Where state guarantees supporting commercial banking activities distort competition, they must be abolished: the case of CDC IXIS

Rosalind BUFTON, Directorate-General Competition, unit H-3

Introduction
Commission decisions have consistently confirmed that the financial sector is subject to competition rules, including those relating to state aid, in exactly the same way as other sectors of the economy are. Whilst acknowledging banks’ special responsibilities in respect to depositors and the need to guard against systemic risk, the Commission has considered that measures should be put in place and indeed are put in place by the market and the appropriate regulatory authorities, to meet these situations. Therefore, banks cannot plead that they should benefit from a special treatment with respect to state aid rules.

This has given rise over a period of time to a number of sometimes widely publicised cases in which state aid to financial institutions has been investigated then authorised or refused, always according to the same rules of analysis used for undertakings of all sectors of the economy. At a certain period these have mainly been in rescue and restructuring cases or at other periods, cases concerning capital injections by state bodies in various forms. For example, in March 2003 the Court of First Instance has upheld that the Commission’s approach to determining the state resources which constitute state aid to a bank and to the German bank WestLB in particular, is correct in principle (1)( cf ‘The judgment of the Court of First Instance concerning the transfer of capital to Westdeutsche Landesbank Girozentral (WestLB)’ in this issue of the newsletter). Capital injection decisions consistently refer to the now well established market investor principle which stipulates that for a capital injection using state resources not to be considered as state aid, it must be able to demonstrate that a private investor would have behaved in the same way.

State guarantees
A series of decisions have now been taken relating to another form of state aid. This is state guarantees given to financial institutions which are active in competitive markets rather than activities of public interest. State guarantees vary in form and scope, but their effects are extremely similar. They give payment assurance to creditors. This allows a creditor to deal with a guaranteed institution without taking account of an underlying risk as it would do in dealing with any similar institution not benefiting from such a guarantee. Consequently, for example, rating agencies (2) are willing to attribute the famous ‘triple A’ rating to institutions benefiting from a state guarantee, more easily and more quickly than to other similar institutions because the guarantee provides that the state will pay if the bank cannot. Such advantages clearly distort competition. This is why the Commission proposed that the German Authorities should abolish the guarantees after a transition period given to a number of public banks such as the Landesbanken. Agreement on the conditions for the phasing out of the guarantees was reached in 2002 and the law amending provisions for public sector banks has already been adopted.

Recently the French Authorities have accepted the Commission’s proposal on the phasing out of the guarantee to CDC IXIS, the commercial subsidiary of the French state bank Caisse des Dépôts et Consignations (CDC).

What is CDC IXIS?
CDC is a public financial institution created in the 19th century whose mission was to conduct a number of public services on behalf of the state. Over time, its portfolio of activities evolved, reaching a situation where CDC decided to clarify its legal and business structure by creating a separate legal entity, CDC IXIS, to which its commercial banking activities were transferred at the end of 2000. CDC decided to support its subsidiary by giving a guarantee covering a large part of CDC IXIS activities.

CDC IXIS may not be a household name as its customers are exclusively institutional investors, major securities issuers and companies. Contrary to most commercial banking institutions whose activity

(1) Albeit considered by the Court to be insufficiently substantiated in the specific case.
(2) The companies Standards and Poor’s, Moodys and Fitch IBCA are internationally recognised institutions which are specialised in the evaluation of credit risk. Using certain methodologies they rate issuers of debt instruments such as bonds according to a company’s apparent ability to repay a short or long term loan. The rating is one of the criteria used by banks to determine the price and other conditions (in particular length of operations and the overall credit line) which is attributed to a counterparty. The top rating in S&P’s scale is referred to as Triple A.
is driven by retail and corporate banking markets, CDC IXIS (with a total balance sheet of over €250 billion and a pre-tax profit of €506 million for 2002), is an investment bank. It is present in International financial markets, in Asset Management as well as in Banking and Securities services. CDC IXIS also manages the intragroup treasury operations. In addition to the operations registered in the balance sheet, like most financial institutions but more so in investment banks than retail banks, a very large part of its activity is reflected in operations which are not registered in the balance sheet but in the ‘off-balance sheet items’. This refers to transactions which have not materialised during the accounting period but for which there is a probability that the transaction may or will do so at a certain point in the future. Examples include Interest Rate SWAPS where one bank may wish to swap a floating interest rate for a fixed interest rate over a given period which will end at some time in the future. Such transactions are evaluated in respect of the amount of risk they contain for the future. Netting, which offsets debts and credits can reduce the apparent risk.

Why is the guarantee to CDC IXIS not compatible with state aid rules?

A commercial bank may not benefit from a state guarantee if it constitutes state aid unless the conditions of the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to state aid in the form of guarantees are met (1). This was clearly not the case for CDC IXIS.

It was established that the guarantee to CDC IXIS is qualified under state aid rules as a state guarantee. The guarantor, CDC, is a public bank sui generis operating and funded through state resources. Important strategic and business actions of CDC are under the control of the state whose representatives make up the highest management body. For these reasons amongst others, it was beyond reasonable doubt that CDC could not give a guarantee to CDC IXIS without taking account of the requirements of the public authorities and it was extremely unlikely that such a decision could be taken without its knowledge and therefore imputation to the state was confirmed.

