I. General principles of State aid law

II. Bank recapitalizations

III. Guarantees

IV. Treatment of impaired assets

V. Restructuring plans and other undertakings
I. State aid under the EC Treaty

A. General principles

- **General prohibition of State aid (Article 87(1) EC)**
  - Subject to exceptions:
    - Companies in difficulty (Art. 87(3)(c))
    - Serious disturbance in national economy (Art. 87(3)(b))
  - Aid must be notified to the Commission, which has the exclusive power to approve/reject (Article 88(3) EC)
  - Non-notified (and non-allowed) aid is illegal and must be recovered

- **R&R guidelines (2004):**
  - **Rescue aid:** temporary (maximum 6 months) and reversible assistance designed to keep the beneficiary afloat
  - **Restructuring aid:**
    - Based on restructuring plan approved by the Commission
    - Aid may include structural measures
    - Plan must restore long-term viability
    - Plan must include significant measures (in particular sell-off of assets) ensuring that beneficiary’s contribution to restructuring costs is in principle more than 50%
    - Additional measures to avoid undue competition distortions
I. State aid under the EC Treaty

B. The State Aid Procedure

- Notification of proposed aid to DG COMP by the Member State(s) granting the aid

- Commission approval required before aid may be granted ("stand-still obligation"), except if a general scheme was already authorized

- Two phases:
  - Preliminary phase: within 2 months after complete notification - in practice, can be a few days in emergencies linked to the financial crisis
  - Formal investigation, if Commission has doubts on compatibility - in practice, 4 months minimum

- The decision-making process:
  - Decision by the College of 27 Commissioners
  - In certain limited cases, possible decision by the Commissioner for Competition after consulting the President of the Commission and two other members.

- The main players:
  - Commission (DG COMP, cabinets)
  - Member States (Treasury, Central Bank, Perm Rep)
  - Beneficiary
  - Competitors
I. State aid under the EC Treaty
C. State aid and the financial crisis(1)

- Pre-October 2008: Commission approvals based on Article 87(3)(c) (aid to companies in difficulty) - Northern Rock, IKB, Sachsen LB

- Since October 11, 2008:
  - Four major phases:
    - Dealing with the emergencies: October 2008-December 2008
    - Good bank/bad bank: the recapitalization issue: December 2008-March 2009
    - Reorganising the market – toxic assets and the first final decisions: March 2009- July 2009
    - Since July 2009: the restructuring issue- tough times ahead?
  - > 70 decisions, including more than 25 general schemes, and more than 30 aids to individual institutions
  - All notified support mechanisms were authorized, most of them in preliminary procedure, article 87(3)(b)
  - All authorizations were subject to commitments
  - Review after 6 months in most cases
Main principles

- All measures must be non-discriminatory and limited in time
- Appropriateness: aid must be "well-targeted"
- Necessity: aid must be limited to the minimum
- Proportionality: limitation of competition distortions
II. Recapitalizations

Distinction « financially sound banks » vs « banks in distress »

- Recapitalization of financially sound banks:
  - State remuneration (7-9.3% in euro-area, can be as high as 10%)
  - Safeguards against competition distortions: prohibition to advertise recapitalization, competitive tendering process in case of M&A. However, no restriction to balance-sheet size
  - Exit requirements: pricing structure encouraging redemption, increase of global remuneration through e.g. call options, step-up, restrictive dividend policy

- Recapitalization of banks in distress
  - State remuneration (at least 10% for tier-1)
  - In-depth restructuring plan
  - Stricter behavioral safeguards:
    - Similar to safeguards on guarantees (e.g. Restrictions to commercial conduct, pricing, market shares, balance-sheet expansion) - cf. Germany
    - Ban on dividends during the restructuring period; restrictive policy afterwards (cf. Germany)
    - Limitation of executive pay and bonuses
    - Obligation to restore and maintain an increased solvency level
    - Timetable for redemption of state participation- cf. Fortis, sale to private operator (BNP paribas)
III. Guarantees (1)

