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Financial Support Measures to the Banking Industry in the UK

European Union: European Commission

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Subject: State Aid N 507/2008 – UK
Financial Support Measures to the Banking Industry in the UK

Sir,

I. PROCEDURE

1. On 12 October 2008 the UK notified a package of measures designed to ensure the stability of the financial system.

II. DESCRIPTION

1. The objective of the measures

2. In response to the ongoing exceptional turbulence in world financial markets, the UK intends to bring forward a package of measures (hereinafter referred to "the scheme" or "financial support measures") designed to restore stability to the financial system and to remedy a serious disturbance to the economy of the UK. These measures have as their objective restoring confidence and encouraging healthy inter-bank lending, through the provision of liquidity, the recapitalisation of the financial sector and provision of state guarantee to new debt issuance.

3. The proposed measures fall into three parts:
   A. Bank Recapitalisation Scheme (hereinafter "The Recap Scheme"): Making available new Tier 1 capital for banks and building societies to strengthen their balance sheets and permit them to restructure their finances, while maintaining their support for the economy as a whole.
   B. Wholesale Funding Guarantee Scheme (hereinafter "The Guarantee Scheme"): Providing a State guarantee of short and medium term debt insurance designed to reopen the market for short and medium term wholesale funding, thus addressing the problems of banks which are fundamentally sound but which, due to the current financial crisis, are unable to refinance their wholesale funding as it matures.
   C. Short-Term Liquidity Measures (hereinafter "The STL-Measure"): The provision of short term liquidity, mainly by extending the collateral accepted for sterling and US dollar money market operations.

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2. The Beneficiaries

4. Eligible institutions will be sufficiently capitalised UK incorporated banks (including UK subsidiaries of foreign institutions) which have substantial business in the UK and building societies.¹ A UK incorporated bank has a "substantial business" for this purpose if it is eligible to sign up for the Bank of England's Standing Facilities in accordance with its Framework for the Bank of England's Operations in the Sterling Money Markets (i.e. with eligible liabilities above £500 million).

3. Description of the measures

A. The Recap Scheme

5. The objective of the Recap Scheme is to facilitate increases of Tier 1 capital in participating banks in order to strengthen the financial institutions’ capital base against possible future losses.²

6. Financial institutions that want to join the scheme have to commit to increasing their total Tier 1 capital ratio up to at least […].³

7. These benchmarks are in addition to existing regulatory ratios which focus also on total capital. The benchmarks require significantly more high quality capital than the international regulatory minima, which will still apply. The amount of additional capital that is required of eligible institutions in order to be able to participate in the Wholesale Funding Guarantee Scheme is calculated by the Financial Services Authority (hereafter FSA), therefore, by reference to the amount of capital that is required to ensure that UK banks have sufficient capital to withstand the stresses that may arise over the coming months and years and still be able to meet their regulatory requirements, as well as sufficient capital to support ongoing lending in the UK economy.

8. To facilitate the capital increases the UK will make available a £25 billion cash facility, to be drawn on if required, for the purchase of preference shares or, for building societies which cannot issue preference shares, permanent interest bearing shares (hereinafter “PIBS”); or to assist in the raising of ordinary equity. In addition the UK has indicated its willingness to provide a further maximum of £25 billion to support eligible institutions in the form of preference shares, PIBS or to assist in raising ordinary equity. There is a formal time window of six months for the Recap Scheme.

9. Participation in the Recap scheme is not compulsory in order to be able to participate in the Guarantee Scheme. Provided institutions fulfil commitments to increase their Tier 1 capital ratios to the level described in point 6, they will be eligible for the latter, whether this is achieved through existing shareholders or under the Recap Scheme. However any institution that wishes to participate in the Guarantee Scheme must carry out its recapitalisation within 6 months.

10. In the event that the UK provides capital, the issue of securities or the underwriting of an issue will be on terms which will vary depending on the particular circumstances of the institution. If preference shares are subscribed they will contain a fixed interest element and an element based on the particular institution’s risk profile. This resulting interest rate will be in the region of 12%. The preference shares are unlikely to carry voting rights and are to be redeemable at the option of the issuer, i.e. the financial institution.

