Enforcement of State aid control in the banking sector: BAWAG-PSK

Martin LOEFFLER and Daniel BOESHERTZ

On 27 June 2006 the Commission decided to approve a State guarantee of € 900 million granted to BAWAG-PSK by Austria. The guarantee provided collateral for specific bad loans with the consequence that the assets remained valuable and no value adjustments had to be carried out.

The exit of inefficient firms is a normal part of the operation of the market. Therefore, the provision of rescue or restructuring aid to firms in difficulty may only be regarded as legitimate subject to certain conditions. The Commission authorizes restructuring aid only under the following conditions:

i) a restructuring plan, which must be endorsed by the Commission, has to be prepared, and fully implemented, restoring the firm’s long-term viability (without additional aid).

ii) Compensatory measures must be taken in order to ensure that the adverse effects on trading conditions are minimized as much as possible, so that the positive effects pursued overcome the adverse ones. In addition, the Commission may impose any conditions and obligations it considers necessary in order to ensure that the aid does not distort competition to an extent contrary to the common interest.

iii) The amount and intensity of the aid must be limited to the strict minimum of the restructuring costs necessary to enable restructuring to be undertaken in the light of the existing financial resources of the company, its shareholders or the business group to which it belongs.

1. Background

BAWAG-PSK is the fourth largest bank in Austria. It is active in all areas of financial services in Austria and abroad. It operates the largest centrally managed distribution network in the country, has 1.2 million private and more than 60,000 business customers. On 31 December 2005, the balance sheet total was € 57.9 billion with savings deposits of around € 18 billion. BAWAG-PSK holds a strong position as a principal provider of banking services to the public sector. Governmental transfers and wage pay-outs to public employees are handled by the Bank. The Bank has also expanded internationally with branches, subsidiaries or participations in the Czech Republic, Slovakia, Slovenia, Hungary, Malta and Libya. The Bank’s history goes back to 1922 when a “Bank for workers” was founded for managing the financial assets of the unions. Until 2006, BAWAG-PSK was indirectly wholly owned by the Austrian federation of trade unions (“ÖGB”).

The economic difficulties of BAWAG-PSK resulted mainly from two specific sources, the “Caribbean” and “Refco” transactions, conducted by some members of the management. These transactions were made possible because of insufficient risk controlling and the circumvention of existing control instances by the participants.

The “Caribbean” transactions were primarily conducted between 1995 and 2001. Considerable funds were used in order to speculate on currency exchange rates. The invested funds were nearly totally lost because the anticipated development did not take place. From 2001 onwards up to October 2005, the losses were often restructured and reduced by partial write-offs. The business relationship of BAWAG-PSK with the bankrupted US broker Refco, which took place over 1998-2005, consisted mainly in a participation of BAWAG-PSK in Refco, cooperation between BAWAG-PSK and Refco in several areas and the granting of loans from BAWAG-PSK to Refco. In April 2006, complaints were filed against BAWAG-PSK in the USA by Refco, the Refco’s creditors committee, the Department of Justice and the Securities and Exchange Commission. During the course of these proceedings, a large amount of money was frozen by court order until a settlement was negotiated with the authorities of the United States and with the Refco creditors. The relationship with Refco resulted in total expenses and provisions of approximately € 1 billion for BAWAG-PSK.

In October 2005, BAWAG-PSK was hit by the insolvency of Refco and, at the same time, the losses of the „Caribbean“ transaction came to light. These events led to value adjustments requiring

(1) Directorate-General for Competition, unit D-3 and unit F-3. The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors. The authors want to thank the other members of the case team, namely Vincent VEROUDE (Chief Economist Team) and Jürgen FOECKING (Unit A3).

(2) Commission Decision of 27.06.2007 in case C 50/2006, BAWAG-PSK.
the provisioning of an amount which could not be brought by the Bank’s own resources. Alerted by the press, depositors massively withdrew money from current and savings accounts in late April/early May 2006. Globally, the current and savings accounts held by the bank were reduced by several billion euros.

2. The State guarantee

On 8 May 2006, in order to stop the bank run and to secure the liquidity of the bank, Austria granted by law a guarantee for receivables of BAWAG-PSK for a amount of € 900 million. Without the guarantee, BAWAG-PSK would not have been able to comply with the solvency and equity capital provisions of the Austrian Banking Act and therefore not able to close the 2005 annual accounts.

The conditions of the guarantee obliged the owners of the Bank to sell their shares in BAWAG-PSK to an independent third party within one year. The guarantee would end 60 days after BAWAG-PSK was sold but, in principle, not later than 1 July 2007. An extension under certain conditions was however possible.

The guarantee of Austria could only be drawn if, cumulatively, i) BAWAG-PSK was not sold, ii) BAWAG-PSK, its direct and indirect shareholders had been requested to pay and to disclose their financial situations and obliged to pay up to the limit of their capacities for payment before the guarantee could be called on, iii) the economic threat to the bank continued to exist and iv) an insolvency of the Bank threatened or has already occurred. The drawdown of the guarantee was also permitted if insolvency threatened only because the guarantee would expire on 1 July 2007; the Federal Government could avoid the drawdown under the guarantee by extending it. However, this required an additional decision by the Federal Government.

