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(INFORMATION)

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COMMISSION

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

(2008/C 270/02)

1. INTRODUCTION

1. The global financial crisis has intensified markedly and has now impacted heavily on the EU banking sector. Over and above specific problems related in particular to the US mortgage market and mortgage-backed assets or linked to losses stemming from excessively risky strategies of individual banks, there has been a general erosion of confidence in the past weeks within the banking sector. The pervasive uncertainty about the credit risk of individual financial institutions has dried up the market of interbank lending and has consequently made access to liquidity progressively more difficult for financial institutions across the board.

2. The current situation threatens the existence of individual financial institutions with problems that are a result of their particular business model or business practices whose weaknesses are exposed and exacerbated by the crisis in the financial markets. If such institutions are to be returned to long-term viability rather than liquidated, a far reaching restructuring of their operations will be required. Under the prevailing circumstances, the crisis equally affects financial institutions that are fundamentally sound and whose difficulties stem exclusively from the general market conditions which have severely restricted access to liquidity. Long-term viability of these institutions may require less substantial restructuring. In any case however, measures taken by a Member State to support (certain) institutions operating within its national financial market may favour these institutions to the detriment of others operating within that Member State or in other Member States.

3. The ECOFIN Council on 7 October 2008 adopted Conclusions committing to take all necessary measures to enhance the soundness and stability of the banking system in order to restore confidence and the proper functioning of the financial sector. The recapitalisation of vulnerable systemically relevant financial institutions was recognized as one means, among others, of appropriately protecting the depositors’ interests and the stability of the system. It was further agreed that public intervention has to be decided on at national level but within a coordinated framework and on the basis of a number of EU common principles (1). On the same occasion the Commission offered to shortly issue guidance as to the broad framework within which the State aid compatibility of recapitalisation and guarantee schemes, and cases of application of such schemes, could be rapidly assessed.

4. Given the scale of the crisis, now also endangering fundamentally sound banks, the high degree of integration and interdependence of European financial markets, and the drastic repercussions of the potential failure of a systemically relevant financial institution further exacerbating the crisis, the Commission recognises that Member States may consider it necessary to adopt appropriate measures to safeguard the stability of the financial system. Due to the particular nature of the current problems in the financial markets:

— interventions should be timely and the support should in principle be temporary,
— Member States will be watchful regarding the interests of taxpayers,
— existing shareholders should bear the due consequences of the intervention,
— Member States should be in a position to bring about a change of management,
— the management should not retain undue benefits — governments may have inter alia the power to intervene in remuneration,
— legitimate interest of competitors must be protected, in particular through the State aid rules,
— negative spill-over effects should be avoided.

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sector such measures may have to extend beyond the stabilisation of individual financial institutions and include general schemes.

5. While the exceptional circumstances prevailing at the moment have to be duly taken into account when applying the State aid rules to measures addressing the crisis in the financial markets the Commission has to ensure that such measures do not generate unnecessary distortions of competitions between financial institutions operating in the market or negative spillover effects on other Member States. It is the purpose of this Communication to provide guidance on the criteria relevant for the compatibility with the Treaty of general schemes as well as individual cases of application of such schemes and ad hoc cases of systemic relevance. In applying these criteria to measures taken by Member States, the Commission will proceed with the swiftness that is necessary to ensure legal certainty and to restore confidence in financial markets.

2. GENERAL PRINCIPLES

6. State aid to individual undertakings in difficulties is normally assessed under Article 87(3)(c) of the Treaty and the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (1) (hereinafter ‘R&R guidelines’) which articulate the Commission’s understanding of Article 87(3)(c) of the Treaty for this type of aid. The R&R guidelines are of general application, while foreseeing certain specific criteria for the financial sector.

7. In addition, under Article 87(3)(b) of the Treaty the Commission may allow State aid ‘to remedy a serious disturbance in the economy of a Member State’.

8. The Commission reaffirms that, in line with the case law and its decision making practice (2), Article 87(3)(b) of the Treaty necessitates a restrictive interpretation of what can be considered a serious disturbance of a Member State’s economy.

