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State Aid N 664/2008 – Support Measures for the Banking Industry in Hungary

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EUROPEAN COMMISSION

Brussels, 12.2.2009
C(2009) 993 final

**Subject: State Aid N 664/2008 – Hungary
Support Measures for the banking industry in Hungary**

Madame,

I. PROCEDURE

1. Following pre-notification contacts between the Commission and the Hungarian authorities, on 22 December 2008 Hungary notified a scheme consisting of two measures designed to ensure the stability of the Hungarian financial system. The notification includes a letter of the Hungarian Central Bank ("*Magyar Nemzeti Bank*", hereinafter: "MNB") confirming the necessity of the measures. Further information was received on 28 January, 2 February and 6 February 2009.

II. DESCRIPTION OF THE SCHEME

1. Legal basis and objective of the measures

2. In response to the ongoing exceptional turbulence in world financial markets, Hungary intends to bring forward a scheme consisting of two measures (hereinafter referred to as "the scheme" or "the measures") designed to ensure the stability of the Hungarian financial system.
3. The notified scheme comprises two measures:
 - A. Recapitalisation: The Hungarian Government will increase the capital adequacy ratio of credit institutions of systemic importance by providing Tier 1 capital in the form of preference shares. This measure aims at building and maintaining an adequate buffer of capital for the credit institutions concerned, and thus enhancing their liquidity and their ability to lend to the real economy.
 - B. Guarantee: The Hungarian Government will provide, in return for an appropriate remuneration, a State guarantee for debt instruments with a maturity of between three months and five years designed to make funding available to credit institutions.

Dr GÖNCZ Kinga
Minister for Foreign Affairs
Bem rakpart 47
H - 1027 BUDAPEST

4. The principles of the proposed measures are laid down in the framework law "Reinforcement of the Stability of the Financial Intermediary System" (hereinafter: "the Act")¹. The Act was adopted by the Hungarian Parliament on 15 December 2008 and published in the Hungarian Official Gazette ("*Magyar Közlöny*") on 22 December 2008².
5. The Recapitalisation measure will be implemented by a government decision authorising the Minister of Finance pursuant to Article 8(2) of the Act to conclude, under certain conditions, contracts with the credit institutions. The expiry of the government decision is 31 March 2009.
6. The Guarantee measure will be implemented by a government decree specifying Article 6, the guarantee provisions of the Act. The Act entitles the State to grant guarantees until 31 December 2009; however, the implementing decree itself expires 30 June 2009 and foresees that its prolongation is subject to the Commission's approval.
7. The government decree and the government decision will be implemented upon approval by the Commission.

2. The Beneficiaries

8. Beneficiaries of the scheme are fundamentally sound credit institutions of systemic importance established in Hungary³.
9. Whether a financial institution is of systemic importance, will be assessed by the MNB and the Hungarian Financial Supervisory Authority ("*Pénzügyi Szervezetek Állami Felügyelete*", hereinafter: "PSZÁF"). They shall, in accordance with Article 3 of the Act, monitor continuously the state of the regulated financial institutions.
10. The beneficiaries of the scheme will be selected by the Minister of Finance on the basis of MNB's and PSZÁF's recommendation, whereby:
 - MNB evaluates, among others, the impact the applicant has on other regulated entities (banks and financial institutions), financial markets (e.g. its size in terms of issuance, deposit market share, stock exchange exposure), financial infrastructure (e.g. how concentrated the market is) and on the real economy in addition to its short term liquidity situation;
 - PSZÁF assesses the applicant's medium and long term liquidity.

3. Description of the measures

A. Recapitalisation

11. Article 1(1) of the Act empowers the Hungarian State to undertake the recapitalisation of certain financial institutions with an overall budget of HUF 300 billion⁴. The measure aims at increasing the capital adequacy ratio of the participating banks in order to strengthen the credit institutions' capital base and thereby boost the confidence of other market players. The ultimate goal of the measure is to improve the overall liquidity situation of the Hungarian banking system so as to maintain lending to the real economy. Hungary has been particularly affected by the financial crisis, to the extent that the IMF and the EU had to grant emergency loans in November 2008 in order to calm tension on

¹ "2008. évi CIV. törvény a pénzügyi közvetítőrendszer stabilitásának erősítéséről".

