Restructuring banks in crisis — overview of applicable State aid rules

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1. A complete set of State aid rules for financial institutions in the current crisis

The Communication of 22 July 2009 on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, (2) (the Restructuring Communication) provides the framework for the use of State aid for bank restructuring. Together with the three previous Communications on banking (3), recapitalisation (4) and impaired assets (5), these rules form a body of guidance for assessing various support measures in favour of banks during the present systemic crisis.

The Restructuring Communication to banks which are under an obligation to restructure, sets out the conditions that will have to fulfil to comply with the State aid rules with a view to ensuring that they return to long-term viability without State support, contribute to the restructuring costs (burden-sharing) and adopt measures to limit competition distortions.

The Commission’s guidance has pursued two linked objectives: i) supporting financial stability, by giving legal certainty to rescue measures taken by the Member States and promoting long term viability, and ii) safeguarding the internal market and a level playing field across banks. This is achieved in two steps: first, by setting the parameters for access to rescue aid in a coordinated manner, and then through a more thorough and forward-looking assessment of the banks’ restructuring needs to ensure their return to viability without State support and the return of the financial sector to normal market functioning through mechanisms that minimise competition distortions.

The rules on banks’ restructuring aim to strike a balance between short-term financial stability and long-term concerns for the preservation of normal market functioning, the single market in financial services and an undistorted competitive process. This balance reflects the development and evolution of the crisis. At the beginning of the financial turmoil, safeguarding financial stability was an overarching objective. Therefore a wide array of rescue measures, including loans, guarantees and recapitalisations, were temporarily allowed. However, conditions for access to these measures were laid down to ensure a coordinated response and a level playing field, among other things by setting a price that banks were required to pay for the State support. The extraordinary action and amount of money put into the banking system in the first months of the crisis (6) was effective in halting the panic and restoring trust. The price, set chiefly in relation to the banks’ risk profile (7), kept in relative check the size of the aid for individual institutions while allowing the amounts necessary to maintain financial stability. The length of temporary approval of rescue measures (6 months) was set to give time to stabilise the situation of individual beneficiaries and propose lasting solutions adapted to their specific circumstances. The restructuring process, conducted in the framework set in the Restructuring Communication, supplements the rescue policy actions

(1) 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.
with structural changes leading to the beneficiaries’ return to long-term viability without State support, addressing moral hazard, and limiting competition distortions created by aid. One year since the beginning of the acute phase of the financial crisis, with lesser risks to financial stability and signs of recovery in the outlook, the balance started tilting towards creating conditions for the return to normal market functioning.

2. The Restructuring Communication

The rules governing State aid for restructuring of ailing banks in the current crisis have three main goals:

- that banks become viable in the long term and capable of operating without State support. A thorough restructuring plan, demonstrating strategies to achieve viability also under adverse economic conditions, needs to be based on rigorous stress-testing of the bank’s business. The benchmark of long-term viability may imply different solutions across banks, ranging from limited restructuring with no divestments to an orderly winding-down of unviable entities. An adjustment in the bank’s business model can be necessary, also to reduce systemic risks;

- that restructuring aid is kept to the minimum and the bank and its capital-holders contribute to the costs of restructuring as much as possible with their own resources. This should contribute to addressing moral hazard and to creating appropriate incentives for their future behaviour. This is achieved through setting an appropriate price for State support, through temporary restrictions on payment of dividends and coupons on hybrid capital by loss-making banks and through various behavioural commitments ensuring that State aid is not used to finance market-distorting activities not linked to the restructuring process;

- that undue distortion of competition caused by restructuring aid is limited. Tailor-made to the market circumstances of each case and to the scale of State intervention indicative of market distortion caused by State aid, measures to limit competition distortion may include divestments, temporary restrictions on acquisitions by beneficiaries and other behavioural safeguards. These measures are designed not only to limit distortions between aided banks and those surviving and restructuring without State aid, and between banks in different Member States, but also to create conditions which foster the development of competitive markets after the crisis.

As the Restructuring Communication addresses the specific circumstances of the present crisis, it only applies to the financial sector until 31 December 2010. Its sectoral scope is therefore limited and it applies temporarily in the present crisis situation. In practice, the Commission will apply this guidance when assessing cases of restructuring aid notified to the Commission before the end of 2010. As regards non-notified aid, the usual rules applicable for the assessment of unlawful State aid will apply (assessment on the basis of the rules in force at the time such aid was granted).

