REAL ESTATE AND MORTGAGE CREDIT

Considering the changes made in management of the real estate and mortgage credit over the past few years, the Executive Committee analysed this business as a whole.

The estimated cash flows of the business were projected based on current operating results and assuming the business plan and projections approved by the Executive Committee for real estate business and a set of assumptions related to the estimated future evolution of the businesses of mortgage credit originated in real estate agents network and real estate promotion.

The Real estate and mortgage business comprises the current Banco de Investimento Imobiliário operations plus the income associated with other portfolios booked in Banco Comercial Português.

The business plan and estimates for Real estate and mortgage business comprises a five-year period, from 2018 to 2022, considering, along this period, a compound annual growth rate of -4.3% for total assets and of 1.1% for the allocated capital.

As a consequence of the impairment test made at the end of 2016, it was recognised during 2016 an impairment loss of Euros 40,859,000 corresponding to 100.0% of the goodwill associated. As at 31 December 2017 and 2016, the goodwill associated with the real estate and mortgage credit is totally impaired.

31. INCOME TAX

The deferred income tax assets and liabilities are analysed as follows:

(Thousands of euros)

	2017			2016		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Deferred taxes not depending on the future profits (a)						
Impairment losses	976,535	-	976,535	927,675	-	927,675
Employee benefits	838,769	-	838,769	789,000	-	789,000
	1,815,304	-	1,815,304	1,716,675	-	1,716,675
Deferred taxes depending on the future profits						
Impairment losses	1,001,097	(50,303)	950,794	928,645	(50,303)	878,342
Tax losses carried forward	321,774	-	321,774	494,785	-	494,785
Employee benefits	32,026	(1,804)	30,222	60,083	(27,248)	32,835
Financial assets available for sale	33,531	(26,461)	7,070	60,828	(5,458)	55,370
Derivatives	-	(6,821)	(6,821)	-	(7,444)	(7,444)
Intangible assets	39	-	39	39	-	39
Other tangible assets	9,827	(3,409)	6,418	8,289	(3,547)	4,742
Others	26,344	(19,407)	6,937	34,258	(27,366)	6,892
	1,424,638	(108,205)	1,316,433	1,586,927	(121,366)	1,465,561
Total deferred taxes	3,239,942	(108,205)	3,131,737	3,303,602	(121,366)	3,182,236
Offset between deferred tax assets and deferred tax liabilities	(102,175)	102,175	-	(118,677)	118,677	-
Net deferred taxes	3,137,767	(6,030)	3,131,737	3,184,925	(2,689)	3,182,236

(a) Special Regime applicable to deferred tax assets

SPECIAL REGIME APPLICABLE TO DEFERRED TAX ASSETS

The Extraordinary General Meeting of the Bank, held on 15 October 2014, approved the Bank's adherence to the special regime applicable to deferred tax assets, approved by Law no. 61/2014, of August 26, applicable to expenses and negative equity variations recorded in taxable periods beginning on or after 1 January 2015 and the deferred tax assets that are recorded in the annual accounts of the taxpayer to the last period prior to that date and the taxation of the expenses and negative equity variations that are associated with them. Pursuant to Law no. 23/2016, of 19 August, this special regime is not apply to expenses and negative equity changes recorded in the tax periods beginning on or after 1 January 2016, or to tax assets associated with them.

The Law no. 61/2014, of 26 August, provides an optional framework with the possibility of subsequent resignation, according to which, in certain situations (those of negative net result in individual annual accounts or liquidation by voluntary dissolution, insolvency decreed in court or revocation of the respective authorization), there will be a conversion into tax credits of the deferred tax assets that have resulted from the non-deduction of expenses and reductions in the value of assets resulting from impairment losses on credits and from post-employment or long-term employee benefits. In this case, it should be constituted a special reserve corresponding to 110% of its amount, which implies the simultaneous constitution of conversion rights attributable to the State of equivalent value, which rights can be acquired by the shareholders through payment to the State of that same amount. Tax credits can be offset against tax debts of the beneficiaries (or from an entity based in Portugal of the same prudential consolidation perimeter) or reimbursable by the State. Under the regime described, the recovery of deferred tax assets covered by the optional regime approved by Law no. 61/2014, of 26 August, is not dependent on future profits.

The above-mentioned legal framework was densified by ordinance no. 259/2016, of 4 October, about the control and use of tax credits, and by the ordinance No. 293-A/2016, of 18 November, which establishes the conditions and procedures for the acquisition by the shareholders of the referred rights of the State. According to this legislation, among other aspects, these rights are subject to a right of acquisition by the shareholders on the date of creation of the rights of the State, exercisable in periods that will be established by the Board of Directors until 10 years after the date of its creation, and the issuing bank shall deposit in the name of the State the amount of the price corresponding to all the rights issued, within 3 months of date of the confirmation of the convertion of the deferred tax asset into tax credit. Such deposit shall be redeemed when and to the extent that the rights of the State are acquired by the shareholders, or exercised by the State.

