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Dear Colleagues,

Cleaning up bank balance sheets is a pre-condition for sustainable growth and for revitalised financial integration in Europe through the creation of the banking union. To strengthen the gradual recovery that is now at its early stages, we need to make decisive progress on both of these fronts in the coming months.

The European Council of June 2013 concluded that the balance sheet assessment in the transition towards the Single Supervisory Mechanism (SSM) will consist of an asset quality review and a stress test. In case a balance sheet assessment indicates capital needs, the bank concerned will be required to recapitalise in the first place via private sources, relying on public funds only as a last resort. In this context, the European Council further concluded that Member States participating in the SSM will make appropriate arrangements, including the establishment of national backstops, ahead of the completion of the balance sheet assessment.

Pending the entry into force of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) and when there is recourse to public money, the EU's burden-sharing framework is defined by the revised state-aid guidelines, which were presented in the recent Banking Communication and entered into force on 1 August 2013. The revised state-aid guidelines ensure a minimum level playing field in the application of burden sharing within the European Union, with adequate safeguards for preserving financial stability. According to the revised guidelines, shareholders and junior bondholders would be required to fully contribute to building the capital base of a bank before public money could be injected.

Under the Stability and Growth Pact, public capital injections are, in general terms, regarded as one-off or temporary measures and as relevant factors for financial stability, which means that they do not count against the Member State in the context of the excessive deficit procedure.

In broad terms, the treatment of capital injections requiring recourse to public backstops can be summarised as follows (detail is given in the annex).

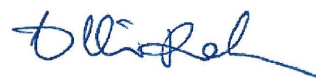
1. For a Member State in which the capital injection would lead to an apparent breach of the debt or deficit criterion of the Pact, financial stabilisation operations in the above context would be taken into account as a relevant factor in the Commission's assessment of compliance with the criteria, and thus an excessive deficit procedure (EDP) would normally not be opened. Member States with debt above 60% of GDP however would be an exception and an excessive deficit procedure (EDP) would be opened, unless the amount of capital transfers is limited so that it allows them to keep the nominal deficit close to the 3% reference value. The EDP recommendation in such a case would consider that such operations are usually of a one-off nature.

2. For a Member State that is already in EDP, a capital injection would not lead to a stepping-up of the procedure, as one-off and temporary measures are netted out of the fiscal effort recommended to correct the excessive deficit by the deadline.

3. For the abrogation of the EDP, the deficit has to be brought below 3% of GDP in a sustainable manner. While a capital injection could thus lead to a delay in abrogating the procedure, this would not result in a stepping-up of the procedure for the same reasons as given under (2), provided that the recommended fiscal effort (measured by the change in the structural balance) had been delivered.

The revised state-aid guidelines clarify that bank share-owners and junior creditors would need to contribute before taxpayers' money is spent to foot the bill in the case of possible bank bail-outs. At the same time, it is clear from the above that the EU fiscal rules provide no disincentive to effective public backstops.

Yours sincerely,



ANNEX

1. Recording capital injections in the government accounts

Eurostat has developed and published detailed guidance on the statistical treatment of public capital injections into banks.[1] Practically, the main question raised at the occurrence of capital injections is whether to record them as a purchase of equity, i.e. a financial transaction or 'below-the-line' operation increasing debt but not deficit; or to record a capital transfer, i.e. an 'above-the-line' operation increasing both debt and deficit.

The 'shareholder principle' is applied to judge whether the government acts in a way comparable to market agents, such as shareholders of a financial corporation. If the government has provided capital in its capacity as a *bona fide* investor (shareholder), meaning that it is seeking a return on the capital, then the operation should be recorded as a financial transaction without an impact on the deficit (but affecting government debt). In contrast, if no *bona fide* investor would be willing to carry out such an operation (essentially because it would consider the money to be lost or, at least, that the transaction would not provide a sufficient rate of return) then it must be recorded as a capital transfer increasing both the government's deficit and debt.

In the case of the asset quality review, the fact that the private sector is given the opportunity to inject the capital before the government intervenes shows that private investors are not willing to invest more in the corporation. This would imply that the capital injection on behalf of the government is likely to be recorded as (debt- and) deficit-increasing.

2. Excessive Deficit Procedure: establishing whether an excessive debt or deficit exists

The identification of an apparent breach of either the debt or deficit criterion triggers the preparation of a report under Article 126(3) TFEU. The report of the Commission shall take into account all relevant factors and any other factor, which the Member State may put forward, when assessing compliance with the deficit and debt criteria.

Specifically, Article 2(3) of Regulation[2] 1467/97 stipulates that "*The Commission shall give due and expressive consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In this context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances*".

