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**Subject: State Aid – N 556/2008 – Portugal
Recapitalisation scheme of credit institutions in Portugal**

Sir,

I. PROCEDURE

1. On 5 November 2008 Portugal notified a scheme to strengthen the financial soundness of credit institutions, whose legal basis is the law n.º 63-A/2008 adopted on 24 November 2008 ("the Law").
2. On 14 November 2008, the Commission requested additional information by e-mail to the Portuguese authorities, who sent their answers on 18 November 2008 (registered 19 November 2008). The Commission requested additional information by e-mail dated 12 February 2009.
3. On 12 March 2009, the Portuguese authorities sent the Commission a Ordinance ("the Ordinance" hereinafter) to implement the Law. From then until 8 May 2009, the Portuguese authorities and the Commission exchanged a series of e-mails. On 29 April 2009, a meeting was held between the Portuguese authorities and the Commission. Finally, on 7 May 2009, the Portuguese authorities communicated a series of commitments.

II. DESCRIPTION

A. Objectives of the measures

4. The objective of the measure is to strengthen financial stability by recapitalising credit institutions established in Portugal in order to increase their creditworthiness and to allow the beneficiary to maintain a significant level of financing of the real economy. While the legally

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required minimum capital ratio would ordinarily be sufficient to ensure that goal, this is not the case in the current crisis. This measure is also in line with the recommendations of the Portuguese Central Bank to establish a Tier 1 ratio no lower than 8%.

B. Duration and budget

5. The notification applies to capitalisation operations of credit institutions performed within a 6 months window starting from the date of approval by the Commission of the notified scheme
6. The Law sets a ceiling of four billion Euros (global budget of the aid scheme). This scheme forms part of the National Initiative to Strengthen Financial Stability, and its global budget is included in the 20 billion Euros dedicated to that general initiative.

C. Eligible credit institutions

7. All credit institutions with registered office in Portugal can have access to the notified recapitalisation scheme independently of their financial soundness.
8. Pursuant to the Law and the Ordinance, the strengthening of the capital can be utilised for:
 - 8.1. Credit institutions possessing adequate soundness and solvency as evaluated according to applicable legislation;
 - 8.2. Credit institutions that have or are at risk of having a level of own funds, solvency or liquidity which is below legally established thresholds¹.

D. Process of the recapitalisation operations

9. Access to public recapitalisation is dependent on the application submitted by the interested credit institution to the Portuguese Central Bank, stating the reasons for the new capital and complemented by a plan for strengthening the own capital.
10. The Law requires that the plan referred to in the preceding paragraph must contain, in particular, the following information:
 - 10.1. An outline of the objectives for strengthening the capital base, with an indication of the development, make-up and structure of those own funds over the plan's duration, as well as the type of operation envisaged for the taking up of the additional capital;
 - 10.2. Up-to-date information concerning the asset situation, as well as the prudential ratios and indicators concerning liquidity, asset quality and risk hedges;
 - 10.3. A strategic programme of the activities of the credit institution over the plan's duration, including any changes to the structure of the corporate group of which the credit institutions forms a part, as well as any changes to the equity holdings of the credit institution, particularly non-financial holdings, and also development projections concerning returns, liquidity position and capital adequacy
11. The principles set out in the Law were complemented by the Ordinance by requiring that the interested credit institutions have to present, amongst other:

¹ Pursuant to Article 141 of the General Portuguese Scheme of Financial Enterprises and Credit Institutions

- 11.1. a demonstration of the necessity of capital injection with an up-to-date description of the credit institution's financial situation, taking due consideration of its short- and medium-term risks;
 - 11.2. a duly justified concrete proposal concerning the form of the recapitalisation to be carried out, the conditions of this operation and the amounts required from the State in light of capital available from private shareholders;
 - 11.3. a description of the characteristics of the instruments to be used in the context of the recapitalisation operation allowing verification of their eligibility as Tier 1 own funds;
 - 11.4. a description of the strategy as to how the capital instruments will be used, in particular concerning the contribution of the credit institution to the financing of economic activities, especially of households and small- and medium-sized enterprises ("SMEs");
 - 11.5. a description of the measures adopted or to be adopted, in the latter case along with the presentation of the implementing schedule, with a view to the strengthening of the credit institution's corporate governance system, in particular through an increase in the number of independent administrators, and the strengthening of its risk's management;
 - 11.6. a description of the dividend policy and of the remuneration of members of the management and supervisory boards;
 - 11.7. a presentation of the estimated duration of the public investment, of data demonstrating the future return to a financial stability of the credit institution and of the plan for disinvestment; and
 - 11.8. an identification of the contribution of other entities, in particular private shareholders, including a description of the features and the amount of that contribution.
12. The Portuguese Central Bank is responsible for analysing the application, taking into due consideration in particular the contribution of the credit institution to the financing of economic activity, notably in respect of households and SMEs, and the need to strengthen the credit institution's own funds.
 13. The Portuguese Central Bank communicates its duly reasoned recommendation to the member of the Government responsible for the finance area, within 10 working days. This period may be extended by 10 working days if this is required by the complexity of the decision.
 14. In its recommendation, the Portuguese Central Bank will assess, amongst other matters, the asset adequacy of the applicant credit institution and the guarantees provided by the latter to pursue a sound and prudent business policy.
 15. The Portuguese Central Bank can request the applicant credit institution to provide any additional information and data deemed necessary for the analysis of the application.
 16. The member of the Government responsible for the finance area will decide, by means of ministerial order, whether to approve the recapitalisation operation, as well as its terms and conditions and the charges to be borne by the applicant credit institution. That decision can be modified later according to circumstances, in particular in the event of serious or systematic default on the financial commitments given by the credit institution.

