infer from this the appropriate statistical treatment.

In this respect, it is worth recalling that the role of state aid decisions in a statistical analysis is mentioned in the Eurostat Guidance note of 2012 "*The impact of bank recapitalisations on government finance*": the state aid decisions "*may provide, in normal circumstances, some indications (notwithstanding 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.*" Also, the MGDD chapter III.2, *BOX 1 Recording of transactions: straightforward cases and difficult areas,* mentions that "*qualification by the European Commission of government payments as "state aids" should be taken into consideration for the statistical treatment as an analytical indicator. The flows deemed to be State aids have to be recorded as capital transfers*".

Considering the above, it is clear that a decision of DG COMP does not to be considered as a single decisive factor for the decision on the statistical classification in national accounts of the transactions in question – but might help in deciding on the classification in a number of circumstances. A decision on the existence of State Aid implies a non-commercial nature of a transaction, with the implication, well noted in the MGDD, of recording a non-financial transaction. On the other hand, if the DG COMP assessment determines that a certain measure is not State aid, this would be an element to consider for statistical analysis, particularly with respect to the inference that could be drawn on future profitability. This is particularly relevant for the part of injected amounts that are exceeding the loss.

[1] http://ec.europa.eu/competition/state_aid/cases/267912/267912_1899392_142_2.pdf

Nonetheless, according to national accounts rules, the absence of State aid elements does not preclude the recording of a non-financial transaction, for instance in the presence of past losses. In short, the fact that flows deemed to be State aids have to be recorded as capital transfers does not mean (and it is written nowhere in the MGDD) that flows not deemed to be State aids have to be recorded as financial transactions.

This being recalled, the rules for capital injections in public corporations as defined in ESA 2010 and in the MGDD are fully applicable.

The Portuguese statistical authorities in their analysis mention ESA paragraph 20.199 and conclude that the mere fact of possible future profits (which were acknowledged by DG COMP in their non–State aid decision of the whole recapitalisation) is a sufficient criteria for recording a transaction as acquisition of equity.

However, Eurostat would like to point out that ESA paragraph 20.199 should be read in its entirety without breaking into first and second parts: "*In many cases, payments made by government units to public corporations are intended to compensate for losses in <u>the past or in future</u>. Government payments are treated as an acquisition of equity only if there is sufficient evidence of the corporation's future profitability and its ability to pay dividends*."

The analysis of the above paragraph is as follows. First, the existence of past losses and prospects of future losses are to be considered – and lead to a capital transfer according to ESA 20.198(a). Second, the prospects of a sufficient rate of return and of dividends might open the possibility to record a financial transaction. This second step is by construction exclusive from the first step, given that future losses are incompatible with a sufficient rate of return.

The Portuguese statistical authorities argue that paragraph 20.199 must be read as meaning "*If and only if there is sufficient evidence of the corporation's future profitability and its ability to pay dividends, the payments have to be treated as a financial operation independently of past losses*". However, ESA 20.199 reads "*only if*" and not "*if and only if*", as quoted by the Portuguese statistical authorities, which is the basic distinction between 'equivalence' and 'implication': thus, according to the wording of ESA 20.199, future profitability is a 'necessary condition' and not a 'necessary and sufficient condition' for a financial recording.

ESA 2010 paragraph 20.198 reads:

> *(a) A payment to cover <u>accumulated, exceptional or future losses</u>, or provided for public policy purposes, is recorded as a capital transfer. Exceptional losses are large losses recorded in one accounting period in the business accounts of a corporation, which usually arise from downward revaluations of balance sheet assets, in such a way that the corporation is under threat of financial distress (negative own funds, breach of solvency, etc.).*
>
> *(b) A payment where the government is acting as a shareholder in that it has a valid expectation of earning a sufficient rate of return, in the form of dividends or holding gains is an acquisition of equity. The corporation must enjoy a large degree of freedom in how it uses the funds provided. When private investors are part of the capital injection, and the conditions for private and government investors are similar, this is evidence that the payment is likely to be acquisition of equity.*

It is thus unjustified to restrict the indent (a) to cases that "*corresponds to the general one when the public corporations tend to record losses as they are not operating in market* *conditions*", as suggested by the Portuguese statistical authorities. 'Policy purposes' is just one of the cases foreseen by this paragraph item, and 'exceptional' losses are also explicitly covered by it.

