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State Aid: European Commission issues Communication on Recapitalization of Financial Institutions

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In the past two months, the European Commission (**"Commission"**) has approved a great number of national schemes for stabilizing the financial sector as well as individual recapitalization measures. Member States and potential beneficiary institutions have nevertheless called for more detailed guidance as to whether specific forms of recapitalization are accepted under State aid rules. In particular the fact that the real economy has started to be affected as well as the fact that even financially sound banks may need State capital to ensure an adequate level of loans to companies calls for further clarification.

Hence, on 5 December 2008, the Commission issued an additional communication on the recapitalization of financial institutions in the current financial crisis (**"Communication"**)[1].

The Communication must be seen in the context of other guidance documents of the European institutions. The Commission already adopted a Communication on the application of State aid rules to measures by Member States in relation to financial institutions in the context of the current global financial crisis on October 13, 2008 (**"Banking Communication"**)[2], and the Governing Council of the European Central Bank (**"ECB"**) adopted recommendations on November 20, 2008 (**"ECB Recommendations"**). The Communication takes full account of the ECB Recommendations and is based on the same fundamental principle as the Banking Communication, namely that state support for banks must not result in recipient banks enjoying an artificially advantageous competitive position compared to banks not receiving aid e.g. in other Member States. The Communication provides supplementary guidance for new recapitalization schemes and opens up the possibility for adjustment of existing recapitalization schemes.

Possible competitive concerns

It is recognized that recapitalization contributes to financial stability and restores confidence needed for inter-bank lending, ensures lending to real economy, and may provide a solution for financial institutions facing insolvency. In order to tackle the anti-competitive effects of recapitalizations, which for example can result in a subsidy race among Member States, the Communication outlines three principles which are at the core of all measures against the financial crisis:

- A coherent and coordinated approach must be followed within the European Union to **ensure fair competition between Member States**.

- Recapitalization schemes must ensure an appropriate degree of differentiation between beneficiary banks according to their risk profiles to **ensure fair competition between banks**.

- Public recapitalization must not have the effect of putting banks which have recourse to it in a better position than those who have not to **ensure a return to normal market functioning**.

As far as the balance between the objective of recapitalization of banks and its potential anti-competitive effects is concerned, the Communication makes clear that the conditions tied to recapitalization should ensure a level playing field, and in the longer term a return to normal market conditions which require proportionate and temporary measures. This balancing requires to pay particular attention to the **risk profile** of the beneficiaries.

Difference in treatment of fundamentally sound banks and those in difficulties

In principle, banks with a higher risk profile should pay more for the recapitalization measures they call upon. Financially sound banks may be entitled to relatively low rates and correspondingly significantly reduced conditions on public support in the long term.

Indicators to assess the risk profile of a financial institution are: compliance with regulatory solvency requirements, prospective capital adequacy as certified by the national supervisory authorities, pre-crisis and current CDS spreads and ratings. However, there may be exceptional cases, where lower remuneration may be accepted for distressed banks on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures.

Principles common to the different types of recapitalization

In order to limit distortions of competition, the market situation of each financial institution should be taken into account before recapitalization measures are implemented. This will maintain a level playing field between banks who call upon financial support of the State and those who do not as well as create incentives for the banks to reimburse the State at the earliest point in time.

The assessment of the overall design of recapitalization measures will be mainly guided by the following elements: objective of recapitalisation, soundness of the beneficiary bank, remuneration, exit incentives, in particular with a view to the replacement of State capital by private investors, to ensure the temporary nature of the State's presence in banks' capital, safeguards against abuse of aid and competition distortions, and the review of the effects of the recapitalization scheme and the beneficiaries' situation through regular reports or restructuring plans where appropriate.

Scenario 1: Recapitalization at current market rates

Where similar terms apply to public capital injections and those of private investors (30 percent or more) and where there is no significant alternation of incentives of private investors, the Commission will accept the remuneration set in the deal without further ex ante safeguards or exit incentives.

Scenario 2: Temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy

To set an adequate level of remuneration for fundamentally sound banks, the assessment should account for:

- The current risk profile of each beneficiary;
- The characteristics of the instrument chosen, including its level of subordination; risk and all modalities of payment;
- Built-in incentives for exit (such as step-up and redemption clauses);
- Appropriate benchmark risk-free rate of interest.

Principles for the pricing of state capital injections

As current interest rates on the market are unnaturally high (about 15 percent), the Commission will accept recapitalization for fundamentally sound banks to be at rates below the current market level. Remuneration should not be too distant from current market prices in order to avoid pre-crisis under-pricing of risks, to provide incentives for exiting the scheme as soon as possible, and to minimize distortions of competition between Member States and banks. The main aim must be facilitating the return to normal market conditions as well as the return of capital from the private sector.