17. The decision, which may establish the terms and conditions of public disinvestment once the objective of strengthening own funds has been achieved, must be taken within 5 working days, or more if needed. The member of the Government responsible for the finance area may: i) return the application to the Portuguese Central Bank if additional clarifications and information are needed; ii) develop other procedures aimed at assuring that the Portuguese patrimonial interests² are protected.

E. Characteristics of the instruments used

18. According to the Law, recapitalisation operations can be performed with any financial instruments that are eligible as Tier 1 capital. However, as stated in the Ordinance, the recapitalisation operations will be realised preferably through the subscription of ordinary or preferential shares. In addition, the Portuguese authorities have undertaken to notify to the Commission any individual recapitalisation measures in which State participation is executed through the subscription of instruments other than ordinary shares or preferential shares with special rights. Therefore, although other instruments are contemplated in the Law, the present notification is limited to these two instruments.
19. Both ordinary shares and preferential shares have no maturity date. Nevertheless, if the articles of association of the company so authorise, preferential shares may, upon issuance, be subject to redemption on a fixed date or when the general meeting of shareholders so decides.³ However, one of the criteria for a capital instrument to be eligible for Tier 1 capital is its permanence and therefore fixing a maturity may render the instrument ineligible as Tier 1 capital.
20. Ordinary shares are the most subordinated instrument. Preferential shares come immediately after ordinary shares as regards their level of subordination. According to the Portuguese Companies Code (Código das Sociedades Comerciais) preferential shares carry a right to a priority dividend of not less than 5% of the respective par value, to be taken from the distributable profits.
21. Apart from the right to vote, preferential shares carry all rights inherent to ordinary shares except that they do not count for the calculation of the capital represented in shareholder meetings. If the articles of association of the company do not allow the holders of non-voting shares to attend the general meeting, holders of non-voting shares from a single issue are entitled to be represented in the meeting by one of them. If the priority dividend is not fully paid during two financial years, the preferential shares are converted into ordinary shares and only lose voting rights in the financial year after that in which the priority dividends in arrears are paid.
22. Pursuant to the Portuguese Companies Code, any priority dividend which is not paid on preferential shares within the financial year must be paid in the three following years provided there is distributable profit. Preferential shares to be issued under the Scheme are not cumulative.
23. Dividends are only paid if there is distributable profit (both for ordinary and preferential shares) and are non-cumulative. In case of liquidation, if the distributable profits or the proceeds of liquidation are insufficient to satisfy the payment of the dividend or the par value of all shares, they shall be firstly divided proportionally between the preferential shares. Only after preferential shares are fully paid can ordinary shares be paid.

² The Portuguese patrimonial interest notion according to which the State to act in a way that preserves the public interest and patrimony, for example, by buying shares at the lowest possible price or selling shares at the highest possible price.

³ Preferential shares that can be redeemed are called “ações preferenciais remíveis”, and this is an additional feature allowed by the legal regime for shares in Portugal.

24. Under the Portuguese Companies Code ordinary shares may be converted into non-voting preferential shares by means of a resolution adopted by the general meeting.

F. Remuneration

1. Recapitalisation by the State together with private investors

25. Pursuant to Article 7(1) of the Ordinance, the public investment for strengthening own funds is considered to take place under normal market conditions if the operation involves, on equal terms, a private participation not lower than 30%.