9. In the light of the level of seriousness that the current crisis in the financial markets has reached and of its possible impact on the overall economy of Member States, the Commission considers that Article 87(3)(b) is, in the present circumstances, available as a legal basis for aid measures undertaken to address this systemic crisis. This applies, in particular, to aid that is granted by way of a general scheme available to several or all financial institutions in a Member State. Should the Member State’s authorities responsible for financial stability declare to the Commission that there is a risk of such a serious disturbance, this shall be of particular relevance for the Commission’s assessment.

10. Ad hoc interventions by Member States are not excluded in circumstances fulfilling the criteria of Article 87(3)(b). In the case of both schemes and ad hoc interventions, while the assessment of the aid should follow the general principles laid down in the R&R guidelines adopted pursuant to Article 87(3)(c) of the Treaty, the current circumstances may allow the approval of exceptional measures such as structural emergency interventions, protection of rights of third parties such as creditors, and rescue measures potentially going beyond 6 months.

11. It needs to be emphasised, however, that the above considerations imply that the use of Article 87(3)(b) cannot be envisaged as a matter of principle in crisis situations in other individual sectors in the absence of a comparable risk that they have an immediate impact on the economy of a Member State as a whole. As regards the financial sector, invoking this provision is possible only in genuinely exceptional circumstances where the entire functioning of financial markets is jeopardised.

12. Where there is a serious disturbance of a Member State’s economy along the lines set out above, recourse to Article 87(3)(b) is possible not on an open-ended basis but only as long as the crisis situation justifies its application.

13. This entails the need for all general schemes set up on this basis, e.g. in the form of a guarantee or recapitalization scheme, to be reviewed on a regular basis and terminated as soon as the economic situation of the Member State in question so permits. While acknowledging that it is currently impossible to predict the duration of the current extraordinary problems in the financial markets and that it may be indispensable in order to restore confidence to signal that a measure will be extended as long as the crisis continues, the Commission considers it a necessary element for the compatibility of any general scheme that the Member State carries out a review at least every six months and reports back to the Commission on the result of such review.

14. Furthermore, the Commission considers that the treatment of illiquid but otherwise fundamentally sound financial institutions in the absence of the current exceptional circumstances should be distinguished from the treatment of financial institutions characterized by endogenous problems. In the first case, viability problems are

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(1) OJ C 244, 1.10.2004, p. 2.
inherently exogenous and have to do with the present extreme situation in the financial market rather than with inefficiency or excessive risk-taking. As a result distortions of competition resulting from schemes supporting the viability of such institutions will normally be more limited and require less substantial restructuring. By contrast, other financial institutions, likely to be particularly affected by losses stemming for instance from inefficiencies, poor asset-liability management or risky strategies, would fit with the normal framework of rescue aid, and in particular need a far-reaching restructuring, as well as compensatory measures to limit distortions of competition (1). In all cases, however, in the absence of appropriate safeguards, distortions of competition may be substantial from the implementation of guarantee and recapitalization schemes, as they could unduly favour the beneficiaries to the detriment of their competitors or may aggravate the liquidity problems for financial institutions located in other Member States.

15. Moreover, in line with the general principles underlying the State aid rules of the Treaty, which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimized as far as possible, and taking due account of the current circumstances, all general support measures have to be:

— well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,

— proportionate to the challenge faced, not going beyond what is required to attain this effect, and

— designed in such a way as to minimize negative spill-over effects on competitors, other sectors and other Member States.

16. The observance of these criteria in compliance with the State aid rules and the fundamental freedoms enshrined in the Treaty, including the principle of non-discrimination, is necessary for the preservation of the proper functioning of the internal market. In its assessment, the Commission will take into account the following criteria to decide upon the compatibility of the State aid measures enumerated below.

3. GUARANTEES COVERING THE LIABILITIES OF FINANCIAL INSTITUTIONS

17. The principles set out above translate into the following considerations as regards guarantee schemes protecting liabilities established by way of a declaration, legislation or contractual regime, it being understood that these considerations are of a general nature and need to be adapted to the particular circumstances of every individual case.