Entry level price for recapitalization

For an appropriate calculation of the adequate price of recapitalization, the Commission refers to the method outlined in the ECB Recommendations. The price for fundamentally sound banks can be determined on the basis of a price corridor defined by a lower bound (the required rate of return on subordinated debt) and an upper bound (the required rate of return on ordinary shares), thereby reflecting the specific features of individual institutions. This method also differentiates between various parameters: the type of capital chosen, the appropriate benchmark risk-free interest rate and the individual risk profile at national level of all eligible financial institutions. The application of this methodology by using average values results in indicative rates of return of 7 percent on preferred shares with features similar to those of subordinated debt and 9.3 percent on ordinary shares of Euro area banks. The Commission will accept a minimum remuneration based on this methodology. Furthermore, Member States may chose a pricing formula that includes step-up or payback clauses. Alternative pricing methods will only be accepted if they lead to higher remuneration.

Incentives for State capital redemption

All recapitalization measures have to ensure the temporary character of State intervention by offering incentives for State capital to be redeemed as soon as the market allows. The aim to stimulate exit can be achieved by general add-ons to the entry price, price increase over time, step-up clauses, call options, redemption clauses, mechanisms that encourage private capital raising or by introducing a restrictive dividend policy.

The Commission will assess proposed exit mechanisms on a case-by-case basis in order to make sure that there are sufficient exit incentives for the beneficiary banks.

Prevention of undue distortion of competition

Safeguards may be necessary to prevent aggressive commercial expansion financed by State aid. As a general principle, the higher the remuneration is, the less there is need for safeguards. Although mergers and acquisitions can contribute to the consolidation of the banking industry, they should generally be organised on the basis of a competitive tendering process not to privilege those institutions with public support to the detriment of competitors without this support. In addition, behavioural safeguards which take into account the risk profile of the beneficiary bank, the relative size of the capital injection and the reached level of capital endowment may be necessary. Particularly effective and enforceable safeguards should be applied by Member States when the objective of the recapitalization is financing the real economy.

Review

As already indicated in the Banking Communication, regular review of the measures taken is essential. Six months after the introduction of recapitalization measures, Member States should provide the Commission with information on: the banks that have been recapitalized, the amounts received, the terms and conditions of the recapitalization, the use of the capital received, compliance with commitments made by Member States in relation to exit incentives and other safeguards as well as the path towards exit from reliance on State capital. The Commission will then assess the need for continuation of safeguards and ensure that the aid is limited to the minimum amount and duration. Initially sound banks which find themselves in difficulties after recapitalization must present a restructuring plan to the Commission.

Scenario 3: Rescue recapitalization of banks in difficulties

These banks should be subject to stricter requirements and higher remuneration than fundamentally sound banks, without totally excluding the possibility to take urgent actions where necessary in case of restructuring. Where it is not possible to set the price at a level that corresponds to the risk profile of the bank, it should nevertheless be as close as possible to normal market conditions. The use of State capital for such banks can be accepted only on the condition of either a banks winding up or a far-reaching restructuring, including where appropriate a change of management and corporate governance. A restructuring or liquidation plan (including compensatory measures) will have to be presented for these banks within six months of recapitalization and will be assessed in accordance with the guidelines on rescue and restructuring of firms in difficulties.

Until complete redemption to the State, behavioural safeguards should include: a restrictive policy on dividends, limitation of executive remuneration or the distribution of bonuses, an obligation to restore and maintain an increased level of the solvency ratio compatible with the objective of financial stability, and a timetable for redemption of State participation.

Possible deviation from the proposed methodology

The Commission will also accept pricing mechanisms which are based on a different methodology than those based on the ECB Recommendations (see above) under the condition that it will lead to a level of a total expected annualised return for all banks participating in a scheme sufficiently high to cater for the variety of banks and the incentive to exit.

Conclusion

The Communication aims at facilitating the understanding as to whether or not specific forms of recapitalization and rates of return are acceptable under State aid rules. It strikes a difficult balance between potential anti-competitive effects of state aid and the need to stabilize not only the financial markets but also real economy. For that reason the Communication may also increase acceptance of national recapitalization by financially sound institutions as such a measure may not necessarily indicate a bank's own difficulties.

If you have any questions or require specific advice on any matter discussed in this publication, please contact one of the lawyers listed below.

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[1] *Available at: http://ec.europa.eu/competition/state_aid/legislation/recapitalisation_communication.pdf. See also Mayer Brown Legal Updates: State Aid: Commission State Aid Guidelines on National Measures for Banks in Crisis, 16 October 2008, and EU State aid in the current financial crisis: repayment may be necessary, of November 2008.*
[2] *Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008XC1025(01):EN:NOT; Official Journal C 270, 25.10.2008, pages 8-14.*