OPINION OF THE EUROPEAN CENTRAL BANK

of 3 September 2014

on deferred tax assets

(CON/2014/66)

Introduction and legal basis

On 9 June 2014, the European Central Bank (ECB) received a request from the Portuguese Minister of State and Finance for an opinion on a draft law establishing a special legal framework for the treatment of deferred tax assets (DTAs) of companies and State-owned enterprises, including credit institutions, that are liable for corporation tax (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and on the sixth indent of Article 2(1) of Council Decision 98/415/EC[1], as the draft law relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Background and purpose of the draft law

1.1 In line with Regulation (EU) No 575/2013[2] (hereinafter the 'CRR'), since 1 January 2014 DTAs that rely on the future profitability of credit institutions to be realised are to be progressively deducted from the calculation of their Common Equity Tier 1 (CET1) capital, because such DTAs are not considered as fully ensuring loss absorbency in all scenarios, as required by Basel III standards[3]. Article 39(2) of the CRR provides that under certain conditions DTAs arising from temporary differences are not considered to rely on future profitability. Such DTAs do not require to be deducted from a credit institution's regulatory capital in accordance with Article 38 of the CRR.

1.2 The draft law aims at addressing the negative effects on the level of regulatory capital of credit institutions and other companies[4] arising from the deduction of DTAs from that capital; for this

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1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

3 See 'Basel III: A global regulatory framework for more resilient banks and banking systems', Basel Committee on Banking Supervision, December 2010, revised version June 2011.

4 The scope of this Opinion is restricted to the aspects of the draft decree-law that relate to credit institutions.

purpose the draft law establishes a special scheme that permits certain types of DTAs to be converted into tax credits in line with Article 39(2) of the CRR. This special scheme is applicable to DTAs that result from the non-deductibility for corporation tax purposes of expenses and negative equity changes arising from losses from credit impairments and from post-employment and long-term employee benefits[5].

1.3 According to the draft law, a credit institution may decide within a given time to opt into the schemes[6]. If a credit institution decides to take part in the scheme, the credit institution must create a special reserve in the amount of 110% of the tax credit whenever one is granted which will be subject to the same legal framework as mandatory legal reserves[7]. The establishment of the special reserve also involves the simultaneous creation of rights to equity, which are allocated to the State for no consideration[8]. These rights to equity are negotiable securities that grant their holder the right to require the credit institution to convert the special reserve into share capital, and where applicable, the share premium account, by issuing ordinary shares. The State can exercise the conversion right attaching to the securities at its discretion[9]. As the shareholders of the credit institution have a call option on the rights to equity, the State can sell the securities back to those shareholders and subsequently sell any securities not bought by the shareholders to third parties. These third parties can exercise the conversion right and become shareholders of the institution.

1.4 Furthermore, the draft law aims to ensure that Portuguese credit institutions can operate on a level playing field in Europe, in view of the fact that several other Member States have also introduced similar schemes concerning DTAs.

2. General observations

2.1 The draft law makes use of the possibility opened up by Article 39(2) of the CRR to provide for the non-deduction of certain kinds of DTAs from regulatory capital. The ECB understands that the DTA/tax credit scheme set out in the draft law is of a voluntary nature and applies only to credit institutions that decide to join the scheme.

2.2 As noted in paragraph 1.2 above, the draft law seeks to address the potential negative implications for the regulatory capital of credit institutions arising from the deduction of DTAs from that capital. The ECB takes note of the expected positive impact of the draft law on the regulatory capital of the Portuguese banking sector.

2.3 The ECB recommends that the Portuguese authorities carefully assess the implications of the draft law from the perspective of fiscal debt and sovereign debt sustainability, and that they also take into account the need to break the link between the banking sector and sovereign debt. The

5 Article 1 of the Annex to the draft law.

6 Article 3(1) of the draft law and Article 2 of the Annex to the draft law.

7 Articles 3(3), 6 and 8 of the Annex to the draft law.

8 Article 9 of the Annex to the draft law.

9 Article 10 of the Annex to the draft law.

conversion of DTAs into tax credits might reduce the incentive and/or the regulatory need for shareholders to inject fresh capital into credit institutions. Furthermore, compared with the recapitalisation of the banking sector with cash provided by private investors, the DTA/tax credit scheme might create an additional debt burden for the State, irrespective of the statistical treatment of the scheme; it might strengthen the adverse link between the sovereign debt and participating credit institutions and be less favourable in comparative terms from a bank liquidity perspective. These potential risks may be exacerbated in countries with a high level of sovereign debt, and thus may contribute to financial fragmentation within the euro area.

3. Special reserve

3.1 The draft law introduces new provisions in addition to the application of Article 39(2) of the CRR, namely requirements that institutions participating in the scheme: (1) establish a special reserve in the amount of the tax credit granted plus 10 per cent; and (2) provide for the simultaneous creation of rights to equity to be allocated to the Portuguese State. The ECB understands that these additional requirements are designed to protect the State against the fiscal risks associated with the conversion of DTAs into tax credits described in paragraph 2.3.

3.2 The structure of the scheme is a matter for the Portuguese authorities to determine. The negative impact on the debt sustainability of the sovereign may well be mitigated if the State receives an equity stake in a participating credit institution in exchange for granting tax credits. Nevertheless, such a capital increase subscribed by the State will remain less preferable compared to a capital increase subscribed by private investors. The scheme may result in significant involvement by the State in the ownership of a credit institution if the tax credits granted are large relative to the total common equity of the credit institution, although the ECB understands that such risks might be mitigated by the State being able to sell the securities not only to shareholders but also to third parties, as noted in paragraph 1.3 above. Extensive state involvement in bank ownership is not advisable, not least because of the need to break the link between sovereigns and banks. In addition, potential significant involvement by the State in the ownership of a credit institution may run counter to the principle of ensuring recapitalisation via private investment into credit institutions.

4. Statistical treatment

The ECB understands that Eurostat will provide its views on the statistical treatment of the conversion of DTAs into tax credits under the scheme in due course.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 3 September 2014.

[signed]

The President of the ECB

Mario DRAGHI