18. A significant distortion of competition may arise if some market players are excluded from the benefit of the guarantee. The eligibility criteria of financial institutions for coverage by such a guarantee must be objective, taking due account of their role in the relevant banking system and the overall economy, and non-discriminatory so as to avoid undue distortive effects on neighbouring markets and the internal market as a whole. In application of the principle of non discrimination on the grounds of nationality, all institutions incorporated in the Member State concerned, including subsidiaries, and with significant activities in that Member State should be covered by the scheme.

Material scope of a guarantee — types of liabilities covered

19. In the present exceptional circumstances, it may be necessary to reassure depositors with financial institutions that they will not suffer losses, so as to limit the possibility of bank runs and undue negative spillover effects on healthy banks. In principle, therefore, in the context of a systemic crisis, general guarantees protecting retail deposits (and debt held by retail clients) can be a legitimate component of the public policy response.

20. As regards guarantees going beyond retail deposits, the selection of the types of debt and liabilities covered must be targeted, to the extent practicable, to the specific source of difficulties and restricted to what can be considered necessary to confront the relevant aspects of the current financial crisis, as they could otherwise delay the necessary adjustment process and generate harmful moral hazard (2).

21. In the application of this principle, the drying-up of interbank lending due to an erosion of confidence between financial institutions may also justify guaranteeing certain types of wholesale deposits and even short and medium-term debt instruments, to the extent such liabilities are not already adequately protected by existing investor arrangements or other means (3).

22. The extension of the coverage of any guarantee to further types of debt beyond this relatively broad scope would require a closer scrutiny as to its justification.

23. Such guarantees should not, in principle, include subordinated debt (tier 2 capital) or an indiscriminate coverage of all liabilities, as it would merely tend to safeguard the interests of shareholders and other risk capital investors. If such debt is covered, thereby allowing expansion of capital and thus of lending activity, specific restrictions may be necessary.

(1) It being understood that the exact nature and timing of the restructuring to be carried out may be affected by the present turmoil in the financial markets.

(2) The limitation of the amount of the guarantee available, possibly in relation to the balance sheet size of the beneficiary may also be an element safeguarding the proportionality of the scheme in this respect.

(3) Such as, for example, covered bonds and debt and deposits with collateral in government bonds or covered bonds.
Temporal scope of the guarantee scheme

24. The duration and scope of any guarantee scheme going beyond retail deposit guarantee schemes must be limited to the minimum necessary. In line with the general principles set out above, taking into account the currently unpredictable duration of the fundamental shortcomings in the functioning of financial markets, the Commission considers it a necessary element for the compatibility of any general scheme for the Member State to carry out a review every six months, covering the justification for the continued application of the scheme and the potential for adjustments to deal with evolution in the situation of financial markets. The results of this review will have to be submitted to the Commission. Provided that such regular review is ensured, the approval of the scheme may cover a period longer than six months and up to two years in principle. It may be further extended, upon Commission approval, as long as the crisis in the financial markets so requires. Should the scheme permit guarantees to continue to cover the relevant debt until a maturity date later than the expiry of the issuance period under the scheme, additional safeguards would be necessary in order to prevent excessive distortion of competition. Such safeguards may include a shorter issuance period than that allowed in principle under the present communication, deterrent pricing conditions and appropriate quantitative limits on the debt covered.

Aid limited to the minimum — private sector contribution

25. In application of the general State aid principle that the amount and intensity of the aid must be limited to the strict minimum, Member States have to take appropriate steps to ensure a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee and, where the need arises, the cost of State intervention if the guarantee has to be drawn upon.

26. The exact calculation and composition of such contribution depends on the particular circumstances. The Commission considers that an adequate combination of some or all of the following elements (1) would satisfy the requirement of aid being kept to the minimum:

— the guarantee scheme must be based on an adequate remuneration by the beneficiary financial institutions individually and/or the financial sector at large (2). Bearing in mind the difficulty of determining a market rate for guarantees of this nature and dimension in the absence of a comparable benchmark, and taking into account the potential difficulties in the current circumstances for beneficiaries to bear the amounts that might properly be charged, the fees charged for the provision of the scheme should come as close as possible to what could be considered a market price. Appropriate pricing mechanisms reflecting the varying degree of risks and the beneficiaries' different credit profiles and needs, will be important contributions to the proportionality of the measure,