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[1]http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/The_impact_of_bank_recapitalisations_on_government_fina1.pdf
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/ESTAT-decision-Criteria_for_classif_of_gov_capital_injec.pdf

[2] On *Speeding up and clarifying the implementation of the excessive deficit procedure*

Capital injections would qualify as "financial stabilisations operations during major financial disturbances", in particular, where these measures would be triggered as last resort for systemic reasons.

According to Regulation 1467/97, relevant factors are taken into account in the following way:

- In the case of apparent breach of the deficit criterion:
  - for a Member State with debt below 60% of GDP, the relevant factors are considered irrespective of the level of deficit;
  - for a Member State with debt above 60% of GDP, they are considered only if the ratio remains close to the reference value and its excess over the reference value is temporary.

  Therefore, if the relevant factors can be taken into consideration, a Member State should not be placed in EDP if the breach of the deficit criterion would not have been registered in the absence of the financial stabilisation operation.

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- In the case of apparent breach of the debt criterion (i.e. both for an apparent breach of the debt reduction benchmark, or of the 'sufficient progress' towards it applicable during the three-year transition period[3]), relevant factors are taken into account in the steps leading to the decision on the existence of an excessive deficit when assessing compliance on the basis of the debt criterion, i.e. a Member State would not be placed in EDP if the breach of the debt criterion would not have been observed in the absence of the stabilisation operation.

Two final caveats:

In any event, the Commission cannot use financial stabilisation operations and their impact on debt or the deficit as a justification for not preparing a 126(3) report, as this would be clearly against the provision of Article 2(3) of the Regulation 1467/97, which stipulates that these operations – under certain conditions – shall be taken into account as "relevant factors" in the preparation of the 126(3) report.

With debt above 60% of GDP, a Member State may have to be put in EDP, in case the activation of the fiscal backstops would lead to a deficit above 3% of GDP and not close (by 0.5% of GDP) to the reference value. Nevertheless, should such situation materialise, the ensuing EDP recommendation would take into account the usual one-off nature of such operations, i.e. the nominal deficit would revert by the amount of the one-off.

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[3] When assessing 'sufficient progress towards compliance' through the Minimum Linear Structural Adjustment (MLSA) during the transition period, both the debt and the deficit figures are netted out from debt- and deficit-increasing operations, respectively. The same applies to the computation of the debt benchmarks (backward- and forward-looking), which are used to calculate the required annual MLSA.

3. Assessing compliance with an existing EDP recommendation[4] (or notice)

For a Member State already in EDP at the time when the capital injection is recorded in the government deficit, the treatment would be as follows.

Capital injections into banks would be regarded as one-off and temporary measures, since normally such operation would not become a permanent feature of government expenditure. This has been practice already followed for support operations in the context of the financial crisis.

As such, capital injections would be netted out of the structural balance, which provides the basis for the assessment of effective action in response to an EDP recommendation (or notice). It would therefore be excluded that a negative assessment of effective action, which is the necessary condition for a stepping-up of the EDP, could be the consequence of the activation of fiscal backstops, provided the recommended fiscal effort (as measured by the change in the structural balance) has been delivered.

4. Abrogating an EDP

There are no specific provisions for capital injections into banks or, more in general, for any financial stabilisation operations, when deciding whether an EDP can be abrogated. The general rules on the conditions for abrogating the EDP (as clarified in the Code of Conduct) apply.[5] Namely, the excessive deficit procedure should only be abrogated if the deficit is below 3% of GDP (or below the deficit target specified in the recommendation linked to a debt-based EDP) and the Commission forecasts indicate that it will not exceed the 3% of GDP threshold over the forecast horizon. Beside the respect of the deficit threshold, the debt ratio will need to fulfil the forward-looking element of the debt benchmark.

This basically means that – for a Member State in EDP - if the activation of the fiscal backstop leads to a deficit above 3%, the abrogation of the EDP would be delayed. Moreover, if the activation of the fiscal backstop affects the debt and leads to not compliance with the forward-looking element of the debt benchmark, this would also delay the abrogation of the EDP, even if the deficit stays below 3%.

However, it is excluded that the activation of the fiscal backstops could cause negative assessment of effective action, which is the necessary condition for a stepping-up of the EDP, provided the recommended fiscal effort (measured by the change in the structural balance) has been delivered.

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[4] There is no difference between recommendation issued under a debt-based EDP or deficit-based EDP, as both require annual budgetary targets for the general government balance and annual improvements of the structural balance.

[5] Code of Conduct - Specifications on the implementation of the SGP and guidelines for SCPs, as endorsed by the Economic and Financial Committee (September 2012)