¹ The following institutions have already confirmed their willingness to participate in the Bank Recapitalisation Scheme: Abbey National (subsidiary of Banco Santander), Barclays, Bank of Scotland, HSBC Bank, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland, Standard Chartered
² On 13/10/08 the UK announced that 3 banks, RBS, HBOS and Lloyds TSB, had already drawn £37 billion in funding.
³ Confidential information

[...]
11. If assistance is given to raising ordinary equity, it is in principle done by ‘placing and open offer’. After an open offer to existing shareholders; any shares not taken up will be placed on the market and only the remainder being taken up by the UK as underwriter. According to the UK authorities it is not possible to predict the likely level of uptake by existing shareholders […] The UK will seek the maximum permitted discount of 10% to the share price immediately prior to announcement of the placing and open offer. There is also an adequate subscription fee payable by the institution.

12. The UK will impose the following behavioural conditions to participating institutions in the Recap Scheme:

a) no cash bonuses to be paid to Directors for the current year’s performance (and these to be relinquished voluntarily, where contractually owed)

b) compliance with an Association of British Insurers best practice code on executive pay, commitment to a new FSA code on risk based remuneration at the non-executive level, and remuneration structures to be reviewed to ensure that incentives reflect long-term value creation and risk, rather than short term indicators such as profit and revenues;

c) where a Board member loses the confidence of the Board, they can be dismissed at reasonable and fair cost; and

d) the UK will work with the Board on its appointment of new independent directors (the number to be commensurate with the scale of financial support);

e) commitments to maintain, over the next three years, the availability and active marketing of competitively priced lending to homeowners and to small businesses, at a level at least equivalent to that of 2007;

f) commitments to support schemes to help people struggling with mortgage payments to stay in their homes, and to support the expansion of financial capability initiatives; and

g) the activity of all participating banks (ie across all banks in total receiving financial support, whether recapitalisation or guarantee only) will be limited to the higher of the average historical growth of the balance sheets in the UK banking sector during the period 1987 - 2007, or the annual rate of growth of UK nominal GDP in the preceding year⁴. If the thresholds are exceeded the UK authorities will take the necessary measures to re-establish the discipline, unless there is evidence that the thresholds are exceeded for reasons unrelated to the recapitalisation or wholesale funding guarantee schemes.

B. The Guarantee Scheme

13. The UK will make available a state guarantee of new short and medium term debt issuance. Eligible institutions have a window of six months to issue the new debt that will benefit from the guarantee. It is envisaged that eligible debt will include senior unsecured instruments of varying terms in sterling, US dollar or Euro. Given the typical maturities of instruments used in normal interbank funding arrangements, the guarantee on the instruments can last for up to 36 months, although the banks only have 6 months to issue the debt.

⁴ According to the UK Authorities […].
14. Eligible institutions would comprise those who are eligible under the Recap Scheme and who have a total Tier 1 capital ratio of at least [...]⁵ The Guarantee scheme will therefore only be open to institutions which are sound in terms of their balance sheet, even if in the current climate they have liquidity problems.

15. The fee payable for the guarantee is based on market benchmarks. This will comprised of two elements. The first element will be a measure of institution-specific risk. In normal markets the institution’s current CDS spread would provide a good proxy for its risk status. With the current market turbulence, however, the current CDS spread may be distorted and not constitute an objective measure of risk. Accordingly, the median⁶ of the 5-year CDS spread over the 12 month period ended on 7 October 2008 will be taken for each institution.

16. The second element will be an additional per annum mark-up to compensate the state for facilitating debt issuance at or close to the rate for gilts. This element will be 50 bps⁷. On this basis, the total cost of funding (depending on the specific institution) is estimated to be in the range of 5.4 to 5.9%.

17. The overall limit is set at £250 billion (or its currency equivalent).⁸ In terms of allocation of guarantees to institutions, [...].

18. The allocation [...].

19. The access to the Guarantee Scheme will be reviewed once eligibility is settled (after 31 December 2008).

20. The UK will impose certain conditions to issuing a state guarantee aimed at eliminating or minimising any distortive spillover effects. These will include a prohibition on the institution explicitly promoting itself on the basis of the state guarantee; and a requirement to submit a plan, within six months of applying for eligibility to join the scheme, for maintaining or restoring its ability to borrow in the wholesale market without the benefit of the guarantee (including the cessation of structurally loss-making activities).