2. Other types

26. Where the State acts as underwriter or as guarantor to the issue, the State will be paid a market underwriting fee. The reference for determining the price will be the quoted market price of ordinary shares for quoted credit institutions and a market-based approach for non-quoted credit institutions, with a view to assure the State's patrimonial interests. The Portuguese authorities confirmed to the Commission that the price paid shall be the lowest possible.
27. The return on instruments is calculated by applying the recommendations of the European Central Bank of 20 November 2008. As regards the two instruments used under the notified scheme, the remuneration is calculated as follows:
- 27.1. For *ordinary shares* the remuneration cannot be lower than the rate of return of 5 year public debt plus an equity risk premium of 500 basis points per annum plus an add-on fee of 100 basis points per annum.
- 27.2. For *preferential shares* the remuneration cannot be lower than the rate of return of 5 year government bonds plus the median value of the spread of CDS for the subordinated debt of the credit institution plus an add-on fee of 300 basis points. In addition, the resulting rate must be higher than the lower bound established in Article 341(2) of the Portuguese Companies Code.
28. The rate of return of government bonds is the average yield of benchmark 5 year EMU government bond in the preceding 20 working days plus the average sovereign yield between the 5 year Portuguese government bonds and the 5 year EMU benchmark government bond over the period 1 January 2007 and 31 August 2008.
29. As of the second year after the issuance of the shares the remuneration rate will increase each year by 50 basis points until the reimbursement of the capital injected.
30. If a credit institution decides to pay out dividends to its shareholders, the remuneration rate of the public investment is increased by 50 basis points, to be added to the 50 basis points mentioned in the previous point.
31. Article 5(b) of the Ordinance expressly explains that before taking its decision the government can use any appropriate mechanism to ensure that the public investment is made in terms that assure the State's patrimonial interests. Full valuation is one such mechanism.
32. In addition, the Portuguese authorities informed the Commission that since the public investment is made in terms that assure the State patrimonial interests, the acquisition of ordinary shares has to be done at the lowest possible price, although no conditions are fixed in the Ordinance.

G. Redemption conditions

33. The Law provides that public disinvestment shall be concluded within a maximum timeframe of 3 years from the date of adoption of the Law (24 November 2008), which may exceptionally be prolonged to 5 years when so justified by market conditions.
34. When the credit institution demonstrates an adequate level of own funds, the credit institution may buy the shareholding of the Portuguese State or reimburse the preferential shares covered by the notified scheme, in full or in part.
35. The Portuguese authorities may also, notwithstanding any preferential rights, assign its holding in the share capital of the credit institution to third persons, at any time, in full or in part.
36. Public disinvestment shall be undertaken in market conditions and in a manner that guarantees the capital invested and ensures a suitable return on the same, taking into account the financial stability objectives. During the first two years of public investment the minimum redemption price will be at the acquisition value. From the beginning of the third year the minimum redemption price will increase by 5% per year.

H. Amount injected under this scheme

37. The State participation in the recapitalisation of credit institutions, realised through financial instruments eligible as original own funds (Tier 1), will be capped to 2% of the Tier 1 capital ratio.
38. Credit institutions that are not fundamentally sound are not subject to the 2% of RWA mentioned in the previous paragraph.

I. Behavioural conditions

39. During the period of public investment, any forms of shareholder remuneration that would result in a decrease in the own funds of the credit institution, in particular through the purchase of own shares, is forbidden.
40. For such time as the credit institution retains public investment for the purpose of strengthening its own funds, it is subject to the conditions and charges established by the ministerial order of the member of the Government responsible for the finance area that approves the recapitalisation operation. Such conditions and charges may address, amongst other matters:
 - 40.1. the use of the resources supplied under the own funds strengthening facility, in particular as regards the credit institution's contribution to the financing of the economy, especially the financing of households and SMEs;
 - 40.2. the adoption of good corporate governance principles, which can include an increase in the number of independent administrators;
 - 40.3. the policy concerning the distribution of dividends and the remuneration of members of the company's management and supervisory bodies, as well as the possibility of limiting other compensation, irrespective of its nature, from which the holders of such office may benefit;
 - 40.4. the adoption of measures aimed at preventing any distortion of competition;

- 40.5. the possible increase of contributions to the deposit guarantee funds;
 - 40.6. the adoption of mechanisms allowing the public disinvestment to occur under market conditions that guarantee a suitable return on the capital invested, thus ensuring that taxpayers' interests are protected.
41. Article 10 of the Ordinance further clarifies the duties of the credit institution, including the following:
- 41.1. observance of good corporate management principles, in particular by appointing an adequate number of independent administrators which must not be fewer than that recommended for the companies listed on the Portuguese stock market;
 - 41.2. information on the individual remuneration (fixed and variable) of the members of the administration and supervisory bodies;
 - 41.3. maintenance, if compatible with a prudent management of the institution, of the level of employment and a stock of credit to the real economy, especially to households and SMEs, at least equal to the level reached at the end of 2008 and available under competitive conditions;
 - 41.4. application of safe and prudent management practices in order to ensure that the level of capital would not go below 8%;
 - 41.5. establishment of (or the participation in) mechanisms aimed at supporting households and enterprises having difficulties in fulfilling their credit obligations.