The fee to be paid by BAWAG-PSK was fixed at 0.2% per year for the period ending 30 June 2007 and 1.2% afterwards.

In addition to the State guarantee, two special purpose vehicles (“SPV”) were created by private banks on the one hand and insurance companies on the other hand, which enabled BAWAG-PSK to increase its eligible capital by € 450 million.

The scenario of a sale of BAWAG-PSK to a third party formed the basis of the restructuring plan submitted by Austria in September 2006.

3. The in depth enquiry

Following a preliminary assessment, the Commission had doubts as to the legality and compatibility of the restructuring aid with the common market and opened the formal investigation procedure(6) in November 2006.

The Commission considered that no market operator would have granted the guarantee to BAWAG-PSK, which was a firm in difficulty at that time, for a fee of 0.2%. As a consequence, the State guarantee conferred an advantage on BAWAG-PSK. Furthermore the guarantee was granted by Austria on 8 May 2006, with retroactive effect from 31 December 2005, before the Commission decided on its compatibility. As a consequence, the Commission concluded that the guarantee provided to BAWAG-PSK was an illegal State aid (4).

The subsequent investigation under the Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (5) mainly focussed on two issues: i) the aid element involved in the guarantee, and ii) the compensatory measures, i.e. the measures to mitigate the distortive effect of the aid on competition.

3.1. Assessment of the aid element in the State guarantee

The specific nature of the guarantee

In order to determine the aid element in the guarantee, the Commission had first to consider the specific nature of the guarantee granted by Austria.

The guarantee provided collateral for specific non-performing loans of the Bank. The consequence was that the assets remained valuable and no value adjustments, which would have generated additional losses of € 900 million in the 2005 accounts, had to be carried out. BAWAG-PSK’s core capital ratio could thus be prevented from decreasing below the minimum statutory requirements. In this regard, the effect of the guarantee is similar to that of a capital injection.

Moreover, the guarantee is not comparable to guarantees securing the liabilities of a bank (4). Such guarantees provide direct claims to the creditors of the bank. In the case of insolvency, the guarantor has to meet the liabilities, which cannot

(5) i.e. an aid which is implemented before the adoption of the Commission decision authorizing it. The fact that an aid is illegal does not mean that it is incompatible with the common market.
(6) OJ C 244 of 01.10.2004, p. 2.
be satisfied from its assets. Economically, this type of guarantees reduces the cost of refinancing of the bank via debt/bonds. In guaranteeing the recoverability of about 1.6% of the total assets of the Bank in the deficiency case, the guarantee had also a limited indirect effect on the security of the liabilities but the overall impact of the guarantee can not be considered as comparable.

The aid element depends essentially on the future sale price

A key condition for the granting of the State guarantee was the commitment by ÖGB to sell BAWAG-PSK to independent third parties. It appeared quickly in the assessment that the aid element was directly connected to the expected sales price. Indeed, the recoverability of the claims that BAWAG-PSK had against its shareholders depended on the latter’s ability to repay their debt. It was agreed that the sales price payment has to be used in the following order: first, to satisfy any rights of third parties and claims against the owners under the “Refco”-settlement in the US, secondly to pay all remaining liabilities owed by the direct and indirect owners, and thirdly to reduce the guarantee of the Republic of Austria. Any reduction of the sales price below the sum of the remaining liabilities and the amount of the guarantee (“threshold price”) would have triggered the guarantee in the absence of additional equity support or short term reductions of risk assets.

At the time the guarantee was granted, three major scenarios would have been considered by a market operator:

i) the sale of the Bank at a price above the threshold price with the consequence that the guarantee could have been abolished the day of the closing without being drawn;

ii) the sale of the Bank at a price below the threshold price with the consequence that the guarantee had to be drawn fully or partially;

iii) the sale of BAWAG is not achievable. In this latter scenario the guarantee has to be prolonged until the owner is able to execute the required capital injection or BAWAG-PSK itself has generated the necessary capital reserves.

The Commission was not able on the basis of the available information to determine precisely the probability of each scenario (7). At the time the guarantee was granted, the future development of BAWAG-PSK was not predictable. The situation of BAWAG-PSK in the end of April 2006, a few days before the Federal Chancellor declared in a press conference that Austria would issue a guarantee, was very critical and the reactions by the clients and partners were extremely threatening for the Bank. A run on the branches of the Bank had started, which took on a scale without precedent in recent Austrian history. This situation created a major danger for the liquidity of the Bank. A continuation of the development for even a short period of time would have had lethal consequences for the Bank.

