EUROPEAN COMMISSION

MEMO

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State aid: Commission adapts crisis rules for banks - frequently asked questions

(see also IP/13/672)

What rules has the Commission so far applied to state support for banks during the crisis?

In 2008-2009, following the collapse of Lehman Brothers, the Commission adopted a comprehensive framework for coordinated action to support the financial sector during the crisis, so as to ensure financial stability while minimising distortions of competition between banks and across Member States in the single market.

It spells out common conditions at EU level on how Member States can support banks hit by the crisis in line with EU state aid principles. It comprises the Banking Communication, the Recapitalisation Communication, the Impaired Assets Communication and the Restructuring Communication ("Crisis Communications"). These special rules are based on Article 107(3)(b) of the Treaty on the functioning of the EU (TFEU) that allows the Commission to approve state support to remedy a serious disturbance in the economy of a Member State. They have been updated several times to adapt to the evolution of the crisis - in 2009, in 2010, and a third time in July 2013 through the adoption of a new Banking Communication (see IP/13/672).

The Crisis Communications set out the conditions under which state aid granted by the Member States to banks, under its various forms – guarantees on liabilities, recapitalisations and impaired asset measures – are compatible with EU law.

The Crisis Communications specify the particular features that the **restructuring plans** of aided banks must display.

In line with these criteria, the Commission can only authorise such restructuring plans if they can lead to the restoration of the bank's **long-term viability**. To be approved, restructuring plans must also foresee adequate **burden sharing**, so that aided banks and their capital holders bear adequate responsibility for their past behaviour and contribute to the restructuring as much as possible with their own resources. Finally, as aid to companies in difficulty can be particularly distortive of competition, the plans have to include **measures to limit these distortions** - for example structural measures, such as divestitures, or behavioural measures, such as constraints on acquisitions or on aggressive pricing and marketing strategies funded by state aid.

In cases where the bank cannot return to viability, the Commission can approve the state aid which is necessary for the orderly winding down of the bank.

The Commission has followed these general principles throughout the economic and financial crisis.

The full crisis regime for banks is available at:

http://ec.europa.eu/competition/state_aid/legislation/temporary.html

What has been the Commission's practice so far?

So far, the Commission's restructuring and orderly winding down decisions covered approximately 25% of all European banks (by assets) and more than 60 institutions. By September 2013, the Commission had adopted decisions approving a restructuring plan for 44 banks, 23 approving winding down plans and one negative decision requiring the recovery of the aid granted. For an overview of decisions and on-going in-depth investigations in the context of the financial crisis see MEMO/13/762.

Before the adoption of the new Banking Communication in July 2013, the Commission could temporarily approve state support in any form as **rescue aid**. Member States could also get rescue aid schemes approved. If rescue aid took the form of guarantees which exceeded a set threshold, the Member State had to submit a viability plan to the Commission within six months; if rescue aid was granted in the form of recapitalisations or impaired asset measures, the Member State had six months to submit a **restructuring plan** to the Commission.

Whilst the model of temporarily approving emergency recapitalisations and impaired asset measures first and then discussing the restructuring plan was well-suited for the beginning of the crisis, to avoid panic and bank runs, it did at times lead to long delays in the discussions on the restructuring of aid beneficiaries, sometimes extending for as long as four years. On the other hand, the financial sector assistance programme for Spain illustrates that the process of agreeing on a restructuring plan can be streamlined: the Commission agreed and adopted eight restructuring plans in only three months after the capital shortfalls were identified.

Why has the Commission revised in July those rules and what are the most important changes?

The increasing divergence in economic recovery between Member States and of burden-sharing requirements in the event of bank bail-outs across the EU and the need to reduce and consolidate public and private debt have recently led to tensions and a fragmentation of the markets, due to the different perceptions of risk by investors. This has led to increasing distortions in the Single Market. The adaption of the crisis regime is aimed at remedying these shortcomings.

