DG's Competition Review of Guarantee and Recapitalization Scheme

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DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis

7 August 2009

1. INTRODUCTION

(1) Following the deepening of the financial crisis in the autumn of 2008, the Commission provided guidance in the form of Communications on the design and implementation of State aid in favour of banks. In these Communications, the Commission recognised that the severity of the crisis justified the grant of aid on the basis of Article 87(3)(b) EC and set out a coherent framework for the provision by Member States of public guarantees, recapitalisation measures and impaired asset relief, whether to individual banks or as part of a national scheme. The primary rationale of the guidance in these Communications is to ensure that emergency measures for reasons of financial stability guarantee a level playing-field between banks located in different Member States as well as between banks who receive public support and those who do not. State aid control by the Commission aims to minimise negative spillovers of public interventions between Member States, between beneficiaries of aid with different risk profiles, and between aid beneficiaries and banks that do not benefit from State aid, while facilitating the achievement of the objectives of the schemes.

(2) On the basis of this guidance, the Commission has since October 2008 approved on a temporary basis a large number of schemes under State aid rules. A number of these schemes have already expired or are set to expire. Many Member States have already extended or intend to further extend the schemes’ validity and/or to introduce such schemes where they have not existed so far.

(3) The Commission services, more specifically, DG Competition, have undertaken the review of the existing national guarantee and recapitalisation schemes with respect to their objectives of ensuring financial stability and restoring lending to the real economy while safeguarding the internal market, minimising distortions of competition and paving the way to return to normal market functioning when possible. The results presented in this review are exclusively based on the decision-making practise and experience accumulated by the Commission since the beginning of the crisis.

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2 This review contains a general overview on the measures taken by the Member States during the crisis and is in that way connected to the individual six month reviews per measure undertaken by the Commission pursuant to points 34 and 42 of the Banking Communication and point 40 of the Recapitalisation Communication.
1.1. Ensuring consistency and effectiveness of schemes in the context of their re-notification

(4) This review is in the first place an opportunity to ensure consistency and effectiveness of the schemes authorised to date in light of their extension when they are re-notified. It aims to identify the central elements which form the basis of an acceptable design of guarantee and recapitalisation schemes and may call for adjustments in particular in the light of issues raised by Member States and other parties. This exercise is without prejudice to the possible need to introduce additional elements in the existing and new schemes at a later stage as a result of the continuous review of schemes. This review does not deal with impaired asset relief measures as it is still too early to assess the impact of the measures, given the Commission's relatively limited experience so far with applying the Impaired Assets Communication and with only a limited number of schemes and ad hoc interventions analysed by the Commission effectively implemented.

1.2. Exit strategies

(5) Effectiveness moreover implies the need to develop a strategy to enable state aid to be withdrawn once conditions for a sustainable economic recovery of private markets are met.

(6) The issue will be given further attention in due course, in order to initiate in a timely manner the discussion on the phasing-out of schemes when the crisis starts to abate.

2. STATE OF PLAY OF APPROVAL OF GUARANTEE AND RECAPITALISATION SCHEMES

(7) In the period from October 2008 until mid-July 2009 the Commission approved 11 guarantee schemes, 6 recapitalisation schemes and 5 schemes providing for both guarantees and recapitalisation. In addition, 40 State aid measures were approved outside the schemes. The total volume of the approved guarantee measures amounts to € 2.9 trillion and the recapitalisation measures amount to € 313 billion. So far, 9 Member States have not taken any measures.

(8) Over and above the guarantee and recapitalisation measures, a number of Members States have notified sui generis schemes, including asset relief measures and direct lending. These schemes are not subject to this review.

(9) On 15 April 2009 the prolongation and revision process started with the approval of the prolongation of the UK guarantee scheme. In the meantime ten additional schemes (schemes of Sweden, Finland, France, Italy, Latvia, Spain, Germany, Austria, the Netherlands and Slovenia) have been prolonged. The revision process will continue until the end of September 2009 with a peak of re-notifications having occurred in June.