J. Rescue recapitalisation in favour of credit institutions that are not fundamentally sound

42. When a credit institution is in a situation of financial imbalance, caused by the fact that the value of its own funds, solvency or liquidity is below legally established limits, the financial restructuring and recovery scheme envisaged in Articles 139 *et seq.* of the General Scheme of Financial Enterprises and Credit Institutions⁴ applies.
43. Under the scope of the intervention envisaged in Article 142 of the General Scheme of Financial Enterprises and Credit Institutions, the Portuguese Central Bank can propose the cooperation of the Portuguese State in the financial restructuring of the credit institution, through the activation of adequate financial or monetary support.
44. The recapitalisation operation and the definition of its terms, conditions and charges are conducted by the member of the Government responsible for the finance area, by means of ministerial order.
45. The Portuguese authorities commit to notify to the Commission when, considering the specific situation of the credit institution, it is not possible to apply: *i*) a remuneration equal or higher than the one for fundamentally sound credit institutions ; *ii*) a ban on dividends during the period when the credit institution presents risks of not complying with capital adequacy, solvability and liquidity levels in conformity with the minimum legal requirements. Therefore, the Commission considers that recapitalisation operations in favour of credit institution that are not fundamentally sound which do not comply with points *i*) and *ii*) above are not covered by the present notification.

⁴ See the Portuguese Law n° 298/92 of 31 December 1992.

K. Additional commitments of the Portuguese authorities

46. On 7 May 2009, the Portuguese submitted to the Commission a series of commitments which are set out below.
47. The Portuguese authorities commit to notify to the Commission the prolongation of the scheme six months after the approval of the scheme.
48. Before implementing any recapitalisation measures, the Portuguese authorities commit to provide the Commission with the name of the credit institution benefiting from the State recapitalisation and all the relevant information to allow the Commission to take an informed view on the compliance of the operation with the Scheme including the elements mentioned in Article 2 of the Ordinance (corresponding to the information under points 8 and 9 above).
49. The Portuguese authorities commit to notify to the Commission any recapitalisations in which the State participation is realised through the subscription of instruments different from ordinary shares or preferential shares with special rights.
50. In addition, the Portuguese authorities commit to notify to the Commission, after a maximum of six months the restructuring plan of recovery of a credit institution where the operation of capitalisation with State resources is carried out on the basis of paragraph b) of n.º 1 of Article 2.º and chapter III of the Law n.º 63-A/2008, of 24 November, that is, in the case where it is considered that the credit institution is not fundamentally sound. This would in particular be the case if it either presents or risks presenting a level of capital, solvency or liquidity below the legally established minimum for which purposes the indicators for evaluation of the profile of risk of the Annex to the Commission Communication⁵ of 5 December 2008 (hereinafter the "Recapitalisation Communication") will be taken into account
51. The Portuguese authorities also commit to notify to the Commission, after six months at the latest the restructuring plan of a credit institution where the operation of capitalisation with State resource is carried out on the basis of paragraph a) of n.º 1 of the article 2.º of the Law n.º 63-A/2008, of 24 of November and that, after this operation, it is considered not fundamentally sound. This would in particular be the case if the credit institution either presents or risks presenting a level of capital, solvency or liquidity below the legally established minimum for which purposes the indicators for evaluation of the risk profile of the Annex to the Recapitalisation Communication will be taken into account.
52. The Portuguese authorities commit to submit to the Commission, after six months a report identifying the credit institutions that benefitted from public recapitalisation operations, the amount and terms of each of these operations, the compliance by Portugal with the commitments under this scheme; the compliance by the beneficiary credit institutions with their obligations under the scheme, as well as the evolution of external growth, and the steps taken for disinvestment, when appropriate, from these institutions.

III. POSITION OF PORTUGAL

53. The Portuguese authorities point out that the recapitalisation scheme is urgently needed to avert damage to the Portuguese financial market due to the financial market crisis. The insolvency of financial institutions and the resulting systemic risk would have dramatic consequences not only for Portugal but also for the common market.

⁵ Communication from the Commission: The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C10 of 15.1.2009.

54. A letter from the Portuguese Central Bank dated 7 January 2009 confirms that the aid scheme is needed to avert damage to the Portuguese financial market.
55. The Portuguese authorities acknowledge that the notified scheme is State aid. They stress, however, that the Portuguese government aims to make the scheme as market-oriented as possible.
56. The Portuguese authorities believe that the aid scheme is compatible with the common market in that it helps to “remedy a serious disturbance in the economy of a Member State” within the meaning of Article 87(3)(b) of the EC Treaty.
57. The Portuguese authorities think that the notified aid scheme will not lead to any undue distortions of competition or any negative side effects for other Member States. The scheme is open to all Portuguese financial institutions and all Portuguese subsidiaries of foreign institutions in Portugal and hence is non-discriminatory.

