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Legal Update
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State Aid – New Rules for Financial Institutions during the Crisis

On 1 August 2013, a new Communication from the European Commission on the application of state aid rules to support banks, and where appropriate, insurance companies in the context of the financial crisis comes into effect ("**2013 Banking Communication**").[1] It replaces the previous 2008 Banking Communication[2] and supplements the existing rules.[3]

The new rules are largely based on the Commission's experience with bank bail-outs and restructuring of the recent years; they define the concepts and conditions under which Member States can help banks and insurance companies with recapitalisations and impaired asset measures, liquidity support and liquidation aid.

The new rules aim at improving the restructuring process and the level playing field between banks. While the Commission emphasizes that financial stability remains the overarching objective, it also strengthens the burden sharing requirements. Bank owners and junior creditors will be required to contribute as a first resort, before banks can ask for public funding. Also, banks will in future have to present a restructuring plan, including a capital raising plan, convincingly demonstrating how they will become profitable in the long term before they can receive recapitalization measures. If the viability of the bank cannot be restored, an orderly winding down plan needs to be submitted instead.

1 Communication from the Commission on the application, from 1 August 2013, of state aid rules to the support measures in favour of banks in the context of the financial crisis.

2 Mayer Brown Alert of 16 October 2008 on the 2008 Banking Communication.

3 See also Mayer Brown Alert of 12 December 2008 on the recapitalization of financial institutions; Impaired Asset Communication of the Commission of March 2009; Mayer Brown Alert of 4 August 2009 on the restructuring aid to financial institutions; and the two 2010 and 1011 Prolongation Communications of the Commission.

Recapitalisation and Impaired Asset Measures

Recapitalisations and impaired asset measures (including asset guarantees) are normally granted to cover a capital shortfall. Such shortfall will have to be established in a capital exercise, stress-test, asset quality review or an equivalent exercise at Union, Euro area or national level, and, where applicable, confirmed by the competent supervisory authority. The measures to overcome the capital shortfall will only be approved if the Member State has sufficiently demonstrated in a capital raising plan (to be shown before or at least as part of the restructuring plan) that all measures to limit the aid have been exploited to the maximum extent. The capital raising plan has to identify capital-raising measures, such as, *inter alia*, rights issues, voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive, liability management exercises, capital-generating sales of assets and portfolios, or securitisation of portfolios in order to generate capital from non-core activities. The capital raising plan shall enable the Member State and the Commission to determine the capital shortfall of a bank that needs to be covered with State aid. In respect of such shortfall, a restructuring plan must be submitted.

In order to incentivize banks to avoid recurring to state aid, CEOs and other board members are expected to be replaced if the recourse to state aid could have reasonably been averted through appropriate and timely management action. In addition, executive pay caps should be implemented.

State Aid only after approval. According to the 2013 Banking Communication, the Commission – except in exceptional circumstances – will only authorize recapitalisation and impaired asset measures if it has agreed on a restructuring plan. This is notably different from the previous practice wherein banks could temporarily receive structural aid before the final approval by the Commission was obtained. The Commission will in exceptional cases and only

temporarily approve rescue aid prior to the approval of a restructuring plan but such plan must be submitted within 2 months of the approval. Similar to the merger control procedure, the Commission invites Member States to engage into voluntary pre-notification contacts with the Commission. Such a pre-notification phase should be initiated with the capital raising plan on the basis which the Commission will seek to ensure compatibility with the EU state aid regime.

Burden Sharing. State support can create moral hazard and undermine market discipline. Therefore, any aid should only be granted on terms which involve adequate burden-sharing by existing investors. Hence, losses have to be absorbed first by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall as much as possible, e.g., through a conversion into Common Equity Tier 1 or a write-down of the principal of the instruments. Cash outflows from the beneficiary to the holders of such securities must be prevented to the extent legally possible. By contrast, the Commission will not require contributions from senior debt holders.

The 2013 Banking Communication emphasizes that outflows of funds must be prevented at the earliest stage possible. From the time capital needs are known or should have been known to the bank, banks should take all measures necessary to retain their funds. In this respect, the Commission identifies, *inter alia,* bans to payment of dividends, restrictions on buy back of hybrid instruments, advertising, aggressive commercial practices, and acquisitions.

Exceptions are available where the stability of the financial system is at risk or where the implementation would be disproportionate.

Smaller Institutions. Aid to institutions that have a balance sheet total of not more than EUR 100 million can benefit from a simpler regime. The Commission will authorise aid schemes for recapitalisation and restructurings of small institutions where such schemes have a clear remit and are limited to a period of six months. The sum of the balance sheets of banks that benefit from these schemes must not exceed 1.5% of the total assets held by banks in the domestic market of the Member State concerned.

Guarantees and Liquidity Support

Unlike recapitalisation or impaired asset measures, guarantees on liabilities and liquidity support can be granted before a restructuring plan is approved by the Commission.

Guarantees and liquidity schemes which are available to all banks can be approved by the Commission for a maximum period of six months. The Commission will approve guarantees and liquidity support if the guarantee will only be granted for new issues of credit institutions' senior debt (subordinated debt is excluded), and on debt instruments with maturities from three months to five years (or a maximum of seven years in the case of covered bonds). The remuneration level of the State guarantees must be in line with the formula previously set in the 2011 Prolongation Communication, and a restructuring plan must be submitted within two months for any credit institution which received guaranteed liabilities that exceed both a ratio of 5% of the bank's total liabilities and EUR 500 million. The beneficiary has to refrain from "advertising" the state aid support and from aggressive commercial practices.

National guarantee and liquidity support schemes must be restricted to banks without a capital shortfall as confirmed by the competent supervisory authority. Where a bank with a capital shortfall is in urgent need of liquidity, an individual notification to the Commission must be made.

Liquidation Aid

The Commission welcomes the exit of non-viable banks, and encourages Member States to support the orderly liquidation of a distressed credit institution when it cannot return to long-term viability. Due to the systemic relevance of credit institutions, state aid helping to liquidate failing banks may be compatible with EU law. However, Member States have to submit a liquidation plan to the Commission which requires approval; in addition, no new third party business may be undertaken by the failing bank, and liquidation must as much as possible aim at selling off parts of the bank by means of a competitive process. Claims of shareholders and subordinated debt holders must not be transferred to any continuing economic activity.

A sale of a bank or parts/assets of it may entail state aid to the buyer, unless the sale is organised via an open and unconditional competitive tender and the assets are sold to the highest bidder. In this respect, the Commission will analyse whether the sale process is open, unconditional and non-discriminatory, the sale takes place on market terms, and the credit institution or the government, depending on the structure chosen, maximises the sales price for the assets and liabilities involved. A sale may also entail state aid to the bank or its parts/assets, and the Commission will analyse the remedies needed in order to limit competition distortions.

As far as liquidation schemes are concerned, the 2013 Banking Communication considers that only smaller credit institutions (total assets of less than EUR 3 billion) could fall under a general exemption. Aid measures under an approved scheme in favour or larger banks must be individually notified for approval.

Conclusion

The 2013 Banking Communication establishes a stricter state aid regime for banks and its shareholders; the enhanced burden sharing should make it more difficult for Member States to grand state aid. The fact that restructuring plans must be authorized prior to granting the aid is a significant change to the previous regime where structural aid in the form of recapitalization and impaired asset measures was normally authorized temporarily before the restructuring plan was agreed. The fact that the Commission has issued the new Communication shows that it expects further State aid measures which it will analyse under a less flexible regime.

If you have any questions about any of the issues raised in this update, please contact one of the lawyers listed below or your usual point of contact:

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