

The new Commission guidance on State aid and the financial crisis

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On October 13, 2008, the European Commission released an important Communication regarding the application of its State aid rules to measures taken during the current global financial crisis to support financial institutions.¹ This new guidance is a contribution by the Commission to the efforts taken at the European and world levels to restore confidence in financial markets, which include the Eurogroup statement of October 12 and the coordinated national schemes announced by several European Member States on October 13 to safeguard the financial system. The Commission had already approved (in record time) certain other support schemes triggered by the financial crisis (eight working days for the Northern Rock plan,² and 24 hours for Bradford & Bingley's³). Immediately after releasing the Communication, the Commission approved the Irish and British general support schemes on the basis of the principles outlined in the Communication⁴, which will likely be applied to the other schemes announced by Member States over the last few days.

On December 8, the Commission released a second Communication regarding the recapitalization of financial institutions, which complements the October 13 Communication.

I. GENERAL PRINCIPLES

The key principle of the Communication is the recognition by the Commission that Article 87(3)(b) of the EC Treaty, which allows State aid to remedy “*a serious disturbance in the economy of a Member State*”, is applicable to the current financial crisis. The Commission had until now been very reluctant to apply this provision of the Treaty.

¹ Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (OJ 2008 C 270, October 25, 2008).

² *United Kingdom Restructuring aid to Northern Rock* (OJ 2008 C 14, April 2, 2008).

³ *State aid: Commission approves UK rescue aid package for Bradford & Bingley*, IP/08/1437, October 1, 2008.

⁴ *State aid: Commission approves revised Irish support scheme for financial institutions*, IP/08/1497, October 13 2008; *State aid: Commission approves UK support scheme for financial institutions*, IP/08/1496, October 13, 2008.

For example, it had refused to apply it to approve aid to Germany's new Länder⁵ or, until recently, to support measures in favor of individual banks affected by the subprime crisis.⁶ Accordingly, support measures usually were (until now) cleared in two situations: where the Commission found that no aid had been granted (because the State intervention was made at market prices), or where the Commission found that the aid fulfilled the restrictive conditions of the Rescue and Restructuring guidelines.⁷ Article 87(3)(b) gives the Commission a new basis to authorize exceptional State aid that goes well beyond its pre-existing guidelines.

The Communication, however, stresses that the Commission will not apply Article 87(3)(b) without restrictions. The Commission intends to make an individual assessment of each case, particularly taking account of the statements of the national authorities responsible for financial stability in confirming the risk of serious disturbances. Furthermore, the Commission insists on the need for general schemes, *i.e.*, schemes available to several or all financial institutions in a Member State, to be reviewed at least every six months, and terminated as soon as the economic situation permits. The Commission also stresses the distinction between, on the one hand, the situation of institutions that face a liquidity problem, but that would otherwise be fundamentally sound (absent the current exceptional circumstances), and, on the other hand, the situation of financial institutions that are more fundamentally affected, and that might require substantial restructuring measures under the Rescue and Restructuring Guidelines. Exceptionally, the Communication mentions that this application of Article 87(3)(b) might cover certain *ad hoc* interventions for individual institutions. The Commission, however, clearly indicates its preference for aid granted by way of a general scheme.

As a general rule, the Communication indicates that all measures must: (i) comply with the general principle of non-discrimination; (ii) minimize competitive distortions; and (iii) not exceed what is strictly necessary.

II. GUARANTEES COVERING THE LIABILITIES OF FINANCIAL INSTITUTIONS

Over the last few weeks, governments have used guarantees extensively to support financial institutions in difficulty.⁸ While initially focused on retail deposits, these guarantees have been extended to various kinds of liabilities, including interbank loans.

⁵ Joined cases T-132/96 and T-143/96, December 15, 1999, *Freistaat Sachsen, Volkswagen AG and Volkswagen Sachsen GmbH v Commission of the European Communities*.