The Commission therefore adopted a new Banking Communication that sets out the up-dated EU crisis rules for state aid to banks during the crisis applicable as of 1st August 2013 (see IP/13/672). It replaces the 2008 Banking Communication and supplements the remaining crisis rules. Together, they define the common EU conditions under which Member States can support banks with funding guarantees, recapitalisations or asset relief and the requirements for a restructuring plan. The main changes as compared to the existing regime are:

- **A more effective restructuring process:** Due to changed market conditions, there is less need for structural rescue measures in the form of emergency recapitalisations or impaired asset measures which so far have been authorised temporarily on the basis of a preliminary assessment by the Commission. The new Banking Communication establishes the principle that recapitalisation and impaired asset measures will be authorised only once a restructuring plan has been approved by the Commission. This approach ensures that the amount of aid necessary is more accurately calibrated. The accelerated procedure and faster decision making will give legal security to the beneficiary of the aid without delay and contribute to restoring market confidence as fast as possible.

- **Strengthened burden sharing requirements:** The new Banking Communication raises the minimum requirements for burden-sharing so as to minimise the public intervention and restore a coherent approach throughout the European Union. Banks intending to resort to State aid should undertake all capital raising measures by going to the market, using internal resources, and asking for the contribution of shareholders, hybrids holders, and junior debt creditors. This change actually reprises a practice that has already been applied in a number of European countries. In particular, banks with a capital shortfall will have to obtain shareholders and subordinated debt-holders' contribution before resorting to public recapitalisations or impaired asset measures. This will limit the amount of aid to the minimum necessary, protecting thereby the interests of taxpayers, and will reduce moral hazard that state support can create.

How quickly can the Commission approve a restructuring plan?

The Commission will approve restructuring plans as soon as they meet the compatibility criteria for the authorisation of State aid which ensure that no bank derives an undue competitive advantage from the public intervention. Once this requirement is met, the Commission has in the past often been able to authorise aid within a very short time period.

So as to ensure a swift and efficient procedure, the Commission encourages Member States to discuss restructuring plans with the Commission as soon as a capital shortfall has been identified.

The Commission will offer its assistance on how to ensure compatibility of the restructuring aid and in particular on how to implement the burden-sharing requirements in accordance with State aid rules.

What happens if a bank needs an urgent recapitalisation or impaired asset measure and cannot wait for the approval of its restructuring plan by the Commission?

The new Banking Communication allows the Commission to exceptionally authorise rescue aid in the form of a recapitalisation or an impaired asset measure, if it is required to preserve financial stability.

The competent supervisor will have to confirm that an immediate intervention is necessary to preserve the bank from the withdrawal of its banking license. Such rescue aid can be granted by the Member State on a temporary basis before a restructuring plan is approved by the Commission. Any rescue aid has to comply with the new Banking Communication and should not prevent compliance with the burden sharing requirements set out in the new Banking Communication. The Member State has to submit a restructuring plan within two months of the authorisation of such rescue aid by the Commission.

How does the burden sharing pursuant to the new Banking Communication work?

First, no contribution will be required from senior debt holders, in particular from insured deposits, uninsured deposits, bonds and all other senior debts.

Banks intending to resort to State aid should undertake all measures to minimise the public intervention. To that end, a bank with a capital shortfall should first carry out all possible capital raising measures by private means before it can resort to any public support. The Member State and the bank have to set up a capital raising plan which is to be endorsed by the competent supervisory authority. Capital raising measures can, for example, include rights issues, a voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive, liability management exercises which should in principle be 100 % capital generating, sales of capital-generating assets and portfolios, securitisation of portfolios in order to generate capital from non-core activities, or an earnings retention.

Only if those measures are not sufficient to fill the capital shortfall, then shareholders and subordinated creditors will be required to contribute:

- In cases where the capital ratio of the bank remains **above the EU regulatory minimum**, the bank should normally be able to restore the capital position on its own, in particular through the capital raising measures mentioned above. If there are no other possibilities, including any other supervisory action such as early intervention measures or other remedial actions to overcome the shortfall defined by the supervisory authority, then **subordinated debt must be converted into equity** before State aid is granted.