IV. ASSESSMENT

1. State aid character of scheme

58. As set out in Article 87(1) EC, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.
59. The Commission agrees with the position of Portugal that the credit institution recapitalisation scheme for eligible institutions constitutes aid to the institutions concerned pursuant to Article 87 (1) EC.
60. Indeed, the Scheme will enable the beneficiaries to secure capital on more favourable terms than would otherwise be possible in the light of the prevailing conditions in the financial markets. Since it confers an economic advantage on the beneficiaries and strengthens their position vis-à-vis competitors in Portugal and other Member States, the Scheme distorts competition and affects trade between Member States. The advantage is provided through State resources and is selective since it benefits only beneficiaries under the Scheme.
61. In the event that the State provides capital on equal terms with private investors this could be seen as an indication that the State is acting like a market economy investor and that consequently the Scheme does not provide the benefiting credit institutions with an economic advantage. However, in the current market circumstances, it is very unlikely that such recapitalisation would have been provided by a market economy investor. In a scenario such as the current one, in line with its practice⁶ the Commission considers that in the present market conditions, the investment decisions of the private investors are very likely to be influenced to a decisive degree by the very fact that the State is investing alongside them. Therefore, the provision of capital from private investors which may be concomitant but not necessarily "pari passu" does not allow the conclusion that the State is acting as a market economy investor.
62. Regarding the recapitalisation, the Commission recalls that a market economy investor expects a reasonable return on his investment⁷. However, if a firm is in difficulty or acts

⁶ See the Commission decision of 10 February 2009 in case N 69/2009, *Recapitalisation scheme for fundamentally sounds banks* in Sweden, to be published.

⁷ Joined Cases T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale* [2003] ECR II-435, para. 314

in an industry experiencing particular difficulties it is normally not justified to assume a reasonable return⁸. For the current scheme this is confirmed by the fact that the State is only investing because no market economy operator was willing to invest on similar terms (this is illustrated by the mechanism of the scheme). The Commission consequently finds that the Scheme constitutes State aid within the meaning of Article 87(1) of the EC Treaty.

2. Compatibility of the Financial Support Measures

a) Application of Article 87(3)(b) EC

63. Portugal intends to provide capital injections under a scheme which is granted to assist credit institutions. Given the present circumstances in the financial market and the position expressed by the Portuguese authorities, the Commission considers that it may be acceptable to examine this measure directly under the Treaty rules and in particular under Article 87(3)(b) EC.
64. Article 87(3)(b) EC enables the Commission to declare aid compatible with the common market if it is "to remedy a serious disturbance in the economy of a Member State". The Commission recalls that the Court of First Instance has stressed that Article 87(3)(b) EC needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State⁹.
65. The Commission considers that the present scheme concerns the entire Portuguese economy. It does not dispute the analysis of the Portuguese authorities that the current global financial crisis has eroded confidence in financial institutions' creditworthiness. If these problems are not addressed, it will result not only in difficulties for the banking sector but, owing to that sector's pivotal role in providing financing to the rest of the economy, will also have a systemic effect on the Portuguese economy as a whole.
66. As regards the intervention in favour of credit institutions that are not fundamentally sound, the Commission recently recognized in the content of a recent rescue operation in favour of a Portuguese credit institution¹⁰ that "*the turmoil on the financial markets and in particular the mutual distrust between financial institutions, which has led to an almost total drying-up of interbank lending, has created exceptional circumstances in which the failure of one bank may have detrimental effects on the financial system at large*". Indeed, the Commission accepted the arguments provided by the Portuguese Central Bank in the framework of that case¹¹, that in a country like Portugal, "*the default of a small bank could, under certain conditions have had a domino effect over several financial institutions and thus undermine the confidence in the Portuguese financial system. Given the great uncertainty due to the financial crisis and the necessity of*

⁸ The Commission indicated its position in various Communications, i.e. the Application of Article 92 and 93 of the EEC Treaty to public authorities' holding (Bulletin EC 9-1984), point 3.3; and Communication on public undertakings in the manufacturing sector, OJ 1993 C 307/3.

⁹ Cf. in principle Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Applied in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, page 1, points 153 *et seq* and Commission Decision in Case C50/2006 *BAWAG*, OJ 2008 L 83, points 166. See Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/2008, *Rescue aid to WestLB*, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, OJ 2009 L 104.

¹⁰ Commission decision of 13 March 2009 in case NN 71/2008, *State aid to Banco Privado Português-BPP in Portugal*, to be published.

¹¹ See footnote [9][10?].

external funding of the Portuguese economy, a lack of confidence in the Portuguese financial system could severely affect the whole Portuguese economy".