⁶ See for instance, *Crédit Lyonnais* (OJ 1998 L 221/28, May 20, 1998) or *United Kingdom Restructuring aid to Northern Rock* (OJ 2008 C 14, April 2, 2008).

⁷ Communication of the Commission – Community Guidelines on State aid for rescuing and restructuring firms in difficulty (OJ 2004 C 244/02, October 1, 2004).

⁸ For instance, guarantees represent €400Bn out of the €470Bn of the German scheme announced on October 13, and €320Bn out of the €360Bn of the French scheme announced the same day. On October 13, the Dutch government also announced a €200Bn guarantee on inter-bank loans.

Under the current Commission Notice on Guarantees (“the Guarantees Guidelines”),⁹ State guarantees will be deemed to constitute State aid unless they meet strict criteria. For instance, the extent of the guarantee must be properly defined; the guarantee must not cover more than 80% of each liability covered; the beneficiary must pay a premium covering the risks and the overall costs of the guarantee. It is likely that some guarantees schemes developed during the financial crisis would not have met these criteria. The Communication explains that the Commission may authorize such guarantees schemes on the basis of Article 87(3)(b).

Regarding the material scope of the guarantees, they may cover liabilities extending beyond retail deposits. In particular, the Commission recognizes that the drying-up of interbank lending may justify guaranteeing certain types of wholesale deposits and even those short- and medium-term debt instruments that are not already adequately protected by existing investor arrangements or by other means. However, such guarantees should not, in principle, include subordinated debt (tier-2 capital) or allow for indiscriminate coverage of all liabilities. If such debt were nevertheless to be covered, specific restrictions might be necessary.

The conditions of eligibility must be objective and non-discriminatory. In particular, the Commission makes clear that there should be no discrimination on the grounds of nationality: all institutions that are incorporated in the Member State (including subsidiaries) and that have significant activities in the Member State should be covered by its guarantee scheme.

The duration and scope of schemes extending beyond retail deposit guarantees must be limited to the minimum necessary. The Commission’s approval can (in principle) last for up to two years, but this may be extended further if necessary. The necessity of the scheme must be reviewed by the Member State every six months, under the Commission’s control. Additional safeguards (such as quantitative limits, shorter issuance periods or deterrent pricing conditions) will be required for guarantees covering debt of a maturity date later than the expiry of the issuance period under the scheme.

The Communication reaffirms the principle that there must be as much private sector contribution to the scheme as possible in order to ensure that the Member State aid is kept to a minimum. This may be ensured by an adequate remuneration of the guarantee by the beneficiary, a claw-back/better fortune clause, or a rule ensuring that, in case the guarantee is activated, the private sector covers a substantial portion of the outstanding liabilities incurred by the beneficiary.

The scheme should also contain behavioral constraints in order to avoid undue distortion of competition, such as restrictions on commercial conduct, limitations to the size of the balance sheet of the beneficiaries, or the prohibition of the issuance of new stock options or share repurchases.

⁹ Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ 2008 C 155, June 20, 2008, p. 10-22).

If the guarantee scheme must be invoked for the benefit of individual financial institutions, payment should be followed within six months by a restructuring or liquidation plan to be assessed by the Commission based on its experience gathered in the application of State aid rules to financial institutions.

III. RECAPITALISATION OF FINANCIAL INSTITUTIONS

A. THE OCTOBER 13 COMMUNICATION

Recapitalizations are a second aid mechanism permitted under the new guidelines. Member States may use it to support financial institutions that may be fundamentally sound but that are experiencing distress because of the extreme conditions in financial markets.

The main innovation of the Communication on this issue is that it allows recapitalization to be launched as an emergency measure. By contrast, under the current Rescue and Restructuring guidelines, the Commission allowed such capital interventions only after a Restructuring plan was presented and assessed by the Commission. Rescue aid, which was meant only to cover emergencies, could include only loans lasting not more than six months.