² Official Gazette No. 2008/187.

³ Including subsidiaries of foreign banks but excluding banks operating in the form of branch offices

⁴ HUF 300 billion is equivalent to EUR 1.04 billion using the exchange rates of 29 January 2009.

the country's financial markets. Although indicators of stress have fallen since then, for example the yields on Government bonds have fallen somewhat, additional measures are needed to restore the normal functioning of the Hungarian financial system.

12. The recapitalisation takes the form of preference shares⁵. Given the way that the recapitalisation measure is designed⁶, these preference shares can be classified as Tier 1 capital. The objective of the recapitalisation is to bring the participating banks' Capital Adequacy Ratio (CAR)⁷ up to [...]%, which means that, on average, the Tier 1 ratio of the recapitalised banks will be [...]%.⁸
13. The exact modalities of recapitalisation (e.g. nominal value, amount, remuneration, redemption price) are to be laid down in an agreement between the credit institution and the Hungarian State. Article 8(2)(b) of the Act empowers the Minister of Finance (hereinafter: "the Minister") to conclude this agreement and the implementing government decision sets out its conditions. However, any such agreement will follow the principles described in this decision.
14. The preference shares are non-cumulative, senior to all other categories of shares as regards payout of dividends and bear no voting rights. The preference shares will be issued at nominal price, i.e. the amount of recapitalisation equals the face value of the shares.
15. The return on the preference shares has been calculated in line with the recommendations of the European Central Bank (ECB) of 20 November 2008, which are the following:
 - the average yield of the benchmark 5 year EMU government bond⁹ in the preceding 20 working days;
 - the average sovereign yield spread between the 5 year HUF denominated government bonds and the 5 year EMU benchmark government bond over the period 1 January 2007 and 31 August 2008;
 - since there is no reliable CDS data available for Hungarian banks, the median CDS spread of euro area banks with a rating "A" was used;
 - an add-on fee of [...]% to cover operational costs;
 - an add-on fee of [...]% (required since preference shares are the choice of recapitalisation instrument in this case) .

According to the Hungarian Authorities, as a result of the above figures, the expected annual return on the preference shares will be [...]% above the relevant benchmark rate at the time of the investment.

16. Furthermore, in order to provide an incentive to the banks to redeem the state capital as soon as circumstances make it possible, the amount that has to be repaid to the state increases by a step-up of [...] percentage point each year. For example, if the preference shares were redeemed after 5 years, the bank would have to repay [...]% of the original capital that it received.
17. Since the first figure in the above calculation (average yield of the 5 year German government bonds in the period of 20 working days prior to the capital injection) depends

⁵ Articles 10, 11 and 12 of the Act.

⁶ Non-cumulative dividends, State's put option after 5 years.

⁷ CAR is the sum of eligible Tier 1 and Tier 2 capital as a percentage of risk weighted assets.

⁸ The Capital Adequacy Ratio of the Hungarian banking system was 10,7% (not including the Hungarian Development Bank, Eximbank and Central Clearing House and Depository), of which the ratio related to Tier 1 was 8,87%. The relevant figures for 31 December 2008 are 11.06% and 9.16% (thus the ratio related to Tier 2 is in the region of 1.9%).

⁹ The benchmark EMU bond is the German 5 year government bond.

on the exact date of the recapitalization concerned, it is only possible to give an indicative expected return. In this regard, if a recapitalisation took place on 17 January, when the benchmark interest rate would have been calculated at 2.3%, the annual interest rate on the preference shares would have been [...] % (2.3% + [...] %). Combined with the [...] % annual step-up clause, the overall annual expected return should be in the region of [...] %¹⁰.

18. The financial institution concerned has at any time the possibility to repurchase the preference shares at the price described above. The Hungarian state also has a put option vis-à-vis the beneficiary which can be exercised after 5 years after the issuance of the shares¹¹. This means that after 5 years the state can request repayment of its investment. The Hungarian authorities confirm that the state would exercise this right unless the redemption undermines the stability of the bank and the Hungarian financial intermediary system.