67. Hence, in line with previous decisions¹² the Commission considers that the scheme is apt to remedy a serious disturbance in the Portuguese economy.

b) Conditions for compatibility under Article 87(3)(b)

68. Although there is no established practice as to the conditions for compatibility of aid granted under Article 87(3)(b) EC, it must be stressed that, in the light of the general principle of incompatibility of aid, in order for such aid to be compatible, any aid or aid scheme must comply with general criteria for compatibility under Article 87(3) EC, viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(a) and 4(2) EC, which imply compliance with the following conditions:

- a. *Appropriateness*: The aid has to be well targeted to its objective, i.e. in this case to remedy a serious disturbance in the entire economy. This would not be the case if the disturbance would also disappear in the absence of the measure or if the measure is not appropriate to remedy the disturbance.
- b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case-law of the Court of Justice.¹³
- c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives. This follows from Article 3(1)(g) EC and Article 4(1) and (2) EC, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87(1) EC prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) EC which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective, limiting to a minimum consequential distortions of competition.

c) Assessment of the Recapitalisation Scheme

69. The Commission will assess separately the interventions in favour of fundamentally sound credit institutions and those in difficulty. The scheme will be assessed in line with the Recapitalisation Communication.

¹² See e.g. Commission decision of 10 October 2008 in case NN51/2008, *Guarantee scheme for banks in Denmark*, OJ C 273/2008 of 28.10.2008.

¹³ Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in Case C-390/06, *Nuova Agricast v Ministero delle Attività Produttive* [2008] ECR I-2577, where the Court held that, "As is clear from Case 730/79 [...], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market [...]."

A. Recapitalisation of fundamentally sound credit institutions

70. The Commission has already observed in several cases that credit institutions may need extra capital in the present market circumstances in order to ensure a sufficient flow of credit to the entire economy, thereby preventing a further deepening of the crisis. In addition, uncertainties regarding economic prospects have weakened trust in the long-term solidity of financial institutions. The objective of the Scheme is to ensure that financial institutions are sufficiently well capitalised to better withstand potential losses and thus give room for maintained or increased lending to the rest of the economy. This is in principle an appropriate means to strengthen financial institutions¹⁴ and thus to prevent credit supply restrictions and limit the passing-on of the financial markets' difficulties to other businesses.
71. Indeed, the Scheme expressly requires the benefiting institutions to ensure a continued supply of credit to the real economy. This will be expressly spelled out in the individual agreement between the State and the financial institution, and that requirement will be monitored by the Portuguese authorities who will in turn make reports to the Commission.
72. The Commission consequently finds, in line with its policy¹⁵, that a recapitalisation scheme is adequate to ensure not only that financial institutions possess sufficient capital and are thus able better to withstand potential losses but also that the real economy is provided with sufficient credit. The Commission has already observed in several cases that a recapitalisation scheme is in principle an appropriate means to strengthen the credit institutions and thus to restore market confidence¹⁶. Therefore the Commission considers that the notified Scheme is appropriate to remedy the serious disturbance of its economy identified by the Portuguese authorities.
73. As regards necessity, the Commission must examine whether the aid is limited to the minimum necessary in scope and time.
74. In this respect, the Commission notes positively that Portugal has limited the size of the scheme both as regards the overall amount (capped at EUR 4 billion) and in respect of individual beneficiaries (maximum 2% of the institution's risk-weighted assets) for fundamentally sound credit institutions. The scheme will also be limited in time to six months from its entry into force.
75. As regards proportionality, the Commission considers necessary to assess separately interventions carried out in which at least 30% of capital is contributed by private investors and the remainder of interventions regarding fundamentally sound credit institutions, since these two situations are contemplated by the notified Scheme.

A.1. Recapitalisation with at least 30% of capital contributed by private investors

76. The Commission regards an appropriate remuneration of the capital provided to be the best safeguard to ensure the proportionality of a capital injection¹⁷. Under the Scheme, the Portuguese authorities may take part in recapitalisations in which at least 30% of capital

¹⁴ See point 5 of the Recapitalisation Communication.

¹⁵ See the Recapitalisation Communication.

¹⁶ Commission decision of 12 February 2009 in case N 664/2008 *Support Measures for the Banking Industry in Hungary*, to be published; Commission decision of 10 February 2009 in case N 69/2009 *Recapitalisation Scheme for fundamentally sound banks in Sweden*, to be published.

¹⁷ See point 11 of the Recapitalisation Communication.

is contributed by private investors and on equal terms with the latter. As set out in point 21 of the Recapitalisation Communication, the Commission will accept the remuneration set out in such a deal as appropriate despite the fact that the State's participation is State aid and therefore may incite private investors to accept a price which they might not have otherwise accepted. Indeed, point 21 of the Recapitalisation Communication reflects the fact that a substantial participation of private investors is likely to lead to a remuneration which, although not necessarily identical to the price that would have been paid in a perfectly competitive situation, is nevertheless sufficiently close to the market price as to minimize competition concerns.