21. Institutions that buy guarantees only (ie that do not wish to access the recapitalisation scheme), will be subject to the cap in paragraph 12(g) above. The UK does not propose that the other conditions listed in paragraph 12 above should apply but could review this on a case-by-case basis, in particular if an institution wished to purchase a very large amount of guarantees.

22. Compliance with these commitments would be overseen by the UK authorities.

C. Short-Term Liquidity Measures

23. The Bank of England (hereinafter "The Bank") will extend and widen its provision of short-term liquidity.⁹

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⁵ Eligibility does not follow automatically from the fulfilment of the capital ratio criteria because the UK authorities will still have to have regard to their role in the banking system and the economy, given that these measures are designed to remedy a serious disturbance in the UK economy.

⁶ Taking the median rather than the average avoids taking into account price spiking (whether on the upside or downside). Taking three years CDS spreads is likely to price at about 10bps over the 5 year spread.

⁷ [...].

⁸ This limit however is being kept under review and can be increased after Commission approval.

⁹ For details see market notice of the Bank of England of 8 October 2008 (http://www.bankofengland.co.uk/markets/marketnotice081008.pdf)
24. Firstly, the Bank will make available about £200 billion to eligible banks under the Special Liquidity Scheme (hereinafter "SLS") established in April 2008.\textsuperscript{10} Bank debt guaranteed under the Guarantee Scheme will be eligible as collateral for swaps of Treasury bills under the SLS. The duration of swaps and the SLS remains the same. The ‘hair cuts’ and margining applied to eligible collateral under the SLS remain unchanged. The ‘hair cuts’ and margining applied to eligible collateral under the SLS remain unchanged. The drawdown period of the SLS ends on 30 January 2009.

25. Secondly, the Bank will extend the collateral accepted in its 3-month sterling open market operations (hereinafter “OMOS”) to include bank debt guaranteed under the Guarantee Scheme. It will extend acceptable collateral in its US Dollar one week repo operations to include all collateral currently accepted in OMOS.

III. POSITION OF THE UK

26. The UK authorities accept that the recapitalisation scheme and guarantee scheme contain State aid elements. In their view the extension of the SLS is part of the essential role of the Bank of England and therefore not a state aid. In the event that the Commission concludes that the Liquidity Measures do contain aid elements, the UK Government submits that they form part of a wider package to remedy a serious disturbance in the economy of the United Kingdom which is compatible with the common market.

27. The UK authorities seek urgent authorisation for the financial support scheme. According to the UK authorities, fears regarding the creditworthiness of counterparties have led to an extreme and dangerous flight to quality across the global financial system. Public sector intervention is necessary to restore market confidence. The three elements contained in the scheme: increased capital; a temporary and partial guarantee to stimulate wholesale funding markets; and the provision of necessary liquidity, represent in their view a comprehensive, necessary and proportionate package to restore financial stability in the UK and elsewhere. Given the severe stress in global financial markets and in the UK financial system, it is in their view imperative that the measures are implemented immediately.

28. The UK authorities claim that the scheme is compatible with the common market because it is necessary to remedy a serious disturbance in the British economy pursuant to Article 87(3)(b) of the EC Treaty.

29. A letter sent by the Bank of England dated 12 October 2008 confirms that the notified measures are urgently required to prevent harmful spill-over effects on the entire British financial system and on the economy as a whole.

30. The UK authorities consider that the notified scheme does not involve any unduly adverse spill-over effects on other Member States or undue distortions of competition. The measures are open to any bank with significant business in the UK (whether UK or foreign-owned) which requires it, and therefore is open and non-discriminatory and do not threaten to distort competition.