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3 See overview of decisions adopted by the Commission in the financial sector in the current crisis in Annex 1.
4 See overview of amounts and take-up of aid measures taken to combat the financial crisis per Member State in Annex 2.
3. EFFECTIVENESS AND TAKE UP OF SCHEMES – ISSUES RAISED

(10) In order to assess the effectiveness of the schemes approved since October 2008, the Commission has been able to rely on a number of sources of information, including in particular the information gathered during the work of the EFC Task Force on the effectiveness of rescue schemes.

3.1. Effectiveness

(11) In principle, effectiveness is measured against the objectives agreed by the European Council in October 2008:

- Restoration of financial stability;
- Restoring the provision of credit and lending to the real economy;
- Impact on public finances and the functioning of the internal market.

Restoration of financial stability

(12) The announcement and implementation of rescue measures have played an important role in avoiding a financial markets meltdown and contributed to restoring market confidence. However, confidence in the solvency and earning potential of banks continues to be undermined by concerns about the quality of assets on their balance sheets. The decline in the real economy may also lead to a so-called negative feedback loop which in turn could further deteriorate the resilience of the banking sector. At the same time, while the interbank money market is improving, it continues to show volatility and sensitivity to credit risk and counterparty risk.

(13) Public capital injections have been instrumental in underpinning the level of bank capital. In the absence of these government capital injections a significant number of banks would not have been able to meet market requirements for higher capital ratios and could even have faced the risk of insolvency.

Restoring the provision of credit and lending to the real economy

(14) State guarantees and capital injections were crucial in improving the downward spiral and had a positive impact on banks’ access to wholesale funding, thereby supporting the flow of credit to the real economy. Whereas the flow of credit to the economy has decelerated, the origin of this evolution, i.e. demand or supply driven, is difficult to identify. Continued uncertainty regarding the extent of ultimate losses and more risk-sensitive pricing, as well as the general decline of demand for credit, have also contributed to decelerating volumes of bank lending in the EU. Banks reported for the first quarter of 2009 that the financial market tensions continued to have an adverse impact on their capital positions and lending capacity.

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6 ECB lending survey, 29 April 2009
The amount of public resources potentially committed by Member States in implementing the emergency measures that are in place is significant. As documented in recent IMF papers and the recent report on Public Finances in the EMU 2009 published by the Commission on 5 June 2009, this implies increasing explicit future public debt levels or implicit future debt levels. However, it is too early to judge whether thus far the response of governments to the crisis has been disproportionate. Governments have reported not to face any problems in financing the schemes but it is evident from the widening of the sovereign benchmark spreads and the downgrading of the sovereign debt of some Member States that the market has priced in a significant risk transfer from the private to the public sector.

As to the impact on the functioning of the internal market, the Commission framework helped to prevent major threats to the internal market notably in the early phase of the crisis. The State aid rules, during the crisis, have provided a co-ordination tool in order to ensure a maximum of coherence across national interventions. The various policy measures have proved to be highly effective in averting a meltdown of the financial system and in helping to gradually restore a more normal functioning of markets, as signalled by improvements of typical indicators of market stress. Finally, it should be noted that the impact of financial support measures is reassessed on a regular basis.

3.2. Take-up of schemes by banks

The take-up rate by banks (defined as the actual use of the measure relative to the committed budget) for recapitalisation is considered to be satisfactory by the Member States, whilst the take-up rate for State guarantees remains considerably below that for recapitalisation. The use of recapitalisation measures has been relatively widespread. The take-up rate amounts to 32.8 % for State guarantees and 54.8% for recapitalization measures within schemes and including individual measures outside of schemes.

The take-up rate can only be a first preliminary indicator for the functioning of the schemes. A high take-up in a given Member State is not necessarily an indication of whether the measure is adequate or not. Low guarantee take-up rates in certain Member States are partly due to the fact that the amounts announced under the schemes are higher than the actual needs. Moreover, in some Member States banks were able to access the funds easily on the market, often for a lower price. A relatively high yield on the guaranteed debt was related in many cases to a combination of increasing yields on sovereign debt and liquidity premium on guaranteed debt.

Finally, a scheme may be effective in restoring financial stability even without take-up, as it is often part of a more general strategy by Member States to reassure financial markets by announcing their commitment to support banks.