Concerning the advantages procured by the guarantee, they are both general and specific to the market in which CDC IXIS is active. For example, Rating agencies quote the existence of the guarantee as one of the criteria, though not the only one, contributing to their decisions to award CDC IXIS the top AAA rating. Operating on international financial markets where the attribution of a ‘triple A’ rating gives rise to quantitative (more favourable rates) and qualitative (longer maturities, larger envelopes, greater willingness to trade…) advantages, the distortion of competition was unquestionable as was the effect on cross-border trade. The conditions were therefore met for this measure to be qualified as state aid.

The Commission of course looked to see whether the guarantee could nevertheless be exempted on the basis of the Commission Notice on guarantees. Four aspects in particular were examined. If the first two, concerning the financial viability of the company, did not raise doubts, the remaining two conditions did. These require that a guarantee should be limited and that a market price should be paid.

The CDC guarantee could not be considered as limited in scope or in duration. By definition, a financial institution trading on capital markets will have a portfolio which will vary in value from day to day. Furthermore it includes actual and potential risks which in the case of CDC IXIS are particularly important due to its very strong involvement in derivatives and other off balance sheet operations.

A guarantee for a continuously fluctuating amount and value of operations, and therefore potential outlay by the guarantor, cannot be considered as limited. Indeed, this constitutes a open envelope where the value of the guarantee cannot be calculated by the guarantor or a third party independently of the guaranteed entity. Open envelopes are not authorised under state aid rules.

Furthermore, it is impossible to calculate the market price of the premium for an open envelope, even if such a formula were to exist. In fact in this case, there is no product on financial markets which takes account of both the quantitative and qualitative advantages procured by a state guarantee of this type. The conclusion of the Commission was therefore that this guarantee constituted state aid which could not qualify either for an exemption under the provisions of Article 86.2 in the scope of a public service activity, nor did the exemptions of Articles 87.2 or 87.3 apply.

Appropriate measures proposed that the guarantee should be abolished

A proposal for appropriate measures was adopted by the Commission in January 2003 (2) which

---

(2) This proposal is revised by a proposal adopted on 30 April 2003 and which takes account of a memorandum of understanding of 27 March 2003.
proposed that the guarantee should be abolished. This outlined the new conditions for CDC IXIS operations.

These include the fact that there will be a normal commercial relationship between CDC and CDC IXIS just like those governing any other company with a private shareholder. CDC will have no obligation to grant economic support to CDC IXIS and will take no unlimited liability for CDC IXIS. Creditors of CDC IXIS will be in the same situation as those of private credit institutions.

The French Authorities have agreed on the conditions proposed by the Commission for the phasing out of the guarantee.

The transition period

Such phasing out in this case involves a transition period where a certain part of the activity can still be conducted under the auspices of the guarantee for a limited period of time. A transition period is the shortest time necessary to allow an institution to adapt its organisation, activities and legal environment to the new market conditions under which it will operate without the guarantee. Several factors were taken into account to determine whether or not a transition period was necessary in the case of CDC IXIS and if so, what the characteristics of this period should be. This approach is consistent with that taken for the removal of guarantees to German public banks.

Firstly, the Commission considered not only CDC IXIS but also the counterparties with which CDC IXIS transacts. Uncertainty and instability are factors of risk in international financial markets therefore, it was considered reasonable for there to be a transition period to avoid unnecessarily abrupt and possibly inappropriate adjustments in financial markets. Although this sometimes happens when rating agencies adjust their ratings of a financial institution downwards, it was considered preferable to announce clearly the timetable over which the guarantee will be abolished. The Commission also took into consideration the fact that CDC IXIS is a recently created institution as a separate entity from the mother company CDC.

Consequently the Commission proposed that the guarantee should be phased out progressively. Transactions covered by the guarantee and entered into before 01.04.2003 will remain covered by the guarantee until their maturity. New transactions appearing on the balance sheet which have a maturity extending beyond 23.01.2017 are no longer eligible for the guarantee since 01.04.2003.

All other new on and off balance sheet operations included in the guarantee which will be repaid by CDC IXIS before 23.01.2017 can continue to be issued with the backing of the guarantee until 23.01.2007. This is 4 years after the proposal for appropriate measure was made. There is an exception for a category of operations in which CDC IXIS is specialised. These are off balance sheet transactions which mature after 23.01.2017. CDC IXIS may continue to benefit from the guarantee for these transactions until 23.01.2004. During the few months between the agreement on the conditions for the transitional period and January 2004, CDC IXIS intends to create a special purpose vehicle (SPV) which will be dedicated to this activity and will not benefit from the guarantee. CDC IXIS hopes that the SPV will be attributed the AAA rating. This is quite a common practice in the financial sector. After 23.01.2007 the guarantee will be fully abolished. Creditors making transactions with CDC IXIS will be informed in advance when new operations are issued without the guarantee.

Conclusion

The guarantee to CDC IXIS was not compatible with state aid rules and is already partly abolished. The transition period will allow CDC IXIS to adjust its operational and legal environment to operate at the same level as its competitors. It will also allow counterparties to know clearly when they are transacting with CDC IXIS under the auspices of the guarantee and when not. The market will then be able to operate in full transparency, with banks dealing with CDC IXIS on the basis of its intrinsic credit risk and not partly on its own merits and partly on those of a state guarantee.

Consistent policy will continue to be applied to examine state guarantees to banking activities and where appropriate, require that such guarantees are abolished. This is reflected in a similar situation where the Commission decided recently that state guarantees given to certain public banks in Austria will also be phased out (cf ‘Phase out of State guarantees in favour of the Austrian public banks’ in this issue of the newsletter).