31. The UK authorities have committed that the ‘hair cuts’ and margining applied to eligible collateral under the SLS remain unchanged, and that the only change to the definition of eligible collateral is that bank debt guaranteed under wholesale funding guarantee scheme is now accepted. They have committed that the maximum amount that they will provide to recapitalise eligible institutions will be £50 billion and the limit on the guarantee will be £250 billion. Where preference shares are acquired the UK authorities have committed

\textsuperscript{10} For details see market notice of the Bank of England of 21 April 2008 (http://www.bankofengland.co.uk/markets/money/marketnotice080421.pdf)
to incentivising the earliest possible redemption of the shares. They will do this through a package in which no dividend can be paid out on the ordinary shares whilst any preference shares issued to the UK Authorities remain outstanding and/or a required return on capital provided in the form of preference shares (or PIBS) in the region of 12% per annum. The premium for the guarantee will equate to 50 bps plus the median of the 5-year CDS spread over the 12 month period ended on 7 October 2008 for each institution. The UK authorities commit to seek the Commission's approval if these conditions are altered.

32. The UK authorities declare that all banks entering the guarantee scheme are fundamentally sound, in that they will meet the capital ratios set out in point 6.

33. The UK authorities submit that all possible measures have been taken in order to ensure the Commission that the scheme will not allow the banks to expand their business in a disproportionate manner. To this end, they have undertaken to impose the behavioural conditions set out in point 12 for all beneficiaries of the Recap scheme and the condition set out in 12 (g) for the beneficiaries of the Guarantee Scheme.

34. The UK authorities commit to seek the Commission's approval, should it be necessary for the measures to continue beyond six months. They will also seek approval if the amounts dispensed under the Recap scheme and the Guarantee scheme exceed the thresholds in this notification.

35. Furthermore the UK authorities commit to send to the Commission a restructuring plan within 6 months (or a corresponding later date, if the scheme is prolonged due to the continuation of the crisis) for all banks which have benefited from structural measures which last beyond the duration of the scheme. In addition the UK authorities commit to file individual restructuring/liquidation plans for banks that default on their liabilities and which cause the guarantee to be called upon.

IV. ASSESSMENT

1. State aid character of scheme

36. As set out in Article 87(1) EC, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

37. First, the Commission agrees with the position of the UK that the bank recapitalisation and guarantee arrangements for eligible institutions constitute aid to the institutions concerned pursuant to Article 87(1) EC.

38. The recapitalization and guarantee on the new issued debt allow the beneficiaries to get the required capital as well as liquidity at advantageous conditions. This gives an economic advantage to the beneficiaries and strengthens the position of these beneficiaries compared to that of their competitors in the UK and other Member States and must therefore be regarded as distorting competition and affecting trade between Member States. The advantage is selective since it only benefits the beneficiaries of the scheme and is provided through State resource.

39. In particular, both recapitalisation and the guarantee would not have been provided by a market economy investor. Regarding the capitalisation, the Commission recalls that a market economy investor expects a reasonable return on his investment\(^\text{11}\). However, if a firm is in difficulty or acts in an industry experiencing particular difficulties it is normally

not justified to assume a reasonable return. For the current scheme this is confirmed by the fact that the State is only investing because no market economy operator was willing to invest on similar terms (this is illustrated by the mechanism of the scheme). Regarding the guarantee, the Commission is convinced that in the current circumstances of financial crisis no private investor would have granted such a significant guarantee on senior debt of the participating banks.

40. Moreover, as regards the short-term liquidity measures provided by the Bank of England the Commission shares the point of view of the UK authorities that the Bank’s 3-month sterling OMOS, its US dollar one week repo or the SLS are within the remit of a central bank’s role as a monetary authority, and would normally be characterised as general measures.

41. However, the Commission notes that some beneficiaries will obtain high quality collateral due to the existence of the above State guarantee. It is this guarantee that makes such bank debt into the type of high quality collateral that the Bank requires. While this might be irrelevant from the point of view of the central bank, the collateral is only eligible because of the guarantee. Moreover, given that this expansion of the Bank of England's short-term liquidity is indeed part of a package of the support measures indentified as aid and thus inherently linked to the entire package the compatibility assessment addressing a serious disturbance in the economy of the United Kingdom must also be extended in this respect.

2. Compatibility of the Financial Support Measures

a) Application of Article 87(3)(b) EC

42. The UK intends to provide capital injections and operating aid under a scheme which is granted to assist banks and building societies. Given the present circumstances in the financial market, the Commission considers that it may be acceptable to examine this measure directly under the Treaty rules and in particular under Article 87(3)(b) EC.