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8 Detailed description of take-up by Member States in Annex 2.
3.3. **Issues raised by certain Member States**

(20) In several fora, including the Task Force on effectiveness, issues have mainly been raised in respect of guarantee schemes, as opposed to approved recapitalisation schemes. The major concerns relate to the temporal scope of the liabilities covered by guarantees and the pricing of guarantees.

**Guarantee schemes**

(21) Some Member States are of the opinion that guarantee schemes are drafted too restrictively and that the schemes should in particular be allowed to cover all debt up to five years maturity. This would meet banks' concerns to obtain longer-term financing, would allow for a further dispersion of maturities and would avoid all debt coming to maturity at the same time.

(22) With regard to the pricing of guarantees the following specific concerns have been raised:

**I. Different guarantee value for banks of the same rating**

The pricing scheme does not address the risk of the guarantor, which depends on the rating of the government that provides the guarantee. Consequently, the total cost of a guarantee issued by entities of the same quality is different across Member States depending on sovereign yields. The difference, according to the information submitted by the Member States, can amount up to 50 basis points.

**II. Asymmetry between pricing in the short and long run**

The current pricing guidelines stipulate a flat fee of 50 basis points for the pricing of credit guarantees on bank debt with maturities of less than one year, without consideration of a CDS (credit default swap) spread or any other credit risk measure. Some Member States consider that a flat fee of 50 basis points may favour funding with maturities of less than one year.

**III. Asymmetry in the methodology between banks with and without CDS spread**

The use of a different methodology for banks with and without CDS spread results in situations where smaller banks without CDS spread but with a higher rating than banks with a CDS spread may end up paying a higher fee for a guarantee. Moreover, the credit risk element in the current pricing model is based on pre-crisis data on the pricing of risk. Post-crisis developments are not taken into account.

**IV. Add-ons**

The liquidity premium on guaranteed debt relative to government debt has turned out to be considerably higher than expected, which makes the standard 50 basis points add-on provided for in the ECB recommendation on the pricing of guarantees more onerous than expected.

**Recapitalisation schemes**

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9 EFC Report "Reviewing the effectiveness of financial support measures" addressed to the 3-4 April Informal EcoFin; Member States' replies to a questionnaire sent out by the EFC in February 2009
One of the few concerns raised with regard to recapitalisation schemes was the effectiveness of clauses requiring lending to the real economy introduced by some Member States. For example, in France where such a clause was included as a condition in the scheme, it has been reported to be working well. On the other hand, banks in other Member States have criticised the use of such a clause, indicating that in particular the requirement to increase lending to SMEs might not be reasonable when the demand for financing in this market segment is falling. Banks also consider that complaints about banks' lending policies may originate from non-viable businesses that represent bad lending risks and that are looking for government support. This would indicate that the problem could be the quality of borrowers rather than the willingness of banks to provide funding. Finally, some banks seem to be reluctant to make use of the support measures due to the constraints attached to such a lending clause.

4. ENSURING CONSISTENCY AND EFFECTIVENESS OF SCHEMES IN THE CONTEXT OF RENOTIFICATION

4.1. Guarantee schemes

4.1.1. General principles

On 13 October 2008, the Commission adopted the Banking Communication, where the Commission set out the general principles governing the application of Article 87(3)(b) EC during the banking crisis. As to guarantees covering the liabilities of banks, the Banking Communication provides guidance in particular on eligibility, material scope, duration, limiting aid to the minimum necessary, behavioural commitments and adjustment measures.

4.1.2. Assessment criteria – necessary requirements

In the last eight months, the Commission has consolidated the criteria and the baseline standards that have to be met in order to obtain Commission approval. The relevant criteria, based on the Commission's decision-making practise so far, together with the description of the necessary requirements are described in Table 1 below.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Necessary requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible institutions</td>
<td>Banks incorporated in a Member State, including foreign subsidiaries. Justification required in case other financial institutions than banks are eligible.</td>
</tr>
<tr>
<td>Types of liabilities covered</td>
<td>Newly issued or renewed debt instruments, excluding subordinated debt.</td>
</tr>
<tr>
<td>Temporal scope of liabilities</td>
<td>Debt with maturities of three months up to three years. Maturities up to five years can be guaranteed in exceptional circumstances up to one-third of the total volume of the scheme if justification is provided. There is no limitation on an individual bank level. Exceptionally shorter maturities have been agreed.</td>
</tr>
</tbody>
</table>