2.1. What are the specific rules applicable to banks in the current crisis?

The Commission has over the years developed its experience in dealing with restructuring aid to ailing companies. State aid rules for this purpose are governed by the Community guidelines on rescue and restructuring aid to companies in financial difficulties (9) (‘the Rescue and restructuring aid guidelines’), last revised in 2004. These rules have been applied to bank restructuring cases (7) in normal times. They were, however, untested for a systemic crisis situation in the financial sector.

In the context of the crisis and in relation to the financial sector, the Commission undertook a review of its rules and concluded that the basic philosophy and the main principles of the rescue and restructuring guidelines should be preserved. The basic distinction between rescue and restructuring aid served the purpose of financial stability well, although additional flexibility was necessary for both types of aid. The underlying principles of the guidelines have been confirmed: restoration of long-term viability without State support; minimisation of the aid and adequate burden-sharing; measures to limit competition distortion. The way these principles are put into practice has been adapted when necessary to the specific, temporary circumstances created by the current financial crisis, taking into account the role of the financial system in providing funding to the whole economy and the possible systemic effects arising from the need for a number of European banks to restructure at the same time.

In these circumstances, State intervention in banks’ rescue and restructuring is hallmarked by the vital need to ensure financial stability and restore market confidence. A degree of flexibility in relation to some of the rules set out in the Rescue and restructuring aid guidelines was therefore needed. As far


(7) Such as Crédit Lyonnais, Banco di Napoli, Bankgesellschaft Berlin.
as viability is concerned the Commission tightened the requirement of proving viability under stress assumptions while allowing more time as regards the duration of the restructuring period.

As to burden-sharing, the Commission recognised that in the specific circumstances of the financial crisis it was necessary to reassure banks’ creditors and was not appropriate to enforce an ex-ante quantitative rule on the bank’s contribution to the restructuring costs. However, it designed mechanisms to ensure that safeguarding financial stability in the short term does not result in longer-term damage to the level playing field for banks and to competitive financial markets.

As to distortions of competition, the guidelines put the safeguarding of the internal market in the foreground, while identifying competition remedies in terms of structural and behavioural measures as well as combating distortions in the competitive process and in the markets.

Given the crisis circumstances, compared to the Rescue and restructuring aid guidelines, the Restructuring Communication modulates the Commission’s practice with regard to restructuring aid for the following five aspects in particular.

Firstly, given that the Communication is addressed to one sector, the Commission can specify in detail the type of information that will be required to determine whether the proposed restructuring measures are apt to restore a beneficiary’s long-term viability. The restructuring plan will need to include a thorough diagnosis of the bank’s problems, including a stress test to demonstrate that a restructured bank will be able to withstand adverse macroeconomic conditions, and, where applicable, details on impaired assets. This information is necessary to devise sustainable strategies for a return to viability. The burden of proof on the Member State is set at a high level.

Secondly, given both the uncertainty of the economic outlook and the number of banks that will be restructuring in parallel, special attention is given to ensuring that the timing of the necessary restructuring measures is sufficiently flexible and realistic. The implementation of the restructuring plan can last up to five years, compared to the usual practice of two to three years. This allows in particular more time for finalising certain structural measures, notably to avoid depressing the markets through precipitated restructuring costs. However, it designed mechanisms to ensure that safeguarding financial stability in the short term does not result in longer-term damage to the level playing field for banks and to competitive financial markets.

Thirdly, the Rescue and restructuring aid guidelines require in principle a 50% own contribution by the aid beneficiary to the costs of restructuring. Given the difficulties in gaining access to private capital in the current context and difficulty in calculating restructuring costs the Restructuring Communication chooses not to operate with a fixed threshold for the own contribution. Adequate burden-sharing is achieved primarily through the appropriate price for the State intervention, as set out in the Recapitalisation and Impaired Assets Communications, and through temporary restrictions on coupon and dividend payments to bondholders and shareholders. Where such burden-sharing is not immediately possible due to the market circumstances at the time of the rescue, this needs to be addressed at a later stage of implementation of the restructuring plan, for example through claw-back clauses.

Fourthly, measures aimed at limiting distortions of competition should be designed so as to support the primary objective of restoring the long-term viability of the banking sector, while limiting any disadvantages for other European banks. Where the immediate implementation of structural measures is not possible due to market circumstances (for example where finding buyers for divested assets is objectively difficult), the Commission can extend the time period for the implementation of these measures. Intermediate behavioural safeguards need to be put in place where necessary. In addition, the Communication pays more attention to overall national market structures and market opening measures, to avoid that the large number of simultaneous restructuring cases closes down national market structures, and to preserve cross border activities of banks.