In this context, the Commission has come to the view that:

i) the timing of the sale and the level of the purchase price of BAWAG-PSK were unknown variables, bearing very important risks for a market oriented guarantor;

ii) the time constraints were increasing to a very significant extent the difficulty for an operator to intervene;

iii) the intrinsic value of the Bank was not so low as to fully exclude that a market guarantor would have granted the € 900 million, however conditioned on the high fees.

As a consequence, the Commission has concluded that the aid amount involved in the guarantee could only be estimated within a range. The upper value of this range is € 898 million, i.e. the nominal value of the guarantee minus the guarantee fee of 0.2% paid by the Bank. Fixing the lower value is the most complex; the Commission has estimated that this lower value is at least two thirds of the nominal value of the guarantee.

Additional considerations

The objective of the granting of the guarantee reflected the interests of Austria, which was to re-establish the trust of the investors and partners in the stability of BAWAG-PSK and the financial sector in Austria and to avoid an alleged disproportioned large damage for the Austrian economy (8).

These objectives are not in line with the intrinsic interests of a market investor, which are to maximise the return (taking into account the level of risk acceptable for a given rate of return), to take

(7) The fact that ÖGB sold BAWAG-PSK to a consortium led by the U.S. private equity group Cerberus Capital Management L.P. in December 2006 could not be considered in the Commission’s assessment because it has only to consider what would have been known by a potential investor in April/May 2006.

(8) However, the Commission has considered that Austria has not demonstrated that BAWAG-PSK’s insolvency/bankruptcy would have had systemic implications on the Austrian financial system and, more globally, on the whole Austrian economy. The Commission therefore has decided that Article 87(3)(b) is not applicable in the present case.
control of or significant influence in the Bank and to use the decision-making power to succeed the turn around.

Furthermore, where an undertaking in difficulty needs financial support and is not able to pay an appropriate remuneration in the short term, a guarantee including the payment of an annual fee is technically not the appropriate instrument. The negative impact of a considerably high fee would have threatened the success of the reorganization and the continuation of the Bank.

Finally, a private investor would have been more prone to intervene with a capital injection, which would have given a stake in the Bank, and decision making power to ensure success of the restructuring. However, according to both the Commission and Austria, no private investor would have been willing to provide funds which would be considered as equity capital (9).

### 3.2. Compensatory measures

The Community Guidelines on State aid for rescuing and restructuring firms in difficulty state that measures must be taken to mitigate as far as possible any adverse effects of the aid on competitors. The measures must be in proportion to the distortive effects of the aid and, in particular, to the relative importance of the firm on its market or markets.

In exchange for obtaining the approval, in addition to the commitment by its former owner ÖGB to sell BAWAG-PSK, Austria submitted several other commitments to divest assets, reduce capacities or market presence. Some divestments were included in the restructuring plan and had already taken place, for example the sale of the shares in Voestalpine AG. Additional commitments were also adopted, for example the sale of a 50% share in PSK and BAWAG insurances, the sale of considerable real estate assets and the sale of its holdings in ATV Privat-TV Services AG.

In its core business, BAWAG-PSK agreed to reduce the volume of its loans to the Federal Republic of Austria for a given period of time and committed to temporary refrain from participating in tender procedures in which the Republic of Austria seeks to commission so-called Primary Dealers to issue bonds for the Federal Republic. These two measures have been regarded as particularly relevant by the Commission because they take place in markets where the Bank will have significant market position after restructuring and go beyond anything necessary to restore viability. Furthermore, as a condition for the granting of the State guarantee, BAWAG-PSK had to sell its shares in the Austrian National Bank; this participation was of real significance for the Bank. Moreover, shares in Bank Frick & Co. AG and Hobex AG have been sold. By selling its participation in Hobex, which is active in debiting authorization, BAWAG-PSK withdrew from an important sector, where the most important banks are present in Austria.

While 3 branch offices in Vienna are to be closed, the Commission has not considered this closure as an effective compensatory measure because it has not been demonstrated that the relevant branches are not loss-making activities which would have to be closed at any rate to restore viability.

Besides, the Bank has also undertaken to sell the essential part of its non-core business activities.

Finally, no aid other than that referred to in Art. 87 (2) of the EC Treaty, or aid granted under research projects jointly financed by the European Union, or aid to general training within approved schemes, or aid for energy savings within approved schemes, can be granted to BAWAG-PSK for a given period of time.

The divestment, closure and other measures will lead to a substantial reduction of BAWAG-PSK business volume, which is consistent with the Commission’s practice regarding restructuring aid for banks (10).

### 4. Conclusion

This decision is important as it sets a comprehensive reasoning on how State guarantees are addressed by the Commission in a State aid perspective.

Thanks to a series of intensive negotiation rounds with Austria and the new owners in spring 2007, the aid could be approved 7 months after the opening of the formal investigation procedure.

Following the closing of the sale of BAWAG-PSK to the Consortium on 15 May 2007, the guarantee was abolished and the private banks and insurance companies were entitled to terminate the respective SPV.

---