One issue was raised by a single Member State: Germany has repeatedly disputed the limit of 2% RWA for recapitalisation.
<table>
<thead>
<tr>
<th>Budget</th>
<th>Either a global budget or a limitation on an individual bank level.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remuneration of guarantee</td>
<td>Minimum fee is pricing described in the ECB recommendations on government guarantees on bank debt of 20 October 2008. Add-on element of 50 basis points can be decreased to 20 basis points if high quality collateral is provided. ECB recommendations provide for lower fee for shorter maturities.</td>
</tr>
<tr>
<td>Behavioural safeguards</td>
<td>Prohibition of marketing of the State guarantee as a commercial advantage.</td>
</tr>
<tr>
<td>Duration of scheme and debt issuing window</td>
<td>Maximum six months with possibility of prolongation after renotification. The debt issuance window for banks cannot be longer than the end of the scheme.</td>
</tr>
<tr>
<td>Submission of restructuring plan</td>
<td>Submission of restructuring plan in case the guarantee is called.</td>
</tr>
<tr>
<td>Review and reporting</td>
<td>Reporting every six months prior to renotification. Review every six months upon expiration of approval. In case of prolongation, notification of prolongation should occur one month before expiration of the scheme.</td>
</tr>
</tbody>
</table>

4.1.3.  Reply to concerns raised by certain Member States

(26) With respect to criticism that guarantee schemes are drafted too restrictively and in particular that all debt should be allowable up to five years maturity it should be borne in mind that currently up to one-third of the approved overall amount of the guarantee can be used for maturities up to five years\(^{11}\). Each Member State can decide on the attribution of the five-year maturities, with no limitations per individual bank when the total budget ensures that the bank will retain part of the risk to prevent excessive moral hazard.\(^{12}\)

(27) The different price of the State guarantee for banks is a general and broad concern. As already indicated by the ECB it is difficult to address this problem as it is inherent to the fact that banks are located and choose to be located in different Member States.

(28) As to the asymmetry in the methodology between banks with and without CDS spread, the current pricing model does not take into account the changes occurred in the banks' credit status since 31 August 2008. Thus banks that have been downgraded during the crisis are still benefiting from their previous higher credit standing. This was considered as an appropriate means to restore financial stability but could arguably be adjusted towards the current CDS spread level to better reflect changes in market conditions and reduce distortions across banks. By analogy for banks without CDS spread the current credit rating could be used.

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\(^{12}\) In exceptional cases, when justified by the particular business model of the bank concerned. A derogation to this principle can be allowed upon individual notification. See Commission approval of guarantees for NordLB, case NN25/2008, OJ C182, 26.07.2008, page 1
The existence of an asymmetry between pricing in the short- and long-term seems to be less justified. This asymmetry is caused by difference in remuneration that has to be paid for the guarantee depending on the maturity of the issued debt. For short-term debt, a flat add-on fee of 50 bp has to be paid, while the fee for longer-term debt is based on a fixed fee combined with a fee depending on the banks’ CDS spread. This provides incentives for the issue of short-term debt which could be problematic. Ideally, banks should gradually move to longer term debt in order to secure in a sustainable way their maturity transformation role. This issue needs to be monitored in further reviews on the effectiveness of schemes.

As to the add-on element of 50 basis points it has to be clarified that already now it can be reduced to 20 basis points when high quality collateral is provided\textsuperscript{13}. It is important nevertheless to maintain a strong incentive for banks to seek funding without recourse to State guarantees.

4.2. Recapitalisation schemes

4.2.1. General principles

The Recapitalisation Communication of 5 December 2008 gives guidance on the assessment by the Commission of recapitalisation schemes notified by the Member States. Its main principles are:

- Adequate remuneration, reflecting the bank’s risk profile, should be paid for the recapitalisation;
- Exit incentives should be present, making it unattractive for the beneficiaries to rely on the State any longer than necessary;
- There should be behavioural safeguards to prevent the distortion of competition;
- A restructuring plan should be submitted for each bank that falls into difficulties after the recapitalisation or is considered an unsound bank before the recapitalisation took place. Member States should provide a viability plan in respect to banks that are considered to be fundamentally sound;
- Regular review and reporting should be provided in order to determine the need for continuation of the schemes.