- In cases where the bank **no longer meets the minimum** regulatory capital requirements, **subordinated debt must be converted or written down** before State aid is granted.

Under the Banking Communication, the Commission can make an exception to the burden sharing requirements only when the implementation of writing down or conversion of subordinated creditors would lead to disproportionate results or would endanger financial stability. This could cover cases where the aid amount to be received is small in comparison to bank's risk weighted assets and the original capital shortfall has been significantly reduced through capital raising measures. The Commission will decide about the application of the exception on a case by case basis.

How can the enhanced burden sharing be implemented at national level? Can it be implemented for banks which are not in national resolution procedures? Can it be implemented if a Member state does not have yet a resolution law?

Any public recapitalisation or asset protection measures trigger an obligation to comply with the conditions that the Commission set for authorising such State aid. The Commission has exclusive competence for determining the compatibility conditions of such aid.

As regards the technical implementation of the burden sharing rules, there are three main avenues that Member States and banks with a capital need that cannot be filled by capital raising measures could pursue:

1) **Voluntary agreements**, subject to the approval of the Commission, could be sought between the bank's owners and holders of subordinated debt to convert debt into equity. A sufficiently high conversion rate should normally ensure that a very high percentage of subordinated debt holders agree to the conversion which would be 100% capital generating.

2) Member States can put in place **statutory tools** to enable them to proceed in compliance with State aid rules. In the past some Member States have put laws in place to enable enhanced burden sharing by creditors, affecting existing contracts[1].

3) A **holding company** could be created in which the partial ownership in the bank to be recapitalised would be recorded on the asset side, whereas the equity, hybrids and subordinated debt existing in the bank prior to the State intervention would constitute the liability side, with the same seniority structure as the one that existed before in the bank.

Independently from the implementation modalities chosen, a **"no creditor worse off" principle** should be respected, meaning that subordinated creditors will not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted.

Is burden sharing in such circumstances legally possible?

Limits to the technical feasibility of burden sharing are considered in the Communication and should be addressed on a case by case basis.

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[1] See for example Spain, Law 9/2012 on the restructuring and resolution of credit institutions; Denmark, Act on Financial Stability; Ireland, Credit Institutions (Stabilisation) Act 2010; the Netherlands, Act on Special Measures for Financial Corporations (Intervention Act).

As regards property rights it is worth noting that junior debt will normally be converted but not written down so that the enhanced burden sharing requirement does not lead to expropriation. Furthermore, the "no-creditor worse off principle" ensures that subordinated creditors will not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted. In the past, conversion of junior creditors in such circumstances took place on the basis of national legislation introduced for this purpose.

Does such enhanced burden sharing apply to cases in which a bank meets the regulatory minimum requirements but not the higher requirements set by the supervisory authority, following a stress test exercise for example?

A stress test revealing a capital shortfall is as such not relevant for State aid control. Indeed, an appropriate amount of time is available to the banks to fill the capital gap. In most cases, banks will be able to address the capital needs by their own means.

Against this framework, according to the new Banking Communication, State aid control would only become relevant when the private means to raise capital had been exhausted and a bank would need to resort to public resources to fill the gap. In these cases, the bank's soundness becomes doubtful. In this respect it is to be noted that the capital shortfall ultimately depends on the capital requirement as set by the competent supervisory authority, and that the application of the Commission's burden sharing rules depends on the Member State's decision to remedy that capital shortfall by means of injecting public resources.

Does the new Banking Communication deal with the responsibility of the management of failed banks and remuneration policies?

In order to set the right incentives for banks' management and minimise state aid, the top management of a bank having received aid should be replaced when appropriate.