43. Article 87 (3) (b) EC enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State. The Commission recalls that the Court of First Instance has stressed that Article 87 (3) (b) EC needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State."

44. The Commission considers that the present scheme concerns the entire British banking industry. The Commission does not dispute the analysis of the UK that the current global financial crisis has made access to liquidity more difficult for financial institutions across the board and has also eroded confidence in the creditworthiness of counterparties. In these circumstances, even fundamentally sound financial institutions are facing the prospect of going out of business. The Commission also considers that if the issues of lack of liquidity and lack of confidence are not addressed, it will result not only in difficulties for the banking sector but, due to that sector's pivotal role in providing

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12 The Commission indicated its position in various Communications, i.e. the Application of Article 92 and 93 of the EEC Treaty to public authorities' holding (Bulletin EC 9-1984), point 3.3; and Communication on public undertakings in the manufacturing sector, OJ 1993 C 307/3.

financing to the rest of the economy, will also have a systemic effect on the British economy as a whole. The Commission does not dispute that the present scheme is designed to address the problems of the lack of liquidity and lack of confidence that are currently striking British banks. Therefore it finds that the scheme aims at remedying a serious disturbance in the British economy.

b) Conditions for compatibility under Article 87 (3) (b)

45. Although there is no established practice as to the conditions for compatibility of aid granted under Article 87 (3) b) EC, it must be stressed that, in the light of the general principle of incompatibility of aid, in order for such aid to be compatible, any aid or aid scheme must comply with general criteria for compatibility under Article 87 (3) EC, viewed in the light of the general objectives of the Treaty and in particular Articles 3 (1) (a) and 4 (2) EC, which imply compliance with the following conditions:15

a. Appropriateness: The aid has to be well targeted to its objective, i.e. in this case to remedy a serious disturbance in the entire economy. This would not be the case if the disturbance would also disappear in the absence of the measure or if the measure is not appropriate to remedy the disturbance.

b. Necessity: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case law of the Court of Justice.16

c. Proportionality: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures’ objectives. This follows from Article 3 (1) g EC and Article 4 (1) and (2) EC, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87 (1) EC prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87 (3) b) EC which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective, limiting to a minimum consequential distortions of competition.

c) Assessment of the Recap Scheme

46. The objective of the Recap Scheme is to shield the economic capital of the banking system and to ensure that banks are sufficiently strongly capitalised to meet potential stress. The Commission has observed already in various cases that mark-to-market valuations of securities can in the ongoing financial turmoil have such detrimental effects on the balance sheet of a bank that their capital risks falling below the minimum quotas required by the law of banking supervision.17 This has thus created fears regarding the creditworthiness of banks. In order to tackle these, the UK authorities intend to undertake

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16 Cf. Case 730/79, Philip Morris [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in. Case C-390/06, Nuova Agricast v Ministero delle Attività Produttive of 15 April 2008, where the Court held that, "As is clear from Case 730/79 […], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market […]."

a public sector capital intervention. This is in principle an appropriate means to strengthen the banks and thus to restore market confidence.\textsuperscript{18}

47. In addition, the Commission notes that the scope of the scheme is limited to in principle solvent companies, whose capital base shall only be strengthened against possible losses. Indeed, the provision of capital is thus intended not but to prevent companies which are fundamentally sound from falling into difficulty because of the existing ongoing crises. The scope of the Recap Scheme seems thus appropriate to strengthen the UK banking sector and to contribute to the revival of interbank lending in the UK.

48. The recapitalisation Scheme is also limited to the minimum necessary in scope and time.

49. As regards scope, the Commission noted previously that several measures might be possible to restore confidence in the banking sector.\textsuperscript{19} It concluded that for Denmark a guarantee scheme was essentially sufficient. However, this does not mean that in other situations other means are not necessary. Indeed not all financial institutions may at the moment experience the same distress because of extreme conditions in financial markets. While some might only suffer from the shortage of liquidity some others might be more exposed to mark-to-market devaluations. However, the problem of write downs can not be solved solely with a guarantee on debt but also requires confidence building measures aimed at restoring the trust of third parties in UK financial institutions. In this respect the Commission considers that recapitalisation can be an appropriate measure.

