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State Aid - The European commission updates the special crisis regime to banks

On 6 December 2011, the European Commission published a Communication to extend the application of the special State aid regime for banks that had been adopted during the financial crisis.[1] The extension of the crisis framework responds to the need to tackle the continued tensions in the financial markets, now increased by the European sovereign debt crisis. The rules will apply as of 1 January 2012 for as long as required by market conditions.

At the same time, the Commission has taken the opportunity to clarify and update some of the rules relating to this crisis regime, such as pricing and conditions for State recapitulations and for State guarantees, as well as on restructuring plans. These rules shall facilitate the implementation of the banking package agreed by the Heads of State and Government of the EU Member States on 26 October 2011 for the purpose of strengthening the capital of banks and providing guarantees on their liabilities.[2]

Background

The crisis State aid regime was introduced in the autumn of 2008 after the collapse of the investment bank Lehman Brothers which triggered a financial crisis worldwide.[3] The crisis posed an enormous challenge for the EU's State aid regime, which was conceived to ensure a level playing field in the single market. The size and nature of the support required for the banks, the number of the schemes and the complexity of the cases that had to be examined and approved were overwhelming.[4]

In order to cope with these exceptional circumstances and provide guidance to Member States, the European Commission issued four Communications: the Banking Communication, the Recapitalisation Communication, the Impaired Assets Communication and the Restructuring Communication.5 These special rules were introduced on the basis of Article 107(3)(b) of the Treaty on the functioning of the EU that allows the Commission to approve state support to remedy a "serious disturbance in the economy of a Member State".

The rules have been maintained since then but with adaptations reflecting the market conditions but also the dimension and duration of the crisis. In July 2010, the remuneration of the government guarantees on banks' debt was increased to better reflect the risk profile of the beneficiaries and to avoid excessive dependence on an instrument that represents a high contingent risk for public finances. Then, in December 2010, the regime was again extended for one year.[6] The main change here was to require all banks receiving support through either capital injection or an impaired asset relief guarantee to submit a restructuring plan regardless of the size of the support.

The Extension of the Crisis State Aid Rules

In its Communication of 6 December 2011, the Commission extends the application, as of 1st of January 2012, of the special State aid rules to support measures in favour of banks for the sake of financial stability. The Commission recognises that the financial crisis is not over and that the exceptional circumstances for State aid to be approved under Article 107(3)(b) of the Treaty are still met. In fact, the recent tensions in the European sovereign debt markets have put the banking sector under increasing pressure, particularly in terms of access to funding. Moreover, the European Banking Authority (EBA) just published a formal Recommendation, and the final stress test figures, related to banks' recapitalisation needs, so a number of banks will (continue to) need support from Member States to be able to operate in the markets.[7]

The Commission has therefore decided to keep in place the special regime to assess the compatibility with the Treaty rules of any State aid granted to banks and continue to "apply the necessary proportionality in view of the systemic character of the crisis".[8] This entails maintaining the rules that establish the conditions for support in the form of funding guarantees, recapitalisation and asset relief (the Banking, Recapitalisation and Impaired Assets Communications), as well as the requirements for a restructuring or viability plan (the Restructuring Communication). The Commission will continue to insist on the long-term viability of the banks, taking into account elements that demonstrate that banks can survive without the need for significant restructuring, particularly when their lack of capital mainly derives from a crisis of confidence in the sovereign debt.

The Communication specifically mentions that the rules will apply as long as required by market conditions.

State Recapitalisations

Following the banking package in October and yesterday's EBA's recommendation, the Commission anticipates more State capital injections to banks in order to reach the temporary buffer of 9% capital ratio. In case of capital injections bearing a fixed remuneration, the Recapitalisation Communication will continue to provide the guidance on the pricing formula. The Commission now amends the Recapitalisation Communication by providing more detailed explanation on how to assess the adequate remuneration for capital instruments that do not bear a fixed return, that is, when Member States decide to recapitalise their banks using instruments like ordinary shares bearing a variable – and hence, uncertain - remuneration, such as, dividends and capital gains.

Under the new rules, guidance is given on the use of market-based valuations to determine an adequate remuneration for the State in question. As a general rule, the Commission will assess the remuneration of such capital injections on the basis of the issue price of the shares. For listed banks, the benchmark share price will be the quoted market price of shares with equivalent rights to those attaching to the shares being issued. For non-listed banks, there is no market price and hence, Member States can use an appropriate market-based valuation approach (including a peer group P/E approach or other generally accepted valuation methodologies).

Shares will be subscribed at an appropriate discount to the latest share price (after adjustment for the dilution effect) immediately before the announcement of the capital injection. The discount will depend, among other things, on the size of the capital injection compared to the bank's existing core Tier-1 capital and whether or not the shares carry voting rights. As to hybrid capital instruments, such instruments should include an "alternative coupon satisfaction mechanism", allowing coupons that cannot be paid in cash to be paid in shares in order to cater for circumstances in which banks may be unable to pay the agreed remuneration in the short term.

Finally, the Commission requires that any recapitalisation measures include appropriate "exit incentives", that is, incentives for the banks to exit the public support as soon as possible.