B. The Guarantee measure

19. Under Article 1(1)(c) of the Act the Hungarian state is also empowered to make available a State guarantee to the credit institutions covering new debt.
20. The guarantees cover debt issued after the entering into force of the Act and the expiry of the measure (in principle 30 June 2009, which can be prolonged, upon approval by the Commission, until 31 December 2009). Only interbank lending activities are guaranteed, subordinated loans and capital investment are not covered by the measure. The maximum amount that can be guaranteed is HUF 1500 billion¹².
21. The guarantee is limited in so far as only debt with duration from 3 months up to 5 years is eligible.¹³ The amount of the guarantee for loans exceeding 3 years is limited to one third of the scheme's budget and in any case cannot exceed HUF 450 billion
22. The guarantee will be provided for an appropriate fee, which is calculated based on the European Central Bank Recommendations on Government Guarantees on Bank Debt (hereinafter: "ECB recommendation"). Thus, in the absence of CDS data, the CDS spread for the lowest rating category, which is A, is used, namely 73.50, with an additional per annum mark-up of 50 basis points¹⁴. Hence, the annual guarantee fee will be 123.50 basis points.¹⁵
23. The exact modalities of the guarantee (e.g. guaranteed debt, guarantee fee) are to be laid down in an agreement between the credit institution and the Hungarian State. On the basis of Article 6(1)(c) of the Act the implementing government decree empowers the Minister to conclude this agreement and sets out its conditions. However, any such agreement will follow the principles described in this decision.

¹⁰ This figure is calculated using the Yield-to-Call pricing method. This is a rate of return measuring the performance of a callable bond, from the time of purchase to its call date. In this case, the return is based on the assumption that the preference shares pay a [...] % coupon for 5 years and are redeemed at [...] % of their issue/purchase price at the end of the fifth year.

¹¹ Article 12 of the Act.

¹² Equivalent to EUR 5.22 billion as of 29 January 2009.

¹³ In the Hungarian credit market housing loans have a considerable share with a maturity well above 5 years. Therefore, in duly justified cases (covering mortgage loans for retail customers) the maturity up to 5 years could be accepted.

¹⁴ Point 8 thereof.

¹⁵ The Commission notes that the pricing structure used by Hungary is based on the ECB recommendation for debt for a maturity of over 1 year. In view of previous decisions, a flat guarantee fee of 50 basis points for new short-term (less than one year) debt would also be acceptable, as this would be in line with the ECB recommendation.

24. In addition, beneficiary banks would not be allowed to follow unfair commercial practice by advertising the state guarantee.

4. Veto right and behavioural conditions

25. As a safeguard element, the recapitalisation and the guarantee are coupled with the subscription of the state to a so called special veto share¹⁶, giving the state veto rights in certain cases.
26. The veto shares have a mere symbolic price, since their aim is to enable the State to object to decisions which would lead to a misuse of the funds or which would be detrimental to the stability of the financial system¹⁷. No remuneration is attached to the veto shares. After the redemption of the preference shares or termination of the guarantee, they are withdrawn as well.
27. The veto share gives the State potential influence in the financial institutions decision-making. The state has the right to appoint at least one member to both the managing and the supervisory boards of the beneficiary financial institutions¹⁸. In addition Hungary will impose the following behavioural conditions to participating institutions in the scheme:
- a) Each participating credit institution is obliged not to advertise the state interventions¹⁹.
 - b) Limitation in the salary, remuneration and benefits for the top managers of the financial institutions concerned during the existence of the State participation²⁰.

III. POSITION OF HUNGARY

28. The Hungarian authorities accept that the scheme contains state aid elements. Hungary considers that the scheme is compatible with the common market because it is necessary to remedy a serious disturbance in the Hungarian economy pursuant to Article 87(3)(b) EC.
29. A letter sent by the MNB President to the Finance Ministry dated 19 December 2008 and transmitted to the Commission on 22 December 2008 confirms that the notified measures are urgently required to prevent harmful spill-over effects on the Hungarian financial system and on the economy as a whole.
30. The Hungarian authorities seek urgent authorisation for the notified financial support measures. The current global financial crisis has made access to liquidity more difficult for financial institutions and has also undermined the general confidence in the creditworthiness of counterparties. In these circumstances, even fundamentally sound financial institutions might be faced with the menace of going out of business. The Hungarian authorities consider that the failure to address the issues of lack of liquidity and confidence in the banking sector could also have, due to its vital role for the real

¹⁶ Articles 13 and 14 of the Act.