For the same reasons, failed banks should apply strict executive remuneration policies. The new Banking Communication sets out a cap on total remuneration, in line with the rules of the Commission's Capital Requirements Directive IV, as long as the entity is under restructuring or relying on state support. The total remuneration may not exceed 15 times the national average salary in the Member State where the beneficiary bank is incorporated, or 10 times the average salary of employees in the beneficiary bank.

This will give management the proper incentives to implement the restructuring plan and repay the aid.

What are the main changes as regards schemes?

The new Banking Communication establishes the principle that recapitalisation and impaired asset measures will be authorised only once the bank's restructuring plan is approved. In light of this principle, public **recapitalisation schemes** are in principle not available in accordance with the new Banking Communication, unless they are for small institutions or are needed to preserve financial stability.

Guarantee schemes will continue to be available in order to provide liquidity to banks. However, only banks without a capital shortfall as defined by the competent supervisory authority will be eligible for liquidity under such schemes. The new Banking Communication also codifies the Commission's assessment criteria for guarantee schemes.

Does the new Banking Communication include provisions on aid granted for the orderly winding down of a bank (or "liquidation aid")?

The new Banking Communication codifies the Commission's case practice on liquidation aid. In particular it sets out the criteria for authorising liquidation aid and orderly winding down schemes and for selling a bank during the orderly winding down procedure. The Commission can now also approve liquidation aid schemes for banks of limited size, provided that such schemes comply with the requirements laid down in the new Banking Communication.

When did the new Banking Communication enter into force? Does the new Banking Communication also apply to pending cases?

The new Banking Communication entered into force on **1 August 2013**. It does not apply to pending cases: all notifications registered prior to 1 August 2013 are examined according to the rules in force at the time of the notification; all notifications from 1 August 2013 onwards are according to the new Banking Communication. Aid granted without prior Commission authorisation after the publication of the Communication in the Official Journal of the European Union is examined on the basis of the new Banking Communication; in all other cases, aid is examined on the basis of the rules in force at the time when the aid was granted.

So to which cases do these rules apply?

All of the revised rules, including higher burden sharing from subordinated creditors, apply to all banks which notify public recapitalisation or asset protection after 1st August 2013:

- banks which need public recapitalisation or asset protection for the first time;
- banks which have received aid in the past and for which the Commission approved a restructuring plan, in case they need additional/new public recapitalisation or asset protection not notified before 31.07.2013;
- banks which have received aid in the past and which are in the process of discussing their restructuring or orderly winding down plans with the Commission, in case they need additional public recapitalisation or asset protection which has not been notified before 31.07.2013.

How does the new Banking Communication fit in the overall framework of the Banking Union?

One pillar of the Banking Union is the future framework for recovery and resolution of banks. On 26 June 2013, the European finance ministers agreed on a draft Directive on Recovery and Resolution of Credit Institutions (BRRD, see IP/12/570 and MEMO/13/601). The draft BRRD also foresees bail-in, i.e. the imposition of losses on shareholders and unsecured creditors, including junior and senior bondholders and some categories of depositors, when a bank is resolved. As a next step, the BRRD is currently being negotiated with the European Parliament in the trilogues with a view to adoption by the co-legislators by the end of the year and coming into effect by 2015. At this stage of the discussions, the Council has endorsed the Commission's proposal for the entry into force of bail-in in 2018. However, this issue is currently under discussion in the trilogues.

The new Banking Communication is applicable as of 1 August 2013. Its burden-sharing requirements apply to all state aid granted to banks, not only resolution scenarios. It can help to ensure a smooth passage to the future bail-in regime under the BRRD, whereas it will not pre-empt any such future regime. Similarly, it facilitates the transition towards the functioning of the Single Resolution Mechanism (see IP/13/674 and MEMO/13/675), proposed by the Commission on the same day as the Banking Communication was adopted. As long as State aid is present in resolution funding, the Commission will continue to exercise its exclusive competence for State aid control.

The Commission will review the Crisis Communications as deemed appropriate, in particular light of the changes in market conditions or in the regulatory environment.