The Portuguese statistical authorities are considering reading the above paragraph 20.198 in a fragmented way, seeing paragraphs (a) and (b) as two completely separate cases, whereas in fact the (a) and (b) paragraphs are closely interlinked.

It is also explained further in the MGDD Part III.2.2.2.1. paragraphs 12, 13 and 14. "*When the corporation has accumulated net losses or made "one off" losses, as a general rule, the capital injection is treated as a non-financial transaction (…)*". Paragraph 13 foresees possibility to partition the transaction between non-financial and financial in case the capital injection exceeds the amount of loss. However even in the above special case "*the capital injection is treated as a non-financial up to the limit of the losses and as a financial transaction beyond this amount*".

ESA 20.198 (a) mentions explicitly that "*A payment to cover accumulated, exceptional or future losses, or provided for public policy purposes, is recorded as a capital transfer (…).*" In the CGD case, it has been widely recognised that the capital injection undertaken by the Portuguese government would not have ta ken place in the absence of past losses.

As regards the argument put forward by the Portuguese statistical authorities on the heterogeneity of treatment of cases when private banks benefited from capital injections (currently recognised in Portuguese national accounts as F.5) with cases when the object of an injection was a publicly owned bank, Eurostat would like to stress that similar recording may be envisaged for the private accounts too. Nonetheless, national accounts sometimes foresee some recordings specific to certain sectors. It is worth acknowledging that if ESA has a separate chapter devoted to General Government, it is because, as explained in ESA 20.01 "*(…) the powers, motivation, and functions of government are different from those of other sectors*". It is thus not surprising that there is a need for "*additional rules on some more difficult issues of classification and measurement for the general government sector (…)*".

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) Participation of private shareholders under the same conditions as government

2) Accumulation of net losses during the years prior to the capital injection

3) Likelihood of a sufficient rate of return[2]

<u>*Private party investment*</u>

Following ESA 2010, the MGDD chapter III.2 indicates that a key question is whether there are private shareholders investing. The MGDD part III.2.2.3.1 specifies further which conditions are necessary for private shareholders to fulfil for the capital injection to be treated as financial transaction: 1) private investors take a significant share in equity, 2) they

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[2] It should be recalled that this criteria is to be checked in case of no existence of accumulated past losses. In case of significant losses accumulated over the past, its application is less relevant.

exercise the usual influence of minority shareholders and 3) bear risks and rewards similar to government, as regards their rights on the net assets in the event of liquidation. ESA 20.198b explicitly makes a reference to "similar conditions" for private investors' participation to be evidence that the payment is likely to be acquisition of equity.

As pointed out by the Portuguese statistical authorities, in the case of CGD, there are no private shareholders, and the instrument that is offered for investment to private parties is not ordinary equity but an hybrid instrument defined as *Fixed rate reset perpetual additional Tier 1 capital temporary write down notes*. The private parties investing in the CGD instruments will not gain ownership, and cannot be considered as shareholders. Thus, the above first and second conditions are not fulfilled. In addition, as the private investors are investing on different grounds as compared to government (hybrid capital instrument vs ordinary shares) also the third above condition is not met. Therefore, the conclusion could be reached that, in the CGD recapitalization, there is no private shareholder investing in the meaning of ESA 20.198b.

The Portuguese statistical authorities in their note emphasize that the fact that private investors participate in this operation should not be ignored in the analysis, and that it is not a decisive factor that the instruments chosen for private investors and government are different. Eurostat disagrees with the ultimate conclusion of this analysis for the reasons mentioned above. Moreover, Eurostat points to the fact that whereas private participation similar to that of government usually implies a financial recording (assuming no past losses) and private participation taking a different form than that of government could still feature as a criteria for supporting the recording as financial transaction, such participation would rank amongst the factors needed to be considered (pointing to sufficient future profitability or absence thereof).