Finally, the Commission does not apply the ‘one time last time’ rule (a) to restructuring aid to banks in times of crisis, reflecting inter alia the uncertainty about the recovery outlook.

2.2. Who needs to restructure?

The previous Banking, Recapitalisation and Impaired Assets Communications set out in detail when a bank needs to present a restructuring plan. In particular, Member States need to notify a restructuring plan to the Commission where it has recapitalised a distressed bank or when a bank, in connection with the crisis, has received aid (except for participating in a guarantee scheme) exceeding 2% of the bank’s total risk-weighted assets.

For banks that are not distressed and have received a limited amount of aid, no restructuring plan is required. However, Member States will have to submit a viability review enabling the Commission to assess the viability of these banks and the Communication explains what type of information the Commission will expect to receive in these cases. It will be less

(a) The Rescue and restructuring aid guidelines (see section 3.3, points 72–77) stipulate that the company may receive rescue and restructuring aid only once within a 10-year period.
detailed than for a restructuring plan but still needs to credibly demonstrate that the bank is fundamentally sound and will restore its long-term viability without State support.

The scenarios below illustrate in more detail the situations where a bank receiving State aid needs to present a restructuring plan or not.

**Scenario 1:**
A bank benefits from a liability guarantee under an approved scheme and has received no other State aid → no need to present any plan; the duration of the guarantees expires in line with the approved conditions of the scheme.

**Scenario 2:**
A bank benefits from a liability guarantee under an approved scheme and has called this guarantee → it needs to present a restructuring plan within 6 months of calling the guarantee, in line with the conditions of the authorised scheme. If the bank is going to be liquidated, or its size is very small, the Commission may waive the obligation to provide a restructuring plan.

**Scenario 3:**
A bank has received State aid in the form of a recapitalisation under an approved scheme under the terms and conditions for fundamentally sound banks in line with the Commission decision authorising that scheme → within 6 months the Member State needs to present a review of the functioning of the scheme, which needs to include details of all banks that have benefited from it as well as a description of the path towards exit from reliance on State capital for each individual bank. If the Commission, upon examination of the information provided, agrees with the assessment that the beneficiary bank remains fundamentally sound and accepts its exit plan, no further restructuring plan is necessary.

**Scenario 4:**
A bank has received State aid in the form of a recapitalisation under an approved scheme under the terms and conditions for fundamentally sound banks in line with the Commission decision authorising that scheme, but subsequent to the provision of the capital it fell into difficulties and does not remain fundamentally sound any longer → it needs to provide a restructuring plan as soon as possible.

**Scenario 5:**
A bank has benefited from State aid in the form of recapitalisation or asset relief under an ad hoc individual measure, and the Commission’s approval decision comprises an obligation to present a restructuring or a viability plan within a specified timeframe → it needs to provide a plan as specified in the decision.

**Scenario 6:**
A bank has benefited from an impaired asset relief measure (i) in compliance with all the requirements of the Impaired Assets Communication, (ii) not exceeding, together with any other aid already received (except for participating in an approved guarantee scheme if this guarantee has not been called), 2% of the bank’s risk-weighted assets, and (iii) where appropriate valuation would not have led to its technical insolvency → it needs to provide a viability review within 3 months of resorting to the impaired asset measure. If the Commission, upon assessment of the information provided, agrees that no further measures are needed for restoring the bank’s long-term viability or limiting the competition distortion, then no further plan is required.

**Scenario 7:**
A bank has benefited from impaired asset relief and (i) an appropriate valuation of impaired assets would lead to negative equity/technical insolvency without State intervention, or (ii) whenever the total amount of State aid in whatever form (except for participating in an approved guarantee scheme if this guarantee has not been called) exceeds 2% of the bank’s risk-weighted assets, or (iii) when the impaired asset relief departed from the principles of the Impaired Asset Communication, or (iv) where the overall amount stays below 2% of the bank’s total risk-weighted assets but the repetition of aid signals the inability of the bank to undertake remedial action and the risk of further losses → it needs to present a restructuring plan within 3 months of resorting to the impaired asset relief measure.

2.3. What price does the bank pay for a bail-out?

In its decision-making in the current crisis, the Commission has devoted particular attention to the design, scope and implementation arrangements of measures in order to limit competition distortions. Under the usual rules applicable to rescue and restructuring aid to firms in financial difficulties, such measures are a necessary counterweight to any restructuring aid, and the Restructuring Communication maintains this as a principle, albeit recognising an increased need for flexibility.