50. With regard to scope of the measure, the Commission notes positively that the UK, at this point, is limiting the size of Recap scheme to £ 50 billion. It is also limited to six months.

51. Secondly, as regards proportionality, the irreversible nature of capital injections entails the need that the scheme must establish some clear ex ante behavioural safeguards which the Member State must monitor and enforce in order to ensure their observance and to take steps avoiding undue distortions of competition, where appropriate, at a later stage.

52. Adequate safeguards would ensure that the State must, despite the current market failure, obtain an adequate return on its investment.\textsuperscript{20} This is presently achieved by the issuance of preferred shares with an annual interest rate to be paid that amounts to about 12 %. If the state chooses to inject ordinary equity, the issue price of the shares should be fixed on the basis of a market-oriented valuation as indicated above in point 10.

53. Moreover, the behavioural commitments, indicated above in point 12, in particular to maintain its activities at the level at 2007, should ensure that the institutions do not engage in aggressive commercial strategies or expansion of its activities or other purposes that would imply undue distortions of competition. In that context the limitation in lending growth with reference to the total size of the balance sheet of the financial institution is also observed positively.

54. Finally, the Commission notes positively that the UK authorities committed that the beneficiaries will after six month present a restructuring plan.\textsuperscript{21} Such plans are the cornerstone of the Community Guidelines on State aid for Rescuing and Restructuring Firms in Difficulty\textsuperscript{22} (hereinafter "R&R guidelines") which articulate the Commission's understanding of Article 87 (3) (c) EC for this type of aid. For any aid to a firm in difficulty, it is in the common interest that the company returns to long term viability and

\begin{footnote}
\textsuperscript{18} See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 42.
\textsuperscript{19} See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 47.
\textsuperscript{21} 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 cases. The Commission may also consider that there is no need to submit a plan relating to a pure liquidation of the institution, or where the size of the residual economic activity is negligible.
\textsuperscript{22} OJ 2004 C 244, p. 2.
\end{footnote}
that this is sufficiently scrutinized, by means of the restructuring plan. However, and also in line with the R&R guidelines, the Commission will not require such a plan where the beneficiary has redeemed the state's stake within 6 months or commits to do so in the next six months.

55. On the basis of the above, the Recap Scheme of the UK can be considered compatible with the Common market.

d) Assessment of the Guarantee Scheme

56. The objective of the Guarantee Schemes is to provide a safety net to investors in newly issued debt of participating institutions in the UK, so that they can have sufficient access to liquidity. This is a reaction to the international market-failure where even healthy banks are having trouble getting access to liquidity. The Commission has established that such guarantee scheme should help to overcome this market failure by allowing for a revival of the interbank lending and considers it therefore as an appropriate means.\(^{23}\)

57. Moreover, the scheme is targeted at the appropriate beneficiaries as the eligibility of participating firms is limited in principle to solvent companies. However, it is assumed that such firms will increase their Tier 1 capital in the context of the Recap Scheme. Thus, the Commission considers that the design of the present scheme is appropriate to address the problem of refinancing currently faced by UK financial institutions.\(^{24}\)

58. Second, as regards necessity, the guarantee mechanism, whereby a safety net is established to cover all newly issued debt against institutions in the UK, is limited to the minimum necessary in scope and time.

59. As regards scope, the Commission does not dispute that the guarantee scheme is needed to restore confidence of lenders.\(^{25}\) A guarantee on retail deposits would not be sufficient as it would only avoid bank runs but not restore confidence of the institutional lenders. Moreover, the Commission notes positively that the UK is limiting the guarantee to the form of financing that is experiencing the greatest problems at the moment, short to medium term interbank financing. First subordinated debt is not guaranteed. Second, existing debt is not covered but only newly issued debt and only such debt that is short and medium term. Third the UK has also managed to limit the scope of the guarantee scheme so that the institutions have only a window of six months to issue the new debt that will benefit from the guarantee.