¹⁷ E.g.: Excessive dividend policy, excessive acquisition,, excessive management compensation, issuance of other preference shares entitling to dividend and thereby worsening the State's dividends expectations, withdrawal of funds by the owner.

¹⁸ Article 8(3)(d).

¹⁹ Enshrined in the government decision for both the Recapitalisation and the Guarantee measures.

²⁰ Article 8(3)(e).

economy, a systemic effect on the Hungarian economy as a whole. Therefore, the scheme aims at remedying a serious disturbance in Hungarian economy.

31. The increased capital and the temporary guarantee, represent, in the view of the Hungarian authorities, a comprehensive, necessary and proportionate package to maintain the financial stability of and confidence in the Hungarian economy. Given the severe stress in global financial markets and its impact on the Hungarian financial system, it is in their view imperative that the measures are implemented immediately.
32. The proposed state intervention of a temporary nature is necessary to achieve the predefined goals. The scheme is supplemented by appropriate procedural rules and safeguards. Therefore, the Hungarian authorities consider that the notified scheme does not involve any unduly adverse spill-over effects on other Member States or undue distortions of competition.
33. The measures are open to all fundamentally sound banks of systemic importance authorised to operate in Hungary (whether Hungarian or foreign-owned), and thus are open and non-discriminatory and do not threaten to distort competition. Hungary commits that for banks that receive State capital for more than 2% of their risk weighted assets, the Hungarian authority will inform the Commission about the details of their assessment qualifying these companies as fundamentally sound. For banks that are considered not to be fundamentally sound by the Commission, the Hungarian authorities commit to submit a restructuring plan within six months of the recapitalisation.
34. The Hungarian authorities submit that all possible measures have been taken in order to ensure the Commission that the scheme will not allow the credit institutions to expand their business in an unfair manner. To this end, they have undertaken to impose a number of behavioural conditions as set out under points 25-27 of this decision.
35. Furthermore, the Hungarian authorities confirm that the special veto right will only be used by the state if the decision concerned of the general assembly endangers the stability of the financial system, the ability of the bank to respect its obligation towards the state under the recapitalization agreement or involves practices that would distort the market. It will not be used in any way that could otherwise distort competition.
36. The Hungarian Authorities have committed to submit a report for review of the European Commission within six months from the recapitalisation, containing information provided in paragraph 40 of the Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition" ("the Communication on recapitalisations")²¹.
37. The Hungarian authorities commit to seek the Commission's approval, should it be necessary for the measures to continue beyond the approved six months. They will also seek approval if the funds dispensed under the different categories are modified or exceed the thresholds in this notification.

²¹ Adopted on 05.12.2008, Official Journal C 10, 15.1.2009, p. 2-10

IV. ASSESSMENT

1. State aid character of the scheme

38. 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.
39. First, the Commission agrees with the position of Hungary that the scheme constitutes aid to the credit institutions concerned, pursuant to Article 87(1) EC.
40. The recapitalisation and the guarantee to the credit institutions allow the beneficiaries to secure the required capital as well as liquidity on more advantageous conditions than would otherwise be possible in the light of the prevailing conditions in the financial markets.²² This gives an economic advantage to the beneficiaries and strengthens their position compared to that of their competitors in Hungary 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 resources.
41. In particular, it should be noted that no market economy investor would have undertaken the recapitalisation or provided the guarantee. Regarding the capitalisation, given the current difficulties on capital markets, the Commission considers that the State is investing because no market economy operator would have been willing to invest on similar terms. Regarding the guarantee, the Commission is convinced that in the current circumstances of financial crisis no market economy investor would have granted such a guarantee on securities or loans to be provided by the participating banks.²³

2. Compatibility of the Financial Support Measures

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

42. Hungary intends to provide capital injections and operating aid under a scheme to assist credit institutions. Given the present circumstances in the financial market, they invoke Article 87(3)(b) EC Treaty as a basis for compatibility.
43. Article 87(3)(b) EC enables the Commission to declare aid compatible with the Common Market if it is necessary "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.²⁴ The Commission has issued two Communications

²² Recent data show that, reflecting current distressed market conditions, the current yield for hybrid Tier 1 capital, such as preference shares, is in the vicinity of 15% or more on Euro denominated debt. For Hungary, which is not a member of the Euro area, this expected yield is doubtless even higher.