— if the guarantee has to be activated, a further significant private sector contribution could consist in the coverage of at least a considerable part of the outstanding liabilities incurred by the beneficiary undertaking (if it continues to exist) or by the sector, the Member State's intervention being limited to amounts exceeding this contribution,

— the Commission recognizes that beneficiaries may not immediately be able to pay an appropriate remuneration in its entirety. Therefore, in order to complement or partially substitute the preceding elements, Member States could consider a clawback/better fortunes clause that would require beneficiaries to pay either an additional remuneration for the provision of the guarantee as such (in case it does not have to be activated) or to reimburse at least a part of any amounts paid by the Member State under the guarantee (in case it needs to be drawn upon) as soon as they are in a position to do so.

Avoidance of undue distortions of competition

27. Given the inherent risks that any guarantee scheme will entail negative effects on non-beneficiary banks, including those in other Member States, the system must include appropriate mechanisms to minimize such distortions and the potential abuse of the preferential situations of beneficiaries brought about by a State guarantee. Such safeguards, which are also important to avoid moral hazard, should include an adequate combination of some or all of the following elements (3):

— behavioural constraints ensuring that beneficiary financial institutions do not engage in aggressive expansion against the background of the guarantee to the detriment of competitors not covered by such protection. This can be done, for example by:

— restrictions on commercial conduct, such as advertising invoking the guaranteed status of the beneficiary bank, pricing or on business expansion, e.g. through the introduction of a market share ceiling (4),

— limitations to the size of the balance-sheet of the beneficiary institutions in relation to an appropriate benchmark (e.g. gross domestic product or money market growth (5)),

(1) This is a non-exhaustive list of tools contributing to the objective of avoiding undue distortions of competition.
(2) The retention of profits in order to ensure adequate recapitalization could also be an element to be considered in this context.
(3) While safeguarding the availability of credit to the economy notably in case of recession.
— the prohibition of conduct that would be irreconcilable with the purpose of the guarantee such as, for example, share repurchases by beneficiary financial institutions or the issuance of new stock options for management,
— appropriate provisions that enable the Member State concerned to enforce these behavioural constraints including the sanction of removing the guarantee protection from a beneficiary financial institution in case of non-compliance.

Follow-up by adjustment measures

28. The Commission considers that, in order to avoid distortions of competition to the maximum extent possible, a general guarantee scheme needs to be seen as a temporary emergency measure to address the acute symptoms of the current crisis in financial markets. Such measures cannot, by definition, represent a fully-fledged response to the root causes of this crisis linked to structural shortcomings in the functioning of the organization of financial markets or to specific problems of individual financial institutions or to a combination of both.

29. Therefore, a guarantee scheme needs to be accompanied, in due course, by necessary adjustment measures for the sector as a whole and/or by the restructuring or liquidation of individual beneficiaries, in particular for those for which the guarantee has to be drawn upon.

Application of the scheme to individual cases

30. Where the guarantee scheme has to be called upon for the benefit of individual financial institutions it is indispensable that this emergency rescue measure aimed to keep the insolvent institution afloat, which gives rise to an additional distortion of competition over and above that resulting from the general introduction of financial markets so permits, by adequate steps leading to a restructuring or liquidation of the beneficiary. This triggers the requirement of the notification of a restructuring or liquidation plan for recipients of payments under the guarantee which will be separately assessed by the Commission as to its compliance with the State aid rules (1).

31. In the assessment of a restructuring plan, the Commission will be guided by the requirements:
— to ensure that aid is kept to the minimum and that there is substantial private participation to the costs of the restructuring,
— to safeguard that there is no undue distortion of competition and no unjustified benefits deriving from the activation of the guarantee.

32. In this assessment, the Commission can build on the experience gathered in the application of State aid rules to financial institutions in the past, having regard to the particular features of a crisis that has reached a dimension to qualify as a serious disturbance of the economy of Member States.