State Guarantees

The current financial crisis has put banks under significant pressure. The growing tensions in the European sovereign debt markets and an overall increase in the perception of risk in the banking sector have made access to term funding, particularly difficult. The Communication acknowledges this situation and provides detailed guidance on the public support aimed at guaranteeing the issuance of new debt instruments, both secured and unsecured.

The Communication introduces a revised pricing methodology to determine the adequate remuneration for Member States where the guarantees are granted on a national basis. Whilst the aid shall be limited to the strictly necessary, the new pricing formula will allow to refer to median CDS spreads over a three-year period ending one month before the grant of the guarantees. This way the fees paid by the banks will reflect their intrinsic risk, rather than the risk related to the Member State in question or the market as a whole. At the same time, the formula will also adapt the fee to a lower risk in case of covered bonds (as compared to unsecured bonds).

The new rules only apply for guarantees covering debt with a maturity between one and five years (or seven in case of covered bonds). Guarantees to cover debt with a maturity of less than a year will follow the pricing formula that is currently applied. Guarantees aimed at covering debt with a maturity of less than three months will only be allowed in very exceptional cases for the sake of financial stability.

The Commission finally provides for the possibility of creating specific rules for pooling arrangements for guarantees on bank liabilities should this become a reality in the future.

Restructuring Plans

Restructuring plans (or modifications of them) are considered to be essential by the Commission in cases of recapitalisation or impaired asset measures. In fact, in the last three years, the majority of the banks receiving State aid have had to modify their business model in order to compensate for the distortions of competition brought on by capital injections and ensure their future viability.

Recognising this importance, the Commission will continue to require Member States to provide a restructuring plan (or a modified version of a previously adopted one) for all banks that will receive State aid in the form of recapitalisation or impaired asset measures, regardless of the size of the support. This restructuring plan will have to be submitted within 6 months of the date of the Commission decision authorising the rescue aid, or earlier in cases where a previous rescue aid under Article 107(3)(b) of the Treaty has been adopted.

The Communication sheds some light on how the Commission will approach the need to restructuring and how it will undertake the "proportionate assessment" of the long-term viability of banks, particularly now in the context of the banking package. Accordingly, it will consider banks to be viable in the long-term without the need for significant (additional) restructuring, where three conditions are met:[9]

(1) the capital shortage is due to a confidence crisis on sovereign debt;

(2) the public capital injection is limited to the amount absolutely necessary to offset losses stemming from marking sovereign bonds of EEA States to market in banks which are otherwise viable; and

(3) the analysis shows that the banks in question did not take excessive risk in acquiring sovereign debt.

Guarantees of bank debt do not require the submission of restructuring plans by the Member State in question. Yet, those considered to be "heavy users" of guarantees on the liabilities, such as some of the German Landesbanken, will continue to be required to provide viability reviews to the Commission.

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(FOOTNOTES)

1. Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis (2011/C 356/02) (Official Journal, C 356/7, 6 December 2011).

2. The banking recapitulation measures, or banking package, aims to restore confidence in the banking sector by way of guarantees on medium-term funding and the creation of a temporary capital buffer amounting to a capital ratio of 9 % of the highest quality capital after accounting for market valuation of sovereign debt exposures. See the Statement of EU Heads of State or Government of 26 October 2011: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/125621.pdf. See also, Mayer Brown, *The European Sovereign Debt Crisis—Paving the Way Towards Financial Stability*, Legal Update, 14 November 2011; and Mayer Brown, *European Sovereign Debt Crisis—Stabilization Measures, Investor Risks and Opportunities, Teleconference recording*, 10 November 2011.

3. Communication from the Commission — Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis, OJ C 61/1-9, 22 January 2009.

4. There have been around 290 Commission decisions based on Article 107(3)(b) of the TFEU. The overall amount of aid corresponds to 36.7% of EU GDP. For a complete list of Commission decisions on State aid, adopted or still pending, since the beginning of the financial crisis, see: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/858&format=HTML&aged=0&language=EN&guiLanguage=en

5. 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, OJ C 270, 25.10.2008, p. 8 (the "Banking Communication"); the 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, OJ C 10, 15.1.2009, p. 2 (the "Recapitalisation Communication"); the Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.3.2009, p. 1 (the "Impaired Assets Communication") and the Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009, p. 9 (the "Restructuring Communication"). See Mayer Brown news alerts http://www.mayerbrown.com/publications/article.asp?id=5738&nid=6, http://www.mayerbrown.com/publications/article.asp?id=5941&nid=6, and www.mayerbrown.com/publications/article.asp?id=7351

6. On 1 December 2010, the Commission adopted a fifth Communication, the Communication on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis, OJ C 329, 7.12.2010, p. 7 (the "Prolongation Communication"), where it extended the Restructuring Communication – the only one of the four Communications with a specified expiry date – on amended terms until 31 December 2011. The Commission also confirmed that it considered that the requirements for State aid to be approved pursuant to Article 107(3)(b) of the Treaty, which exceptionally allows for aid to remedy a serious disturbance in the economy of a Member State, were still fulfilled and that the Banking, Recapitalisation and Impaired Assets Communications would remain in place.

7. See EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1) of 8 December 2011. These measures form part of the broader banking package referred to above that was agreed by the European Council on 26 October and confirmed during the ECOFIN Council on 30 November, to address the current situation in the EU by restoring stability and confidence in the markets.

8. European Council's consensus on the banking package, para. 6.

9. Communication, para. 14.

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