77. It can be considered a priori that credit institutions recapitalised with a considerable private contribution are fundamentally sound, given that private investors can be expected to have carefully screened their risk profile and to have reached a positive conclusion. In practice, it can be assumed that the private investors will have carried out an analysis that would reflect that referred to in the Annex to the Recapitalisation Communication for determining a bank's fundamental soundness and thus involve inter alia the following indicators (a - capital adequacy), (c - CDS spreads) and (d - rating) Only the criterion of size as indicated in indicator (b) of the Annex to the Recapitalisation Communication is not evident in a partially private solution. However, compliance with this criterion is in the present case ensured by the fact that a ceiling to the recapitalisation has been fixed by the Portuguese authorities precisely so as to stay below the indicated 2% of the benefiting institution's risk weighted assets. Therefore, the Commission has no particular reason to doubt that a credit institution which is provided capital under these provisions of the Scheme is prima facie fundamentally sound.
78. However, a key condition to this assessment is that the terms of the recapitalisation, as required by point 21 of the Recapitalisation Communication, must not significantly alter the incentives of private investors. This would, for example, be the case where the terms of the transaction are not consistent with market requirements and the remuneration is not in line with current market rates, despite the participation of private investors. Amongst other things, the Commission will pay attention to whether the private contribution stems mainly from the current shareholders or other investors with a vested interest in the credit institution and whether the remuneration is below the remuneration indicated as appropriate in points 26 to 30 of the Recapitalisation Communication. The Commission will assess, on a case-by-case basis whether a credit institution benefiting from a capital injection under the Scheme meets the conditions to be considered fundamentally sound, but it considers that the structure of the scheme and the commitments made by the Portuguese authorities give prima facie assurances on these points.

A.2. Other types of recapitalisation of fundamentally sound credit institutions

79. In the case of other types of recapitalisation of fundamentally sound credit institutions, the distortion of competition can be minimised by various safeguards, in particular a market-oriented premium. Appropriate pricing of capital provided by the State that is as market-oriented as possible is viewed by the Commission as the best way of ensuring the proportionate nature of a capital injection scheme¹⁸. Moreover, the price should increase

¹⁸ See, in particular, point 11 of the Recapitalisation Communication.

over time so that there is an incentive for the credit institutions to redeem the capital injections as soon as market circumstances permit¹⁹.

80. In the case at hand, this is achieved by calculating the return on instruments in line with the Recapitalisation Communication which builds on the recommendations of the European Central Bank of 20 November 2008²⁰. The Commission also points out that Portugal has provided for two additional aspects that enhance the incentive to exit: firstly, the amount that has to be repaid to the State increases by a step-up of 50 basis points each year and the minimum redemption price will also increase by 5% per year as from the beginning of the third year. Secondly, the State remuneration increases by 50 basis points if the credit institution decides to pay out dividends to its shareholders²¹. This can be regarded as a further incentive to pay back capital to the State as quickly as possible. In addition, as regards the acquisition of ordinary shares, in view of point 31, the Commission considers that the conditions set in the first section of the Annex of the Recapitalisation communication (pricing of equity) are met.
81. Overall, this remuneration can then be accepted by the Commission as being proportionate for fundamentally sound institutions and the incentives for the recapitalised credit institution to pay back the capital to the State seem sufficiently strong.
82. Furthermore the Commission observes a number of other significant behavioural commitments²². In particular the obligation for the beneficiary to maintain a level of lending to the real economy at least equal to that reached at the end of 2008 should ensure that the institutions do not engage in aggressive commercial strategies or expansion of its activities or other purposes that would imply undue distortions of competition. Indeed, given the impact of the crisis on the credit institutions, the State intervention is aimed at modifying the expected behaviour of credit institutions by maintaining a significant supply of credit. By imposing a level of lending and at the same time capping the level of recapitalisation to 2% of risk weighted assets, the State capital should be mainly channelled to financing the real economy. Moreover, the beneficiary institutions are required to use the funds received to lend to the economy under competitive conditions, with the focus being on the provision of loans to SMEs and on lending to households.
83. The Commission takes particular account of Portugal's commitment, before implementing the recapitalisation measure, to send the list of beneficiary credit institutions and all the relevant information to allow the Commission to take an informed view on the operation.

B. Recapitalisation of credit institutions that are not fundamentally sound

84. As regards the necessity of the measure, the Commission first notes the declaration²³ on a concerted European action plan made by the euro area countries on 12 October 2008 stating that "*Governments remain committed to support the financial system and therefore to avoid the failure of relevant financial institutions, through appropriate*

¹⁹ See, in particular, the Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ 2008 C 270/8, point 39, and point 11 of the Recapitalisation Communication.

²⁰ See point (27) of the present decision.

²¹ See point (30) of the present decision.

²² See point (40) of the present decision.

²³ See document 14239/08 available at: <http://ue.eu.int/showPage.aspx?id=1121&lang=en>

means including recapitalisation. In doing so, we will be watchful regarding the interest of taxpayers and ensure that existing shareholders and management bear the due consequences of the intervention. Emergency recapitalisation of a given institution shall be followed by an appropriate restructuring plan."