33. The Commission will also take into account the distinction between aid measures necessitated exclusively by the current bottleneck in access to liquidity in relation to an otherwise fundamentally sound financial institution, as opposed to assistance provided to beneficiaries that are additionally suffering from structural solvency problems linked for instance to their particular business model or investment strategy. In principle, assistance to the latter category of beneficiaries is likely to raise greater concerns.

4. RECAPITALISATION OF FINANCIAL INSTITUTIONS

34. A second systemic measure in response to the ongoing financial crisis would be the establishment of a recapitalisation scheme which would be used to support financial institutions that are fundamentally sound but may experience distress because of extreme conditions in financial markets. The objective would be to provide public funds so as to strengthen the capital base of the financial institutions directly or to facilitate the injection of private capital by other means, so as to prevent negative systemic spillovers.

35. In principle, the above considerations in relation to general guarantee schemes apply, mutatis mutandis, also to recapitalisation schemes. This holds true for:
— objective and non-discriminatory criteria for eligibility,
— the temporal scope of the scheme,
— limitation of the aid to the strict necessary,
— the need for safeguards against possible abuses and undue distortions of competition, bearing in mind that the irreversible nature of capital injections entails the need for provisions in the scheme which allow the Member State to monitor and enforce the observance of these safeguards and to take steps avoiding undue distortions of competition, where appropriate, at a later stage (2), and

(*) As a matter of principle, the Commission considers that in the event of payments having to be made to beneficiary financial institution, the payment has to be followed within six months by a restructuring plan or a liquidation plan, as the case may be. In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring/liquidation cases. The Commission may consider that there is no need to submit a plan for the pure liquidation of an institution, or where the size of the institution is negligible.

(1) According to the principles of the R&R guidelines.
36. The particular nature of a recapitalisation measure gives rise to the following considerations.

37. Eligibility should be based on objective criteria, such as the need to ensure a sufficient level of capitalisation with respect to the solvency requirements that do not lead to unjustified discriminatory treatment. Evaluation of the need for support by the financial supervisory authorities would be a positive element.

38. The capital injection must be limited to the minimum necessary and should not allow the beneficiary to engage in aggressive commercial strategies or expansion of its activities or other purposes that would imply undue distortions of competition. In that context the maintenance of enhanced minimum solvency requirement levels, and/or limitation to the total size of the balance sheet of the financial institution will be evaluated positively. The beneficiaries should contribute as much as possible in the light of the current crisis through their own means including private participation (\(^1\)).

39. Capital interventions in financial institutions must be done on terms that minimise the amount of the aid. According to the instrument chosen (e.g. shares, warrants, subordinated capital, ...) the Member State concerned should, in principle, receive rights, the value of which corresponds to their contribution to the recapitalisation. The issue price of new shares must be fixed on the basis of a market-oriented valuation. In order to ensure that the public support is only given in return for an appropriate counterpart, instruments such as preferred shares with adequate remuneration, will be regarded positively. Alternatively the introduction of claw-back mechanisms or better fortunes clauses will have to be considered.

40. Similar considerations will apply to other measures and schemes aimed at tackling the problem from the financial institutions’ asset side, that would contribute to the strengthening of the institutions’ capital requirements. In particular, where a Member State buys or swaps assets this will have to be done at a valuation which reflects their underlying risks, with no undue discrimination as to the sellers.

41. The approval of the aid scheme does not exempt Member States from submitting a report to the Commission on the use of the scheme every six months and individual plans for the beneficiary undertakings within 6 months from the date of the intervention (\(^1\)).

42. As in the case of guarantee schemes but having regard to the inherently irreversible nature of recapitalisation measures, the Commission will carry out its assessment of such plans in such a way as to ensure the coherence of the overall results of recapitalisation under the scheme with those of a recapitalisation measure taken outside such a scheme according to the principles of the R&R guidelines, taking into consideration the particular features of a systemic crisis in the financial markets.

5. CONTROLLED WINDING-UP OF FINANCIAL INSTITUTIONS

43. In the context of the current financial crisis a Member State may also wish to carry out a controlled winding-up of certain financial institutions in its jurisdiction. Such a controlled liquidation, possibly carried out in conjunction with a contribution of public funds, may be applied in individual cases, either as a second step, after rescue aid to an individual financial institution when it becomes clear that the latter cannot be restructured successfully, or in one single action. Controlled winding-up may also constitute an element of a general guarantee scheme, e.g. where a Member State undertakes to initiate liquidation of the financial institutions for which the guarantee needs to be activated.