²³ Cf Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at point 32.

²⁴ Cf. in principle case Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Confirmed in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, page 1, points 153 *et seq* and Commission Decision in Case C50/2006 *BAWAG*, not yet published, points 166. See Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30

setting out its application of state aid rules to financial institutions in the current crisis, "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis"²⁵ and "The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition"²⁶.

44. The Commission considers that the present scheme concerns the entire Hungarian banking industry. The Commission does not dispute the analysis of the Hungarian authorities that the current global financial crisis has made access to liquidity more difficult for credit institutions and has eroded confidence in the creditworthiness of counterparties. In these circumstances, even fundamentally sound credit institutions are under severe pressure. The Commission also agrees that if the issues of lack of liquidity and lack of confidence are not properly dealt with, it will result not only in difficulties for the banking sector but, will also have an effect on the Hungarian economy as a whole. The Commission does not dispute that the present scheme is designed to address these problems that Hungarian banks are currently facing. Therefore, it finds that the scheme aims at remedying a serious disturbance in the Hungarian economy.

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

45. In line with the Commission Communication on 'The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis'²⁷, in order for an aid scheme 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)(g) and 4(2) EC, which imply compliance with the following conditions:²⁸
- 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 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.²⁹

April 2008 in case NN 25/2008, *Rescue aid to WestLB*, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, not yet published.

²⁵ Adopted on 13 October 2008, Official Journal C 270, 25.10.2008, pages 8–14

²⁶ See footnote 15 above

²⁷ OJ C 270 of 25.10.2008, p. 8.

²⁸ Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, , at point 41. As well as all following schemes such as N 512/2008 (UK), N 48/2008 (Ireland), N 512/2008 (Germany), N 533 /2008 (Sweden), N 548/08 (France), NN 54/A/2008 (Spain) etc.

²⁹ 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 [...]."

- 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 is limited to that necessary to achieve its stated objective.

c) Assessment of the Recapitalisation Measure

46. The objective of the Recapitalisation is to strengthen the economic capital of the banking system and to ensure that banks are sufficiently strongly capitalised so as to better withstand potential stress. The Commission has already observed in several cases that recapitalisation is in principle an appropriate mean to strengthen the banks and thus to restore market confidence.³⁰
47. The Commission notes that the measure is in principle not aimed at enterprises in difficulty but addresses fundamentally sound financial institutions. The provision of capital can be seen as a confidence building measure aimed at restoring the trust of third parties in Hungarian credit institutions and is thus intended to prevent enterprises which are solvent from falling into difficulties as a result of the existing ongoing crisis. The scope of the recapitalisation scheme therefore seems appropriate to strengthening the Hungarian banking sector and to contributing to the revival of interbank lending in Hungary.³¹
48. In addition, the allocation of capital is done on MNB's and PSZÁF's recommendation, which evaluate the financial institutions based on objective criteria, with special regard to a sufficient level of capitalisation and solvency requirements.
49. The Recapitalisation is also limited to the minimum necessary in scope and time. With regard to its temporal scope, the Commission notes positively that Hungary has limited the window to enter the scheme until the 31 March 2009.
50. With regard to the size of the measure, the Commission notes positively that the budget of the recapitalisation is limited to a maximum amount of HUF 300 billion. Regarding the effect on participating banks, their CAR³² will be raised to [...] %³³, which on average will mean that Hungarian banks will have on average a Tier 1 ratio of [...] % after their recapitalisation (as per point 12). This level of Tier 1 capital is in line with recent recapitalisations approved by the Commission. Given the particular financial problems that Hungary has experienced, which have led to the intervention of the IMF and others, the Commission does not dispute Hungary's opinion that raising the CAR of Hungarian banks to this level can be considered the minimum necessary to restore confidence in the financial system.

³⁰ Commission Decision of 13 October 2008 in Case N507/2008 Guarantee Scheme for banks in the United Kingdom, point 46 et seq. and Commission decision of 27.10.2008 in case N512/2008 *Support measures for financial institutions in Germany*, point 41 et seq.