The Communication applies the same conditions to these recapitalization measures as those for general guarantees schemes, regarding the objective and non-discriminatory criteria for eligibility (such as solvency requirements or the evaluation of the need for support by the financial supervisory authorities), the duration of the scheme (up to 2 years), the limitation of the aid to what is strictly necessary (for instance, through the maintenance of enhanced minimum solvency requirements or the limitation of the size of the balance sheet), safeguards against possible abuses (including behavioral constraints), and the requirement for a restructuring plan to be presented to and assessed by the Commission within six months.

Furthermore, Member States should receive rights whose values correspond to this contribution in the recapitalization. The issue price of new shares must be fixed using a market-oriented valuation. Instruments such as preferred shares with adequate remuneration or claw-back mechanisms will be looked upon favorably.

Member States must report on the use of the scheme every six months and individual plans for beneficiary undertakings must be reported upon within six months of the date of the intervention. The Commission will assess these reports according to the principles of the Rescue and Restructuring guidelines.

B. THE DECEMBER 8 COMMUNICATION

In the weeks following the October 13 Communication, the Commission's decisional practice was mainly focused on aid to distressed banks.¹⁰ However, certain recapitalization schemes were later set up by Member States for fundamentally sound banks, in order to prevent a credit crunch and to contain the spill-over of the financial crisis to the real economy. The Communication of December 8 takes this goal into account and makes a more clear-cut distinction between banks in difficulties on the one hand and banks that are fundamentally sound on the other hand. This distinction will be based on a range of indicators detailed in annex of the Communication: (i) capital adequacy (based on a review by the national supervisory authority, and evaluating the bank's exposure to various risks, the quality of the asset portfolio and the sustainability of its business model); (ii) size of the recapitalization (the Commission will value positively a recapitalization limited to less than 2% of the bank's risk weighted assets); (iii) current CDS (credit default swaps) spreads (the Commission will consider a spread equal or inferior to the average as an indicator of lower risk) and (iv) current rating of the bank and its outlook.

Regarding recapitalization of fundamentally sound banks, the Commission's control aims at preventing the crowding out of market-based operations by State-sponsored interventions. However, the extent of the commitments sought by the Commission is clearly more limited than for distressed banks. Regarding the remuneration of the State recapitalization, the Commission will accept the remuneration set in the recapitalization deal when State capital injections are accompanied with significant participation (30% or more) of private investors and treated on equal terms with the latter. In other cases, the Commission will request a minimal remuneration for the State that should be within a "price corridor" defined for each beneficiary by (i) the required rate of return on subordinated debt (lower bound) and (ii) the required rate of return on ordinary shares (upper bound).¹¹ The Commission indicates that in average, in the Euro area, these bounds are currently between 7% and 9.3%. A further differentiation will be made for each individual bank based on the type of capital chosen (the lower the subordination, the lower the required remuneration), the appropriate benchmark for a risk-free rate and the individual risk profile of the beneficiary. When the level of remuneration is not individualized for each beneficiary, it should normally be set in average above the upper bound (the Communication refers to a level of 10% for Tier 1 capital).

¹⁰ See for instance Commission decision of October 13, 2008 in case N507/2008 *Financial Support Measures to the Banking Industry in the UK* (OJ 2008 C 290, November 13, 2008, p.4), Commission decision of October 27, 2008 in case N512/2008 *Support measures for financial institutions in Germany* (OJ 2008 C 293, November 15, 2008, p.2), Commission decision of November 12, 2008 in case N528/2008 *Aid to ING Groep N.V.*, Commission decision of November 25, 2008 in case NN 68/2008 *Latvian State Support to JSC Parex Banka*.

¹¹ This calculation method is based on the recommendations of the European Central Bank Governing Council of November 20, 2008.