Deferred taxes are calculated based on the tax rates expected to be in force when the temporary differences are reversed, which correspond to the approved rates or substantively approved at the balance sheet date. The deferred tax assets and liabilities are presented on a net basis whenever, in accordance with applicable law, current tax assets and current tax liabilities can be offset and when the deferred taxes are related to the same tax.

The deferred tax rate for Banco Comercial Português, S.A. is analysed as follows:

Description	2017	2016
Income tax	21.0%	21.0%
Municipal surtax rate (on taxable net income)	1.5%	1.5%
State tax rate (on taxable net income)		
More than 1,500,000 to 7,500,000	3.0%	3.0%
From more than 7,500,000 to 35,000,000	5.0%	5.0%
More than 35,000,000 (a)	7.0%	7.0%

(a) Law 114/2017, dated 29 December (State Budget Law for 2018) establishes the increase of the state tax rate for the portion of the taxable income above Euros 35,000,000 from 7% to 9% for taxation periods beginning on or after 1 January 2018.

The tax applicable to deferred taxes related to tax losses of the Bank is 21% (31 December 2016: 21%).

The average deferred tax rate associated with temporary differences of the Banco Comercial Português, S.A. is 31.30% (31 December 2016: 29.43%). The income tax rate in the other main countries where the Group operates is 19% in Poland, 32% in Mozambique, 0% (exemption) in the Cayman Islands and 24.24% in Switzerland.

The reporting period of tax losses in Portugal is 5 years for the losses of 2012, 2013 and 2017 and 12 years for the losses of 2014, 2015 and 2016. In Poland, the term is 5 years, in Mozambique it is 5 years and in Switzerland it is 7 years.

In 2016, Banco Comercial Português, S.A. opted for the Special Regime for Taxation of Groups of Companies (RETGS).

The balance of Deferred tax assets not depending 'on the future profits (covered by the scheme approved by Law no. 61/2014, of 26 August), include the amounts of Euros 210,686,000 and Euros 4,020,000 recorded in 2015 and 2016, respectively, related to expenses and negative equity variations with post-employment or long-term employee benefits and to specific credit impairment losses registered up to 31 December 2014.

The deferred income tax assets associated to tax losses carried forward, by expire date, is presented as follows:

(Thousands of euros)

Maturity	2017	2016
2018	1,870	4,069
2019-2025	112	4
2026	80,758	201,812
2028 and following	239,034	288,900
	321,774	494,785

Following the publication of the Notice of the Bank of Portugal No. 5/2015, the entities that presented their financial statements in Adjusted Accounting Standards issued by the Bank of Portugal (NCA), since 1 january 2016, began to apply the International Financial Reporting Standards as adopted in the European Union, including, among others, the Bank's individual financial statements.

As a result of this change, in the Bank's individual financial statements, the loans portfolio, guarantees provided and other operations of a similar nature became subject to impairment losses calculated in accordance with the requirements of International Accounting Standard 39 - Financial Instruments: Recognition and Measurement (IAS 39), replacing the registration of provisions for specific risk, for general credit risks and for country risk, in accordance with Bank of Portugal Notice No. 3/95.

The Regulatory Decree No. 5/2016, of November 18, established the maximum limits of impairment losses and other corrections of value for specific credit risk deductible for the purpose of calculating the taxable profit in 2016. This Decree declares that Bank of Portugal Notice No. 3/95 (Notice that was relevant to the determination of provisions for credit in the financial statements presented in the NCA basis) should be considered for the purposes of calculating the maximum loss limits for impairment losses accepted for tax purposes in 2016. This methodology was also applied for the treatment of the transition adjustments related to credit impairment of entities that previously presented their financial statements on an NCA basis.

This Regulatory Decree includes a transitional rule that provides for the possibility of the positive difference between the value of the provisions for credit created on 1 January 2016 under the Notice of Bank of Portugal No. 3/95 and the impairment losses recorded on 1 January 2016 referring to the same credits, will be considered in the calculation of the taxable income of 2016 only in the part that exceeds the tax losses generated in periods of taxation started on or after 1 January 2012 and not used. The Bank opted to apply this transitional standard.

The Regulatory Decree No. 11/2017, of 28 December, established the maximum limits of impairment losses and other corrections of value for specific credit risk deductible for the purposes of calculating taxable income in 2017, establishing that the Notice of Bank of Portugal No. 3/95 should be considered for the purposes of calculating the maximum limits of impairment losses accepted for tax purposes in 2017, similar to the regime for 2016.