³¹ Commission Decision of 13 October 2008 in Case N507/2008 Guarantee Scheme for banks in the United Kingdom,, par. 49

³² The sum of eligible Tier 1 and Tier 2 capital as a percentage of risk weighted assets

³³ At the end of December 2008 the Capital Adequacy Ratio of the Hungarian banking system was 11.1%.

51. Moreover, capital interventions in credit institutions must be done at terms that minimise the amount of aid. A key element in this respect is an appropriate, market oriented remuneration on the capital invested.³⁴ The Commission observes that Hungary is requesting a annual remuneration in the region of [...] %³⁵ for the preference shares and, in addition, at the time of redemption, the financial institution has to reimburse the shares at a price which increases [...] % percentage point for each year that the preference are outstanding. This results in an annualised yield of approximately [...] % for the state. Moreover, The Hungarian state can also exercise a put option vis-à-vis the beneficiary 5 years after the issuance of the shares.
52. The recent Recapitalisation Communication, which follows the methodology set out in the aforementioned ECB recommendations on the recapitalisation, sets out the Commission's view on how the appropriate remuneration for the Hungarian Government's capital injection, which is in the form of non-cumulative preference shares, should be calculated. While the Commission notes that Hungarian Government bond yields have risen sharply recently, it considers that it still appropriate to use pre-crises bond spreads, as per the ECB recommendations, to determine the required rate of return for the recapitalisation of fundamentally sound banks.
53. The Commission considers that this capital injection should be priced according to the formula for subordinated debt outlined in section 3 of the ECB paper, with an additional add-on component of [...] basis points due to the hybrid nature of preference shares, outlined in point 5 (i) of the same paper. The formula described in point 15 fulfils these pricing requirements. An additional add-on is required for the fact that the dividend on the preference shares is non-cumulative³⁶. The Commission considers that the annual step-up of [...] percentage point to the redemption price of the preference shares meets this criterion. Furthermore, this annual add-on also provides some incentive for the bank to redeem the state's investment, as proposed in point 31 of the Commission Recapitalisation communication. Therefore, the Commission considers that the expected return can be considered acceptable in the present case.
54. As provided for by the Communication on the financial crisis, the aid must be limited to the minimum necessary so as not to allow the beneficiary to engage in aggressive commercial activities that would imply undue distortions of competition. Consequently, the Commission positively views the overall remuneration of the measure, the requirement that institutions refrain from marketing invoking the measure and the requirement to provide a report within six months of the recapitalisation, as required under paragraph 40 of the Communication on recapitalisations. The Commission also observes a number of significant behavioural commitments, as indicated above in points 26-28. The Commission notes that Hungary, through the use of the veto share, can intervene directly in the banks to ensure that these commitments are respected and that financial stability is not endangered.

³⁴ See in particular the Commission communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current financial crisis, OJ C 270 of 25.10.2008, p. 8, point 39.

³⁵ Given that this based on current EMU benchmark bond, the price at the time of investment may differ slightly. The figures in this paper are correct as of 17 January 2009.

³⁶ Point 5 (ii) of the ECB Recommendation states that 'For preferred shares .. having economic features similar to those of ordinary shares (i.e. non-cumulative, without the possibility of buy back, or perpetual instruments with convertibility to ordinary shares) the required rate of return should be close to the upper bound.' Given that the preference shares in this case only have one feature that is similar to that of equity shares, i.e. that they are non-cumulative, the Commission considers that it is still appropriate to price them closer to the lower bound, which is determined by the price of subordinated debt..

55. Finally, the Commission recalls once more that the measure described can only be undertaken with regards to fundamentally sound financial institutions. The Commission has set out criteria for determining whether banks are fundamentally sound in Annex 1 of the Recapitalisation Communication. In this regard, concerning banks that receive State capital amounting to more than 2% of their risk weighted assets³⁷, the Hungarian authorities will inform the Commission about the details of their assessment qualifying these companies as fundamentally sound. For banks that are considered not to be fundamentally sound by the Commission, the Hungarian authorities commit to submit a restructuring plan within six months of the recapitalisation. In this case, the Commission considers that the institutions concerned should pay at least the price for distressed banks indicated in the Recapitalisation communication, which should in principle be higher than that for fundamentally sound banks³⁸. Where the price cannot be set to levels that correspond to the risk profile of the bank, it would need to be close to what would be required for a similar bank under normal market conditions. However, the use of state capital for these banks can only be accepted on the condition of either a bank's winding-up or a thorough and far-reaching restructuring. Furthermore, the report referred to in point 54 shall contain solid evidence that the beneficiary banks actually were and still are fundamentally sound. Moreover, where a bank that was initially considered fundamentally sound falls into difficulties after recapitalisation has taken place, a restructuring plan for that bank must be notified.
56. On the basis of the above, the Hungarian Recapitalisation Scheme can be considered compatible with the common market.