The Communication also insists on the need for incentive for State capital redemption, such as a pricing structure encouraging exit (for instance with a price increasing over time), an increase of global remuneration through call options or other redemption clauses, and a restrictive dividend policy (although such restrictions are not needed where the level of pricing reflects the bank's profile).

The Commission might also request certain safeguards to avoid undue competition distortions, such as a prohibition to advertise the recapitalization for commercial purposes, competitive tendering process in case of mergers and acquisitions or measures ensuring that the aid effectively contributes to the objective of financing the real economy. However, in contrast with the Commission's recent decisional practice on aid to distressed banks, restrictions to balance sheet growth are not considered a necessary safeguard in case of recapitalization of fundamentally sound banks.

Finally, the Communication requires that recapitalizations of fundamentally sound banks should be subject to a review six months after their introduction. During this review, the Commission will in particular assess the need for adding (or withdrawing) behavioral safeguards. If the bank falls in difficulties after the recapitalization, a restructuring plan must be notified.

Regarding recapitalization of banks that are not fundamentally sound, the Communication briefly recalls the Commission's prior practice, which tends to impose much stricter requirements: (i) remuneration should be higher and closer to market rates (currently at 15%); (ii) the bank must be wound up or subject to a far-reaching restructuring plan that must be presented within six months of recapitalization and (iii) behavioral safeguards must include a restrictive policy on dividends (including a ban on dividends during the restructuring period), limitation of executive remuneration and the distribution of bonuses, an obligation to restore and maintain an increased solvency level and a timetable for redemption of State participation.

IV. CONTROLLED WINDING-UP OF FINANCIAL INSTITUTIONS

Member States may initiate a controlled winding-up of the institutions that have benefited from a recapitalization, a guarantee scheme or other aid. In this context, the Communication provides that the assessment of such scheme and individual liquidation measures should follow the same lines, *mutatis mutandis*, as those of guarantees schemes.

In addition, shareholders (and possibly certain types of creditors) should be excluded from receiving the benefits of any aid in the context of a controlled winding-up procedure.

The liquidation phase should be limited to a period strictly necessary for the orderly winding-up. The beneficiary should not be allowed to pursue new activities and its banking license should be withdrawn as soon as possible.

In order to ensure that no aid is granted to the buyers, the Commission reaffirms that it will take into account the following criteria: (i) the sales process should be open and non-discriminatory; (ii) the sale should take place on the market's terms; (iii) the sales price should be maximized; and (iv) any aid granted to support the economic activity to be sold will be examined under the principles of the Rescue and Restructuring Guidelines.

V. PROVISION OF OTHER FORMS OF LIQUIDITY ASSISTANCE

Member States often accompany guarantee or recapitalization schemes with liquidity support, including support from Central Banks. The Commission reasserts that general, non-selective measures open to all comparable market players in the market (for instance open market operations or standing facilities) are not covered by State aid rules.¹²

Dedicated support to a specific financial institution may also not fall under the State aid rules when the following (non-exhaustive) conditions are met: (i) the financial institution is solvent at the moment of the provision of liquidity; (ii) the facility is fully secured by collateral to which haircuts have been applied; (iii) the Central Bank charges a punitive interest rate to the beneficiary; and (iv) the measure was taken on the central bank's own initiative.

The Communication adds that a scheme involving liquidity support from public sources that does not fulfill these criteria may still be considered as compatible aid, provided that it fulfills the principles of the Rescue and Restructuring Guidelines and is reviewed every six months. Again, the approval of the scheme may cover a period of up to two years, with the possibility of further extension.

VI. RAPID TREATMENT OF STATE AID AND INVESTIGATIONS

The Communication stresses the importance of the Member States informing the Commission of their intentions and of notifying the Commission of plans to introduce such measures as early and comprehensively as possible (and in any event before the measure is implemented). The Communication reasserts the Commission's readiness to take a decision on notified measures within 24 hours if necessary.

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¹² See for instance *Northern Rock* (OJ 2008 C 43, February 16, 2008, p.1).

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