44. Again, the assessment of such a scheme and of individual liquidation measures taken under such a scheme follows the same lines, mutatis mutandis, as set out above for guarantee schemes.

45. The particular nature of a liquidation measure gives rise to the following considerations.

46. In the context of liquidation, particular care has to be taken to minimise moral hazard, notably by excluding shareholders and possibly certain types of creditors from receiving the benefit of any aid in the context of the controlled winding-up procedure.

47. To avoid undue distortions of competition, the liquidation phase should be limited to the period strictly necessary for the orderly winding-up. As long as the beneficiary financial institution continues to operate it should not pursue any new activities, but merely continue the ongoing ones. The banking licence should be withdrawn as soon as possible.

\(^1\) The upfront provision of a certain contribution may need to be supplemented by provisions allowing the imposition of additional contributions at a later stage.
48. In ensuring that the aid amount is kept to the minimum necessary in view of the objective pursued, it needs to be taken into account that the protection of financial stability within the current financial turmoil may imply the necessity to reimburse certain creditors of the liquidated bank through aid measures. The choice of criteria for the selection of the types of liabilities for this purpose should follow the same rules as in relation to the liabilities covered by a guarantee scheme.

49. In order to ensure that no aid is granted to the buyers of the financial institution or parts of it or to the entities sold, it is important that certain sales conditions are respected. The following criteria will be taken into account by the Commission when determining the potential existence of aid:

— the sales process should be open and non-discriminatory,
— the sale should take place on market terms,
— the financial institution or the government, depending on the structure chosen, should maximise the sales price for the assets and liabilities involved,
— in case it is necessary to grant an aid to the economic activity to be sold, this will lead to an individual examination according to the principles of the R&R guidelines.

50. Where the application of these criteria leads to the finding of aid to buyers or to sold entities, the compatibility of that aid will have to be assessed separately.

6. PROVISION OF OTHER FORMS OF LIQUIDITY ASSISTANCE

51. In dealing with acute liquidity problems of some financial institutions, Member States may wish to accompany guarantees or recapitalisation schemes with complementary forms of liquidity support, with the provisions of public funds (including funds from the central bank). The Commission has already clarified that where a Member State/central bank reacts to a banking crisis not with selective measures in favour of individual banks, but with general measures open to all comparable market players in the market (e.g. lending to the whole market on equal terms), such general measures are often outside the scope of the State aid rules and do not need to be notified to the Commission. The Commission considers (1) that the provision of central banks’ funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as:

— the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,
— the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value,
— the central bank charges a penal interest rate to the beneficiary,
— the measure is taken at the central bank’s own initiative, and in particular is not backed by any counter-guarantee of the State.

52. The Commission considers that in the current exceptional circumstances a scheme of liquidity support from public sources (including the central bank) where it constitutes aid, can be found compatible, according to the principles of the R&R guidelines. Provided that the regular review of such a liquidity scheme every six months is ensured (2), the approval of the scheme may cover a period longer than six months and up to two years, in principle. It may be further extended, upon Commission approval, in the event that the crisis in the financial markets so requires.

7. RAPID TREATMENT OF STATE AID INVESTIGATIONS

53. When applying the State aid rules to the measures dealt with in this Communication in a manner that takes account of prevailing financial market conditions, the Commission, in co-operation with the Member States, should ensure both that they achieve their objective and that the related distortions of competition both within and between Member States are kept to a minimum. In order to facilitate this cooperation and to provide both Member States and third parties with the necessary legal certainty on the compliance of the measures undertaken with the Treaty (which is a significant component of restoring confidence to the markets), it is of paramount importance that Member States inform the Commission of their intentions and notify plans to introduce such measures as early and comprehensively as possible and in any event before the measure is implemented. The Commission has taken appropriate steps to ensure the swift adoption of decisions upon complete notification, if necessary within 24 hours and over a weekend.

(2) The principles set out above in point 24 would apply to this review.