d) Assessment of the Guarantee Scheme

57. The objective of the present guarantee scheme is to provide a safety net to investors that purchase the newly issued debt of, or lend to, the participating credit institutions, so that these institutions can have sufficient access to liquidity. This is a reaction to the international market failure where even healthy banks are facing difficulties in fulfilling their central role in financial intermediation. The Commission considers that such guarantee schemes should help to overcome this market failure, by establishing the conditions for the revival of the interbank lending market. It therefore regards the scheme as an appropriate means to meet the objective.³⁹
58. In addition, the scheme is targeted at the appropriate beneficiaries which are all Hungarian banks of systemic importance, including the subsidiaries of foreign banks. Their eligibility is established by the two major regulatory bodies for the financial market in Hungary.
59. As regards necessity, the guarantee scheme is limited to the minimum necessary in material scope and time. As regards material scope, the Commission notes positively that Hungary is limiting the guarantee to the forms of financing that are considered a specific

³⁷ As per Annex 1 of the Recapitalisation Communication, a recapitalisation that exceeds 2% of a bank's risk weighted assets could be an indicator that the bank is not fundamentally sound.

³⁸ As per point 44 of the Recapitalisation Communication.

³⁹ See Commission Decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, at point 42, Commission Decision of 13 October 2008 in case N 507/2008 *Financial Support Measures to the Banking Industry in the UK*, at point 56, and Commission decision of 13 October 2008 in case NN 48/2008 *Guarantee scheme for banks in Ireland*, at point 59.

source of difficulties, i.e. short to medium term interbank lending.⁴⁰ On the other hand it excludes from its scope subordinated debt as well as capital investment and existing debt.

60. As regards temporal scope, the guarantee applies to the newly issued debt for up to three years, or in duly justified cases up to five years. In general, the Commission is of the view that the duration of a guarantee should be as short as possible, i.e. 3 years. In the present case, the Commission accepts that, in the Hungarian market, funding to finance housing loans is an important part of the market. Given that the duration of these loans usually exceeds 3 years, the Commission considers that it is justified that one third of the guarantee budget could be used to cover loans of between 3 and 5 years duration.
61. The Commission notes positively an additional safeguard in the present scheme in so far as it has a limited issuance period, which ends on 30 June 2009, and any prolongation must be re-notified to the Commission. The temporal scope is thus in principle justified.
62. As regards proportionality, the distortion 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 credit institutions pay on average an adequate premium. The banks will pay a premium of 123.50 basis points. This can be considered proportionate and consistent with the recent practice of the Commission.⁴¹ In addition, the Commission notes that this is also in line with the recommendations of the ECB.
63. Finally, the Commission recalls that Hungary has to provide a restructuring or liquidation plan for any institution that causes the guarantee to be drawn.
64. On the basis of the above, the Hungarian Guarantee scheme can be considered compatible with the Common market.

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:

European Commission
Directorate-General for Competition
State Aid Greffe
Rue de la Loi/Wetstraat, 200
B-1049 Brussels
Fax No: +32-2-296 12 42

⁴⁰ This is emphasised in the Commission communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current financial crisis, OJ C 270 of 25.10.2008, p. 8, point 21.

⁴¹ A similar approach is taken in Commission decision of 27 October 2008 in case NN 512/2008 *Guarantee scheme for banks in Germany*, point 66 and the following schemes such as N 533/2008 (Sweden), N 548/08 (France), NN 54/A/2008 (Spain), N524/2008 (The Netherlands), N 567/08 (Finland).

Yours faithfully,

For the Commission

Neelie Kroes
Member of the Commission