60. The UK guarantee shall apply to the newly issued debt for up to three years. However, the Commission normally considers that two years are the longest period necessary for such scheme to safeguard financial stability by contributing to facilitate the resumption of interbank lending.\(^{26}\) Notwithstanding this, the Commission notes positively an additional safeguard in the present scheme in so far as it has a shorter issuance period (i.e. six months) than two years. That means that already after six month the guarantee shall not be used any more to get issue new debt. In this way the overall amount of debt covered is actually much lower than if the guarantee would be given for newly issued debt over two years. The temporal scope is thus also justified.

\(^{23}\) See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 42.

\(^{24}\) See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 45.

\(^{25}\) See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 47.

\(^{26}\) See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 47.
61. Third, as regards proportionality, the distortions of competition is minimised by various safeguards. Above all, the aid amount is minimised through a market orientated premium. It can be estimated that in this way the banks pay on average an adequate premium. The banks will pay in a base case a premium of 50bp plus the median of the 5-year CDS spread over the 12 month period ended on 7 October 2008 for each institution\textsuperscript{27}. This [...] other recent examples of banking guarantee schemes\textsuperscript{28} and can be considered proportionate.

62. Finally, the scheme includes several strong behavioural constraints which help to ensure that the participating banks do not expand their activities under the scheme and thus do not receive more support than necessary for re-establishing their long term viability.\textsuperscript{29} This concern a limitation of the expansion of activities on an individual and an aggregate level of all participating banks against clear benchmarks (see above points 17, 18 and 21).

63. On the basis of the above, the Guarantee scheme of the UK can be considered compatible with the Common market.

e) Assessment of the STL-Measure

64. The objective of the STL-Measure is to provide short and medium liquidity to financial institutions. The Commission observes that it is appropriate that in dealing with liquidity problems of financial institutions, some Member States may wish to accompany guarantees or recapitalisation schemes with complementary forms of liquidity support, in particular with the provisions of public funds from the Central bank.

65. The Commission recalls that the three above conditions indicated in point (45) are the underlying principles for any kind of aid to be approved under Article 87 (3) EC and considers that they have already been put into operation in other areas of application of Article 87 (3). Given that the present measure concerns problems of temporary access to finances, it considers the present framework similar to that tackled as rescue measures under the R & R guidelines.

66. The Bank of England provides a special liquidity facility against collateral under the above indicated conditions but only until end of January 2009 thus for a period shorter than six months. On this basis the Commission observes that the scheme is in principle in line with the principles underlying point 80 of R&R guidelines. Indeed, it is first liquidity assistance for which a market alike premium in the sense of point 25 a) is paid. Second, it is mandated by the same overall economic reasons as the guarantee measures above and should fulfil point 25 b). Third, it can be presumed that given the penalty interest rates, it is limited to the liquidity the company really needs in the sense of point 25 c). Therefore, to the extent that the measure might be considered aid it is compatible with the Common market.

67. The Commission notes that the STL-Measure measure is in principle limited to less than six months, but may be prolonged. The Commission is of the view that, in principle, the scheme could last for up to two years.

\textsuperscript{27} Moreover, the Commission notes as a result the total cost of funding (depending on the specific institution) is estimated to be in the range of 5.4 to 5.9%.

\textsuperscript{28} See Commission decision of 10 October 2008 in case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, at point 47.

\textsuperscript{29} A similar principle is imposed by point 44 of the rescue and restructuring guidelines.
f) The general framework of the package under Article 87 (3) (b)

68. Finally, the Commission acknowledges that the UK committed to report on the operation of the scheme on a bi-annual basis.

69. The Commission would like to reiterate that the window to avail of financial support measures are limited to six months. The Commission is of the view that, provided that the regular review of the liquidity scheme every six months is ensured, the approval of the scheme may also be prolonged. However, apart from the STL-Measure this is only possible in the event that the crisis in the financial markets so requires and upon Commission approval.

V. DECISION

The Commission concludes that the notified measures are compatible with the Common market and has accordingly decided not to raise objections against the notified package, since it fulfils the conditions to be considered compatible with the EC Treaty.

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

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Directorate-General for Competition  
State Aid Greffe  
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Yours faithfully,

For the Commission

Neelie Kroes
Member of the Commission