The Portuguese statistical authorities stress that the injection is carried out for regulatory reasons, and also consider that the hybrid instrument is very similar to equity from both the risks (as the principal can be written-off) and rewards (with equal expected rate of returns) perspectives. While Eurostat observes that the principal is indeed at risk, it is unsure whether the risk profile is similar and certainly considers that the rewards profile is so different that the instrument cannot be deemed to be similar in the meaning of ESA 20.198(b). There is also no reason for injections to be recorded differently based on the sole fact that it is instructed by the regulator.

In the specific case of the CGD, the participation of the private sector is not a decisive element for the classification of the capital injection by government, as there were accumulated losses, and the provisions of ESA 20.198(a), as well as of the MGDD (III. 2.2.2.1. paragraphs 12 & 13) are to be applied.

Accumulation of past losses

As concerns the accumulation of past losses, CGD incurred losses in the years prior to the capital injection. The losses[3] for the period 2011-2016 are the following, as compared to the capital injection: CGD posted accumulated losses of 6323 million over the period 2011-2016, against a capital injection of 750 million in 2012 and 3944 million in 2017. Eurostat understands that the capital injection was received by the Bank and therefore the amount

[3]Because of the contingent nature of deferred taxation, the profit/loss has been used before tax.

injected should be compared with the losses incurred by the CGD individual entity (the Bank) and not the Group.

The Portuguese statistical authorities raised questions on whether the consolidated group accounts, instead of the Bank itself, should be used while assessing the magnitude of the past accumulated losses. Eurostat grants that the consideration of the entity's subsidiaries or related sister entities may be appropriate in a number of circumstances, for the capital injection test. However, this wider consideration may not encompass the whole group, whenever the entity subject to the recapitalization is not the head of the group, or whenever the entity's assets or liabilities cannot be transferred within the group in an unrestricted manner.

In this respect Eurostat would like to stress that, in the decision of the DG COMP, it is clearly stated that the notified recapitalization measures relate to the Caixa Geral de Depósitos, S.A. (“CGD” or “the Bank”). It is clear that the need for the recapitalization operation arose because the Bank was facing impairments and therefore had difficulties in meeting capital requirements. The Portuguese statistical authorities do not contest the fact that the capital injection was undertaken into the Bank. It is also worth mentioning that when it comes to the hybrid instruments *Fixed rate reset perpetual additional Tier 1 capital temporary write down notes* destined for private investors, it is the Bank that is named as the “Issuer”. Banking regulators routinely monitor, aside from the bank itself, the consolidated entity controlled by the bank, but this would be exclusive from parent entities engaged in different businesses and their subsidiaries.

In order to undertake the capital injection test, accumulated past losses should be compared with the amount of capital being injected together with the cumulated capital injections that were recorded as capital transfers. Given that CGD is fully owned by the Portuguese State, the whole amount of losses should be attributed to government for the test. The accumulated losses borne by the State, were, for the period 2011-2016, 6323 million EUR against a capital injections of 4694 million EUR. The accumulated losses borne are higher than the amount of capital injected, thus the capital injection of 2017 for its full amount should be treated as a capital transfer (deficit increasing).

The Portuguese statistical authorities have also pointed out that accumulated losses should be assessed after the DTAs. In this respect, Eurostat would like to mention that a similar approach – disregarding the DTAs – was used for other Member State cases. Generally, corporations show stocks of DTAs in their balance sheet and provide in their annual reports, information of such amounts, This is, however, an estimated amount based on a number of assumptions, and therefore, because of this contingent nature, DTAs are recognised neither as assets (of corporations) nor as liabilities (of government) in national accounts, unless they are of nature of payable tax credits.

Conclusions

Concerning the recapitalization of CGD, based on all the elements above, and, in particular:

- the fact that the decision on the non-existence of any state aid element is not a decisive element for statistical analysis,
- that it cannot be considered that private investors and government participated under similar conditions in the capital injection,

- and that the CGD accumulated losses, over the period 2011-2016, are higher than the capital injections by the State,

Eurostat considers that, following the economic substance of the transaction, the full capital injection undertaken by the Portuguese State in CGD should be treated as a capital transfer, impacting government deficit in the first quarter of 2017.

Procedure

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

Yours sincerely,

(e-Signed)

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