4.2.2. Assessment criteria – necessary requirements

In the Recapitalisation Communication, the Commission has established certain criteria and requirements of acceptable schemes. The review of the Commission's decisional practice with regard to recapitalisation schemes, has provided more insight in these baseline requirements for schemes. The relevant criteria, together with the necessary requirements are shown in Table 2.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Necessary requirements</th>
</tr>
</thead>
</table>

\textsuperscript{13} This has for instance been applied in cases; N655/2008, \textit{Secured Guaranteed MTN Programme for Nord LB}, OJ C 63, 18.03.2009, page 16 and N548/08, \textit{Financial support measures to the banking industry in France}, OJ C 123, 03.06.2009, page 1.
4.2.3. **Additional considerations to improve consistency and effectiveness**

(33) Apart from the necessary requirements of a recapitalisation scheme as set out above, the Commission has also identified in its decisions five additional elements which should be present in prolonged and new schemes in order to ensure consistency and effectiveness. The first three elements (limitation of the amount of recapitalisation, reporting obligation and the lending to the real economy) have already been introduced into the schemes in the context of the latest approvals and the notification of the prolongation of recapitalisation schemes. The last two (limitation of coupon payments on hybrid capital and individual notification for the second recapitalisation) are relatively new elements that may call for adjustments already in the ongoing round of prolongations. More information on these elements is provided below.

(34) Furthermore, since the adoption of the Recapitalisation Communication some Member States have planned to introduce impaired asset relief measures, which will have to comply with State aid rules as set out in the Impaired Assets Communication of February 2009. The introduction of such measures which have also a confidence restoration element is also relevant for the renewal of recapitalisation schemes to ensure consistency and effectiveness. An asset relief measure is believed to have comparable positive effects on a bank's relevant capital ratio to those of a recapitalisation. Therefore, the existence of

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14 Without prejudice to the contractual terms of each hybrid issuance.
asset relief measures is bound to have an effect on the amount of a possible recapitalisation under a scheme. The Commission therefore takes into account, where relevant, the existence of asset relief measures in order to ensure that the aid and the distortion of competition between Member States and banks remains limited to the minimum, especially if banks benefit both from a recapitalisation and impaired asset measures.

**Amount of recapitalisation**

(35) Experience with existing schemes shows that it is advisable for Member States to set an ex ante limit to the amount individual institutions can obtain under the scheme (i.e. maximum tier-1 ratio per institution\(^{15}\)).

**Reporting**

(36) From the start of the crisis, the Commission has insisted on regular reporting by the Member States on the implementation of the approved recapitalisation schemes. In line with point 40 of the Recapitalisation Communication, six months from the introduction of their schemes, Member States should submit to the Commission an overall report on the implementation of the schemes. The information that needs to be provided by the Member States as part of this review includes information on each bank recapitalised under the scheme. It is also necessary to provide an assessment of the bank's business model and further information including the bank's prospective capital adequacy in order to enable the Commission to make an assessment of the bank's risk profile and viability. Furthermore, Member States should provide for each recapitalised bank the path towards exit from reliance on State capital. Any new scheme or prolongation should contain a reporting obligation that complies with the requirements of point 40 of the Recapitalisation Communication.

**Reporting on specific recapitalisations under the scheme**

(37) Any new scheme or prolongation should contain the obligation to inform the Commission at the moment of each recapitalisation taking place in the framework of the scheme about the risk profile of the beneficiary bank\(^{16}\), so that the Commission can assess its situation and draw the necessary consequences in terms of the need to provide a restructuring plan\(^{17}\).

(38) If a bank receives a second recapitalisation the Commission should also be informed, so that it can assess whether that bank can be considered fundamentally sound or requires some restructuring. In the latter case an individual notification would be necessary.

**Lending to the real economy clause**

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\(^{15}\) Member States should introduce objective criteria for determining the level of recapitalisation required in each individual case. Supervisory authorities should verify and confirm these criteria as well as the level of recapitalisation in each case. This justification should be provided to the Commission as part of the regular reporting exercise.