ANALYSIS OF THE RECOVERABILITY OF DEFERRED TAX ASSETS

In accordance with the accounting policy 1 ad) ii), and with the requirements of IAS 12, the deferred tax assets were recognized based on the Group's expectation of their recoverability. The recoverability of deferred taxes depends on the implementation of the strategy of the Bank's Board of Directors, namely the generation of estimated taxable income and its interpretation of tax legislation. Any changes in the assumptions used in estimating future profits or tax legislation may have material impacts on deferred tax assets.

The assessment of the recoverability of deferred tax assets was carried out considering the respective financial statements prepared under the budget process for 2018 and which support future taxable income for each Group's entity considering the macroeconomic and competitive environment, at the same time that incorporate the Group's strategic priorities.

For the purpose of estimating taxable profits for the periods 2018 and following, the following main assumptions were considered:

- In the absence of specific rules regarding the tax regime for credit impairment and guarantees for taxation periods beginning on or after 1 January 2018, the tax rules that were in force in 2015, 2016 and 2017 were considered and of Decree-Laws published at the end of each of the referred years established that the Notice of Bank of Portugal No. 3/95 should be considered for the purposes of calculating the maximum limits of impairment losses accepted for tax purposes;

- The deductions related to impairment of financial assets were projected based on the destination (sale or settlement) and the estimated date of the respective operations;

- The deductions related to employee benefits are projected based on their estimated payments or deduction plans, in accordance with information provided by the actuary of the pension fund.

In addition, as part of the analysis of the recoverability of deferred tax assets, the Bank prepared a sensitivity analysis that considered the possibility of approving a document with changes to the tax treatment of impairment losses for credit and guarantees, in the same proposal for amendment to the State Budget Law Proposal for 2018. This proposal provided for modifications to Articles 28-A, 28-C and 39 of the IRC Code, in order to approximate fiscal rules and accounting rules and introduced a transition period of 19 years with increasing percentages for the tax deductibility of losses due to credit impairment and guarantees not accepted by tax until 31 December 2017 and which became deductible under the envisaged changes.

According to this sensitivity analysis, the Bank also concluded the recoverability of all deferred tax assets recorded as at 31 December 2017.

The projections made take into consideration, in addition to the Group's strategic priorities, essentially reflecting the projection of the Bank's medium-term business in Portugal in terms of results generation, and are broadly consistent with the Reduction Plan of Non-Performing Assets 2018-2020 sent it to the supervisory entity in March 2018, underlining:

- Improvement of the net interest income, considering interest rate curves used under the scope of the projections of net interest income in line with the market forecasts;

- Evolution of the ratio loans and advances over the balance sheet resources from customer by approximately 100% in Portugal;

- Decrease in the cost of risk, supported by the expectation of a gradual recovery of economic activity, consubstantiating a stabilization of the business risk, as well as the reduction of the non-core portfolio. In this way, the gradual convergence of the cost of credit risk (up to 2023) is estimated to be close to those currently observed in other European countries, including in the Iberian Peninsula.

- Control of the operating expenses, notwithstanding the investments planned by the Bank in the context of the expected deepening of the digitization and expansion of its commercial activities;

- Positive net income, projecting the favourable evolution of the ROE and maintaining of the CET1 ratio fully implemented at levels appropriate to the requirements and benchmarks. From 2024 onwards, it is estimated an annual growth of the Net income before income taxes, which reflects a partial convergence to the expected level of ROE stabilized term term.

The analyses made allow the conclusion of the recoverability of the total deferred tax assets recognised as at 31 December 2017.

It is now present the sensitivity of the analysis of the recoverability of deferred tax assets to the estimate of income before income taxes: If there was a 5% reduction / increase in estimated income before income taxes in all years of projections from 2018 to 2028, the deferred tax assets would have a reduction / increase of about Euros 55 million / Euros 67 million.

In accordance with this assessment, the amount of unrecognised deferred tax, by year of expiration, is as follows:

(Thousands of euros)

Tax losses carried forward	2017	2016
2017	2,258	2,453
2018	1,595	1,594
2019-2025	1,772	3
2026	132,901	917
2027 and following	279,887	172,552
	418,413	177,519

The impact of income taxes in Net income and in other captions of Group's equity, as at 31 December 2017, is analysed as follows:

(Thousands of euros)

	2017		
	Net income for the year	Reserves and retained earnings	Exchange differences
Deferred taxes			
Deferred taxes not depending on the future profits (a)			
Impairment losses	48,860	-	-
Employee benefits	16,660	33,109	-
	65,520	33,109	-
Deferred taxes depending on the future profits			
Impairment losses	70,807	-	1,645
Tax losses carried forward (b)	(84,703)	(88,428)	120
Employee benefits	3,023	(4,071)	(1,565)
Financial assets available for sale	10,076	(59,083)	707
Derivatives	1,023	-	(400)
Other tangible assets	1,616	-	60
Others	4,592	(3,972)	(575)
	6,434	(155,554)	(8)
	71,954	(122,445)	(8)
Current taxes			
Actual year	(103,756)	34	-
Correction of previous years	1,643	-	-
	(102,113)	34	-
	(30,159)	(122,411)	(8)