- **Material scope:**
  - May cover liabilities extending beyond retail deposits
  - Should not cover subordinated debt (Tier-2 capital)
  - No indiscriminate coverage of all liabilities
  - Example: Ireland - scheme covers all deposits, covered bonds, senior debt, dated subordinated debt

- **Eligibility conditions:**
  - Objective and non-discriminatory on the grounds of nationality
  - Example: Spain - all institutions registered in Spain accounting for more than 1/1000th of the credit market
III. Guarantees (2)

- **Duration of the approval:**
  - Maximum 2 years or window of 6 months of debt lasting 3 to 5 years

- **Remuneration (ECB recommendations of October 2008):**
  - Maturities exceeding 1 year, 50 BP + median of CDS spreads over last 20 months
  - Maturities up to 1 year: flat fee of 50 BP

- **Review** by Member State every 6 months

- If the guarantee is called, restructuring plan to be submitted within 6 months
IV. Purchase/guarantee of Toxic Assets

A. Examples of national schemes

- Spanish fund (authorized by Commission)
  - outright purchase: limited to AAA covered bonds, reverse auction mechanism
  - temporary purchase (Repo): covered bonds/ ABS, minimum AA

- ING
  - $35.1 Billion perpetual guarantee of ING’s Alt-A Securitized Mortgage Portfolio
  - Sharing of profits and losses of the Alt-A Portfolio on a 80% (Dutch State) / 20% (ING) basis
  - ING remains owner of record of the Alt-A Portfolio
  - ING must provide €25 billion of “extra credit” to individuals and businesses in the Netherlands

- RBS asset protection scheme
  - Injection of £325bn of assets in the Asset Protection Scheme
  - Total “first loss” for RBS 6% or some £20bn
  - Government will cover up to 90 per cent of any further losses.
  - RBS will pay a fee of 2 per cent of the value of the assets insured
IV. Purchase / guarantee of Assets

B. Commission Communication (1)

- Commission Communication of February 25, 2009 (on « impaired assets»)

- Commission recognizes that uncertainty about valuation and localization of bad assets is a key cause for the crisis and that asset relief is thus needed to restore confidence and avoid repeated recapitalization. Commission guidance provided to ensure consistent, community wide approach.

- Impaired asset protection can be ensured via a program for purchasing impaired assets, or for « insuring » impaired assets, or a combination.

- Impaired assets should be kept organizationally separate from other assets

- Commission focus on asset transfer at today's economic value, losses to be assumed by financial institution. If this would lead to insolvency, exceptions can be made for « systemic banks »), but would trigger restructuring requirements.

- The impaired asset communication is no longer based on the distinction between « fundamentally sound » banks and « distressed » banks; rather sliding scale of intensity of restructuring measures depending on the degree of difficulty found to exist.
IV. Purchase / guarantee of Assets

B. Commission Communication (2)

- Key principles of Commission approach:
  1. Transparency and disclosure
     - Prior to being admitted into an impaired asset relief program, a financial institution would have to fully disclose all impaired assets, based on adequate valuation, certified by independent experts and validated by the supervisory authority.
  2. Burden sharing State/shareholders/creditors
     - Participation only against appropriate remuneration
       - Normally – asset purchase at « real economic value ». If higher price is necessary to avoid insolvency – significant restructuring of affected bank and conditions (better fortunes clause).
     - If identified losses lead to technical insolvency:
       - Put participating bank into administration or winding up
       - for systemic banks: guarantee or asset relief for the period necessary to devise a plan for restructuring or winding up
     - The lower the contribution upfront, the higher the need for shareholder contribution later (e.g. conversion of State losses into shares or additional compensatory measures in restructuring)
  3. Behavioral Restrictions
     - Undertaking to lend to the real economy, restrictions on dividend policy and caps on excessive remuneration.
IV. Purchase / guarantee of Assets

B. Commission Communication (3)

4. Aligning incentives for banks to participate
   - Enrolment window of 6 months (as of start of program)
   - Ensure that banks who need it participate, e.g. through mandatory participation or through other incentives.