\(^{17}\) This information to be provided at the moment of each individual recapitalisation differs from the general reporting obligation of Member States discussed in point 36.
(39) Some Member States have inserted a clause inciting banks receiving support to keep up lending to the real economy. The clauses differ significantly in their formulation and in their management. The Commission supports this objective; however it notes that the clause in question should not constrain the way banks normally operate including the way banks operate across borders. Lending provided pursuant to such a clause should normally be based on market terms. Furthermore, the clause should not discriminate geographically resulting in a de facto repatriation of loans to the countries where they receive State support.

**Behavioural safeguards – coupon payments on hybrid capital**

(40) The Commission considers that a careful approach should be taken with regard to coupon payments on hybrid capital. The banks should be able to remunerate capital, both in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities. However, banks should not use State aid to remunerate own funds (equity and subordinated debt) when those activities do not generate sufficient profits\(^{18}\). These restrictions would be applied on a case by case basis and would be without prejudice to the contractual terms of each hybrid issuance.

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Annex 1: State aid cases - situation as at 29 June 2009

Link to State aid: Overview of national measures adopted as a response to the financial/economic crisis:

### Annex 2: Overview of aid measures per Member State

#### EU public interventions in the banking sector (in % of GDP)

<table>
<thead>
<tr>
<th>Capital injections</th>
<th>Guarantees on bank liabilities</th>
<th>Relief of impaired asset</th>
<th>Liquidity and bank funding support</th>
<th>Total for all approved measures</th>
<th>Total effective for all measures</th>
<th>Deposit guarantee scheme (in € unless otherwise indicated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total approved measures</td>
<td>Effective capital injections</td>
<td>Total approved measures</td>
<td>Guarantees granted</td>
<td>Total approved measures</td>
<td>Effective asset relief</td>
<td>Total approved measures</td>
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<td>Austria</td>
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<td>1.7</td>
<td>25.7</td>
<td>5.1</td>
<td>0.4</td>
<td>0.4</td>
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<td>Belgium</td>
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<td>76.6</td>
<td>16.3</td>
<td>10.1</td>
<td>4.2</td>
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<tr>
<td>Cyprus</td>
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<td>Czech Republic</td>
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<td>0.0</td>
</tr>
<tr>
<td>Denmark</td>
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<td>0.0</td>
<td>0.0</td>
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<td>Malta</td>
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<td>6.4</td>
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<td>Poland</td>
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<td>Romania</td>
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</tr>
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<tr>
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<td>48.5</td>
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<tr>
<td>Total EA</td>
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<td>1.4</td>
<td>20.7</td>
<td>8.7</td>
<td>1.1</td>
<td>0.8</td>
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</table>

**NA** - Not Available indicates that the information is not available in the public domain.

**NR** - Not Reported indicates that the amount was not reported by the Member State in its reply to the EFC questionnaire.

(*) Member States shall ensure that the coverage for the aggregate deposits of each depositor shall be at least EUR 50 000 in the event of deposits being unavailable. The same coverage level should apply to all depositors regardless of whether a Member State’s currency is the euro or not. Member States outside the euro area should have the possibility to round off the amounts resulting from the conversion without compromising the equivalent protection of depositors.

(**) The minimum level is £50 000 and in no event less than €50 000.

19 Source: Commission Services. Effective figures are provisional and subject to cross-checking with Member States, cut-off date: Mid May. Approved measures, cut-off date: 17 July 2009.

20 **Glossary:**

**Recapitalisation:** all capital injections, either via a national scheme or via an ad hoc individual rescues; acquisitions of stakes by the governments in the banking sector.

**Guarantee:** all state guarantees on bank liabilities (bond issuance), coverage of the guarantee may vary from one country to another. Maturities covered can range from 1M to up to 5 Y.

**Assets:** all interventions aiming at asset relief, i.e. toxic and impaired assets, "bad banks".

**Liquidity:** all interventions aiming at supporting liquidity and providing extra financing to the bank thanks to a state guarantee. This includes a broad range of interventions, such as liquidity facilities at central banks when there is an explicit guarantee by the state, loans or high quality assets swaps. This category also includes measures supporting the supply of credit to the real economy via banking intermediation. Some of the measures reported in the "liquidity" category were not necessarily assessed as state aid but implied public spending or a contingent exposure for MS' budget.