85. In addition, in section 2.3. of the Recapitalisation Communication, the Commission considers that it could be necessary to recapitalise financial institutions that are not fundamentally sound.
86. Given these considerations, and in line with its recent decisions of recapitalisation scheme benefiting distressed credit institutions²⁴, the Commission considers that a recapitalisation scheme for credit institutions that are not fundamentally sound may be appropriate to restore confidence in the financial market.
87. As regards the necessity of the measure, at the date of the implementation of the recapitalisation, the capital ratio of credit institutions that are not fundamentally sound will not exceed the recommendations of the Portuguese Central Bank (i.e. 8%).
88. As regards the proportionality of the measure, the Commission indicated in the section 2.3. of the Recapitalisation Communication that to accept such an operation, additional safeguards are required such as a remuneration that reflects the risk profile of the beneficiary and is higher than for fundamentally sound credit institutions and that, notwithstanding the need to ensure financial stability, the use of State capital for these credit institutions can only be accepted on the condition of either a credit institution's winding-up or a thorough and far-reaching restructuring. Under the notified Scheme, in any event, the remuneration for distressed credit institution cannot be lower than that for the fundamentally sound credit institution as a consequence of the commitments of point (43) and in line with the assessment in the previous section²⁵. The amount injected may exceed 2% of the RWA in case of recapitalisation of not fundamentally sound credit institution under the notified scheme. The Commission recalls that in line with the Annex of the Recapitalisation Communication, a capital injection exceeding this level could be considered as sufficient to consider the credit institutions as not fundamentally sound. Nonetheless, the Commission notes positively that the amount to be injected is capped. Indeed, the capital ratio of credit institutions that are not fundamentally sound will not exceed the recommendations of the Portuguese Central Bank, at the date of the capitalisation is implemented.
89. The Portuguese authorities have provided additional safeguards. Firstly, the Portuguese authorities undertake to present a restructuring plan no later than six months after the recapitalisation operation and to follow the behavioural commitments required in principle for distressed credit institutions under point 45 of the Recapitalisation Communication. This point states that, behavioural safeguards for distressed banks in the rescue and restructuring phases should, in principle, include: (1) a restrictive policy on dividends, (2) limitation of excessive executive remuneration or the distribution of bonuses, (3) obligation to restore and maintain an increased level of the solvency ratio and (4) a timetable for redemption of the State participation. In the case at hand, all these behavioural conditions are met. Indeed, under the notified Scheme, distressed aided credit

²⁴ See the Commission decision of 9 December 2008 in case N 557/2008 *Support Measures for the Banking Industry in Austria*, to be published; the Commission decision of 3 February 2009 in case N 31a/2009 *Recapitalization of financial institutions and amendment of the Guarantee Scheme in Denmark*, to be published; the Commission decision of 13 October 2008 in case N 507/2008 *Financial Support Measures to the Banking Industry in the UK*, JOCE C/290/2008.

²⁵ See point 77 here above.

institutions have to respect a dividend ban; executive remuneration cannot exceed 50% of the 2007 and 2008 average remuneration (including fix and bonus)²⁶; aided credit institutions should adopt a prudent strategy to maintain the increased level of capital²⁷; exit strategy is a prerequisite for the State intervention.

90. As a consequence of the above considerations²⁸, the Portuguese authorities also have to notify to the Commission when a remuneration required from the recapitalized credit institution cannot be at least equal to the level required for fundamentally sound credit institutions or if the behavioural commitments required in principle for distressed credit institutions are not met²⁹. This includes inter alia a ban on dividends at least during the rescue period since the Portuguese authorities committed to do so during the period "*when the credit institution presents risks of not complying with capital adequacy, solvability and liquidity levels in conformity with the minimum legal requirements*".
91. Finally, as stated previously, the Commission takes particular account of Portugal's commitment, before implementing the recapitalisation measure, to send all the relevant information to allow the Commission to take an informed view on the operation.
92. The Commission recalls that that the aid element contained in the recapitalisation operation will be quantified when assessing the restructuring plan presented for these credit institutions.
93. Given all the above considerations, the recapitalisation scheme can be regarded as being compatible with the common market.

f) The general framework of the package under Article 87(3)(b)

94. The Commission would like to reiterate that period available for financial support measures is limited to six months. The Commission is of the view that, provided that the regular review of the recapitalisation scheme every six months is ensured, the approval of the scheme may be prolonged. However, this extension is only possible in the event that the crisis in the financial markets so requires and upon Commission approval.

V. DECISION

The Commission concludes that the notified scheme is compatible with the Common market and has accordingly decided not to raise objections against the notified package, since it fulfils the conditions to be considered compatible with the EC Treaty.

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State Aid Greffe
Rue de la Loi/Wetstraat, 200

²⁶ Pursuant to Article 9(1) of the Ordinance.

²⁷ Pursuant to Article 10(1)(f) of the Ordinance.

²⁸ Taking also into account the commitments to which it is referred to in paragraph 45

²⁹ See point 45 of the Recapitalisation Communication.

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Yours faithfully,

For the Commission

Neelie Kroes
Member of the Commission