To understand the objectives the Commission follows when requesting banks to adopt measures to limit competition distortion and to design a suitable
remedy, it is useful to enumerate the types of competition distortion these measures seek to address.

State-financed bail-outs have various negative effects. They reward moral hazard in that State aid prolongs distortions of competition created in the period preceding the crisis by excessive risk-taking and unsustainable business models. State-financed bail-outs stop market forces from sanctioning unsustainable business practices and from eliminating inefficient and/or excessively risky players (in particular through bankruptcies) and thus prevent more efficient firms from expanding and/or from entering those markets. On the contrary, in certain cases, bail-outs have the effect of reinforcing the market power of the aided firm, possibly resulting from the risky business decisions in which the firm engaged prior to the crisis, such as certain acquisitions which State aid later helped absorb. From a more general point of view of effective competition contributing to consumer welfare, bail-outs weaken incentives for unaided competitors to compete (on merits), invest and innovate. Finally, the EU internal market context represents an additional concern when bail-outs shift the burden of structural adjustment to changing market circumstances and the related social and economic problems to other Member States, creating barriers to entry and to cross-border activities.

All these effects are still present in times of crisis. Moreover, there are additional reasons why the competition rules increase in importance during a systemic crisis.

First, if on the one hand, for reasons of financial stability, a more limited contribution of the bank and its shareholders to the cost of the restructuring has to be accepted, on the other hand, it is vital to pave the way for a rapid return to normal market conditions. This means that moral hazard must be properly tackled to avoid repeating the mistakes of the past.

Second, banks and Member States across Europe have been hit by the crisis to very different degrees. In a situation of financial, economic and budgetary crisis, differences between Member States in terms of resources available for State intervention become even more marked. And those banks which today need huge subsidies may in recent years have engaged in expansionary strategies to the detriment of their competitors.

Finally, national interventions in the current economic crisis are by their nature bound to promote a focus on the national markets. Even where there is no explicit requirement of lending to the domestic economy, there is a risk of promoting retrenchment into national boundaries. This may hinder the functioning of the internal market for financial services, create entry barriers and reduce incentives for cross-border activities to the detriment of European businesses and consumers.

These aspects are deemed more or less prominent in each case; they are not mutually exclusive but not always cumulative either (for example the market power aspect is not present in every case). The Commission therefore identifies upfront which theory of harm needs to be addressed, depending on the facts of the case, and then assesses the proposed measures from this angle.

Against the background of these rationales, the Restructuring Communication offers two categories of remedies.

A first category comprises burden-sharing measures, i.e. the scope and form in which the beneficiary and its shareholders contribute to bearing the costs of restructuring and return to viability. Proper burden-sharing can in particular address the problem of moral hazard, requiring the firm, its shareholders and hybrid capital holders, as a result of whose actions the bank has been brought to financial difficulties and the subsequent bail-out, to pay as much as possible for the State intervention. This can take the form of a high price for recapitalisations, the level of first loss and remuneration paid for impaired assets reliefs or, more lasting, bans or limitations on coupon payments on hybrid capital. As to the latter, the Commission has specifically announced that banks should not use State aid to remunerate own funds (equity and subordinated debt) when their activities do not generate sufficient profits. Transactions such as coupon payments, buy-backs and the exercise of call-options of Tier 1 and Tier 2 capital instruments may infringe the principle of burden-sharing in so far as they protect the Tier 1 and Tier 2 capital holders from their exposure to the inherent risk of their investment. Banks subject to a State aid investigation have therefore been invited to consult the Commission before making announcements to the market concerning Tier 1 and Tier 2 capital transactions. This is to enable the Commission to balance, considering the concrete circumstances at hand, the interest of the return to viability of the bank with the interest in ensuring burden-sharing and thus of limiting competition distortion.

Burden-sharing can also address to some extent the problem of distorted incentives. Banks should raise cash themselves, to the extent possible, to finance their restructuring from divesting profitable non-essential assets. If they were running an unsustainable expansionary strategy prior to the crisis, they need

(11) MEMO/09/441 of 8 October 2009 — Commission recalls rules concerning Tier 1 and Tier 2 capital transactions for banks subject to a restructuring aid investigation.

(12) Point 26 of the Restructuring Communication.
to finance the restructuring at least partially from their own pocket.