(a) Deferred tax related to expenses and negative equity variations covered by the special arrangements for deferred tax assets (Law No. 61/2014 of 26 August). Under the Law No. 23/2016 of 19 August, this special scheme is not applicable to expenses and negative equity variations accounted in the taxable periods beginning on or after 1 January 2016, neither to deferred tax assets associated with them. The variation occurred in 2017 refers mainly to the impact of the increase in the State tax rate for the portion of taxable income exceeding Euros 35,000,000 from 7% to 9% for taxation periods beginning on or after 1 January 2018.

(b) Taxes on reserves and retained earnings refer to realities recognised in reserves and retained earnings that compete for the purposes of calculating taxable income.

The impact of income taxes in Net income / (loss) and in other captions of Group's equity, as at 31 December 2016, is analysed as follows:

(Thousands of euros)

	2016			
	Net income / (loss) for the year	Reserves and retained earnings	Exchange differences	Discontinued operations and other variations
Deferred taxes				
Deferred taxes not depending on the future profits (a)				
Impairment losses	(12,779)	-	-	-
Employee benefits	21,425	498	-	-
	8,646	498	-	-
Deferred taxes depending on the future profits				
Impairment losses	457,473	1,324	(2,680)	13,683
Tax losses carried forward (b)	132,769	44,174	(652)	-
Employee benefits	8,211	20,759	1,228	-
Financial assets available for sale	-	66,519	(4,953)	-
Derivatives	950	-	(731)	-
Intangible assets	(4)	-	-	-
Other tangible assets	1,248	-	(51)	-
Others (c)	(114,001)	-	1,641	(511)
	486,646	132,776	(6,198)	13,172
	495,292	133,274	(6,198)	13,172
Current taxes				
Actual year	(108,125)	(1,745)	-	2
Correction of previous years	(5,300)	-	-	-
	(113,425)	(1,745)	-	2
	381,867	131,529	(6,198)	13,174

(a) Deferred tax related to expenses and negative equity variations covered by the special arrangements for deferred tax assets (Law No. 61/2014 of 26 August). Under the Law No. 23/2016 of 19 August, this special scheme is not applicable to expenses and negative equity variations accounted in the taxable periods beginning on or after 1 January 2016, neither to deferred tax assets associated with them.

(b) Taxes on reserves and retained earnings refer to realities recognised in reserves and retained earnings that compete for the purposes of calculating taxable income.

(c) The item Others mainly includes the reversal of deferred tax assets in the amount of approximately Euros 92,000,000 relating to the distribution of dividends in 2016 by subsidiaries of the Group.

The reconciliation between the nominal tax rate and the effective tax rate is analysed as follows:

(Thousands of euros)

	2017	2016
Net income / (loss) before income taxes	318,491	(281,280)
Current tax rate (%)	31.5%	29.5%
Expected tax	(100,325)	82,978
Non-deductible impairment	(30,970)	(78,305)
Contribution to the banking setor (a)	(22,631)	(14,880)
Results of companies consolidated by the equity method	28,866	23,848
Other accruals for the purpose of calculating the taxable income	588	30,861
Employees' benefits	12,003	-
Effect of difference of rate tax and deferred tax not recognised previously (b)	167,576	334,449
Derecognition of deferred tax associated with tax losses	(87,208)	-
Correction of previous years	3,782	4,989
(Autonomous tax) / tax credits	(1,840)	(2,073)
Total	(30,159)	381,867
Effective rate	9.47%	135.76%

(a) It respects to the effect of the contribution to the banking sector in Portugal, in the amount of Euros 9,777,000 (31 December 2016: Euros 7,574,000) and the tax on the banking sector in Poland, in the amount of Euros 12,854,000 (31 December 2016: Euros 7,559,000).

(b) The value of 2017 essentially relates to the deferred tax impact of the increase in the state tax rate for the portion of taxable income above Euros 35,000,000 from 7% to 9% for taxation periods beginning on or after 1 January 2018 and the difference of tax rate, mainly of Bank Millennium, S.A in Poland (tax rate of 19%). The value of 2016 includes the impact of the combined effects of the repeal of Banco of Portugal Notice 3/95, the transitional regime provided for in Regulatory Decree No. 5/2016, of 18 November and the special regime applicable to deferred tax assets (annex to the Law no. 61/2014, of August 26), in the amount of Euros 281,170,000.