5. Eligibility of assets
   - Not strictly limited to toxic assets (US mortgage backed securities and associated hedges and securities) in order to restore confidence
   - Flexibility to allow
     - assets affected by specific problems in a MS (e.g., assets related to real estate « bubble » in Spain and UK)
     - other assets without specific justification for 10-20% maximum of total assets
   - Assets that entered the balance sheet after a specified cut-off date prior to announcement of the scheme (e.g. end 2008) are not eligible
   - The wider the eligibility and the greater the proportion of impaired assets of total assets of a bank, the more thorough the restructuring and the remedies to avoid undue distortions of competition will have to be.
6. Restructuring and return to viability

- Commission decision will be valid for only 6 months. Restructuring/viability plan will have to be submitted within 3 months after application for the scheme by the individual beneficiary.

- Extent of necessary restructuring depends on: various criteria such as proportion of assets concerned; transfer price compared to market price; nature of the problems of the bank; soundness of business model and investment strategy; etc.

- In-depth restructuring needed if
  - Asset valuation leads to negative equity/technical insolvency
  - Bank already received State aid to cover or avoid losses or aid exceeds 2% of total risk weighted assets

- Extent of compensatory measures (e.g. downsizing, divestment, behavioral commitments) depends on e.g.: aid amount, volume and risk profile of assets, proportion of losses resulting from the asset, soundness, quality of risk management, solvency ratios in the absence of aid, impact of aid on the market
V. Restructuring plans and other undertakings

A. Restructuring plans- main principles

- Main goal of restructuring plans: to show return to long-term viability. If this goal cannot be reached, liquidation should be contemplated.

- Several restructuring plans submitted before October 2008: Sachsen LB (approved), Northern Rock (pending), Roskilde Bank

- Post-October 2008, in most individual cases, a restructuring plan must be submitted within 6 months:
  - West LB (end-March)
  - Bradford & Bingley (end-March)
  - HRE (early April)
  - Bayern LB (early April)
  - Dexia (early April)
  - ING (mid-May)
  - ...

- The submission of a restructuring plan prolongs the Commission’s temporary 6-months approval until the Commission authorizes (or rejects) the plan.
The Commerzbank Decision (May 2009)

- Previously merged with Dresdner Bank
- The measures: € 18 Bn recap + € 15 Bn guarantee
- 45% balance sheet reduction after 2014, through the sale of Eurohypo, partial withdrawal from Central-Eastern Europe, reduction of real estate assets…
- Reduction of number of branches from 1540 to 1200 from 2010 to 2015
- Staff reduction of –20% (9000 persons)
- No dividend and coupon payment for 2008-2009 (dividend) and 2009-2010 (coupon)
- Acquisition ban until end 2012
- Behavioural commitment against predatory prices (not in the top 3 on main markets)
V. Restructuring plans and other undertakings

C. The July 2009 Restructuring Communication(1)

Applies the principles laid down in previous Communications:

- Restoring long term viability: the bank must be able to cover all its costs and provide an appropriate return on equity at the end of the restructuring period;

- The State aid received must be either redeemed over time or be remunerated based on market conditions;

- The aid must be limited to the minimum necessary and the burden of restructuring costs should be shared between the Member State and the private sector;

- Limiting distortions of Competition and ensuring a competitive banking sector, through structural measures and behavioral commitments;

- Monitoring mechanism based on the submission of detailed regular reports (6 months).
There are not so many differences with the R&R Guidelines:

- **Eligibility**: Not only banks in difficulties but also fundamentally sound banks.
  - Distinction between the two is not clear cut.

- **Time frame**: 5 years to implement the restructuring measures instead of 3.
  - Will the banks really use these five years?

- **Burden Sharing**: No more ex ante formula.
  - The Commission will assess the contribution on a case by case basis. But the Commission does not seem so willing to use its discretion.

- **Limiting distortion of competition**:
  - Caps on issuance of new loans which were imposed in the past may no longer be seen as appropriate: need to meet lending targets to the real economy.
  - Structural measures are in principle allowed.
Conclusion - the challenges and questions ahead

- Does it actually work? The economic imperative
- Will it stand up in Court? The legal imperative
- What about the Single Market? The competition imperative
- Is it still relevant? The existential imperative
- What’s the way to the exit?