A second category comprises measures limiting distortions of competition\(^{(14)}\). Although these measures are not new to the practice of restructuring aid, the restructuring of banking businesses particularly in a situation of a systemic crisis affecting the economy as a whole required a larger set of possible measures to address sector-specific issues.

Experience has shown that structural measures can represent effective and efficient ways of limiting competition distortion. While divestments of stand-alone viable businesses might often represent the most appropriate remedy, the Commission has also accepted carve-outs of business entities potentially capable of entering as a new market player (in particular representing a critical mass in terms of size, clients, etc.), which is especially advantageous in some relatively concentrated markets. The Restructuring Communication also refers to accompanying behavioural measures such as a temporary ban on acquiring competing businesses or the imposition of a claw-back mechanism for example in the form of a levy on the aid recipient. Banks are also prohibited from marketing State support as a competitive advantage. Finally, the Restructuring Communication explicitly mentions that banks cannot use State aid to offer their customers terms (rates in particular) which cannot be matched by their un-aided competitors. This may take the form of limitations on the bank's position in league tables or of various types of price-leadership clauses.

Pursuant to the Restructuring Communication, measures limiting competition distortion should be effective and proportionate. Carve-outs of business units might not always be an ‘effective’ measure if too remote in time and in saturated markets with limited growth potential. The proportionality aspect is reflected in the double criterion determining the nature and form of measures limiting competition distortion: the amount of aid (including the conditions and circumstances under which it was granted) and the characteristics of the market on which the aid beneficiary will operate after its restructuring (including the size and relative importance of the aid beneficiary on that market). In practice, certain limitations continue to apply, as a result of the application of a balancing test to the assessment of the compatibility of restructuring aid to banks. In particular, measures to limit competition distortion should not compromise the prospects of the bank's return to viability\(^{(15)}\). Similarly, these measures should not decrease competition but, instead, ensure that effective competition is preserved\(^{(16)}\). In highly concentrated markets, for instance, where all main players have benefited from State aid, it might be disproportionate to impose limitations on price leadership on all the aided players. As a result of these limitations, measures to limit competition distortion will take account of the particular situation of each bank and will be tailored to market characteristics in each case.

In comparing restructuring cases it is necessary to keep in mind the above limitations and the fact that the amount of aid, to which the scope of measures to limit competition distortion is linked, represents only a proxy for the level of competition distortion. For these reasons the Restructuring Communication stresses that the amount of State aid will be assessed not only in absolute terms but also in relation to the bank’s risk-weighted assets\(^{(17)}\) and that not only the amount, but also the conditions and circumstances under which the aid was granted\(^{(18)}\) will be taken into account. Finally, when comparing the extent of measures to limit competition distortion, caution has to be applied when comparing the size of balance-sheet reductions across cases. The size of the reduction might not always reflect the quality of the structural measures undertaken. There is in particular a need to distinguish between run-offs of activities and divestitures of existing businesses, between measures undertaken in the interest of restoration of viability of the aided bank and those implemented to address a concrete competition concern and, finally, between structural measures put in place in core markets and ancillary markets in which the aided bank is active.

3. Conclusion
The Restructuring Communication entered into force in July. Since then, it has been applied in a limited number of cases. This notwithstanding, some important restructuring decisions have already been taken to date under this legal basis\(^{(19)}\) and a larger number of restructuring cases are still under assessment pending the finalisation of the restructuring

\(^{(14)}\) See section 4 of the Communication.
\(^{(15)}\) Point 32 of the Restructuring Communication.
\(^{(16)}\) Point 31 of the Restructuring Communication.
\(^{(17)}\) Point 30 of the Restructuring Communication.
\(^{(18)}\) For example, Commission decision of 28.10.2009 on the State aid implemented by the United Kingdom for Northern Rock (C 14/2009); Commission decision of 18.11.2009 on the State aid implemented by Belgium for KBC (C 18/2009); Commission decision of 18.11.2009 on the State aid implemented by the Netherlands for ING’s Illiquid Assets Back-Up facility and restructuring plan (C 10/2009); Commission decision of 18.11.2009 in Cases N 422/2009 and N 621/2009 Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme.
plan. As mentioned in the introduction, the challenge in the control of restructuring aid to banks in the current crisis lies in the need for the Commission to reconcile two linked objectives: maintenance of financial stability and preservation of the internal market and of a level playing field across banks. In this context, the Restructuring Communication creates a common framework for State interventions assisting the return of the EU banking industry to business as usual as soon as market conditions permit and the emergence of a more solid sector capable of serving European businesses and citizens.