EUROPEAN COMMISSION

Brussels, 18.11.2009
C(2009)9087 final

Subject: **State aid No. N 428/2009 – United Kingdom**
Restructuring of Lloyds Banking Group

Sir,

1. PROCEDURE

1. By decision of 13 October 2008, the Commission approved a package of financial support measures to the banking industry in the UK (State aid case N 507/2008)[1]. Modifications to this scheme were approved on 22 December 2008 (State aid case N 650/2008)[2].
2. These decisions authorised the UK to implement a recapitalisation scheme for financial institutions, subject to several conditions including the submission of a restructuring plan within six months following the recapitalisation.
3. As required under the terms of the recapitalisation scheme, the UK notified a restructuring plan for Lloyds Banking Group (hereinafter referred to as "LBG") on 16 July 2009, in respect of the recapitalisation measures that bank had received six months earlier. By letter of 20 July 2009 the Commission requested the UK authorities for additional information regarding the restructuring of LBG.
4. By letter of 5 August 2009 the UK authorities submitted a draft LBG forward plan – Amended Restructuring Plan Summary, dated 5 August 2009, as well as an Overview of Lloyds Banking Group. The plan of 5 August 2009 was supplemented by a new proposal on 28 September 2009 and 9 October 2009.
5. A number of meetings, e-mail exchanges and telephone conferences took place between the Commission and the UK authorities.

[1] OJ C 290, 13.11.2008, p.4.
[2] OJ C 54, 7.3.2009, p.3.

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6. On 15 October 2009, the UK authorities informed the Commission of the details of the plan *Seaview Project* put in place by LBG to raise the capital necessary to finance its restructuring plan. The UK authorities informed the Commission of its intention to participate in this capital raising.

7. By letter of 2 November 2009, LBG, in agreement with the UK authorities, made a number of commitments as regards the implementation of the restructuring plan.

2. DESCRIPTION OF THE FACTS

2.1. THE BENEFICIARY

8. LBG is the entity resulting from the acquisition of HBOS by Lloyds TSB in January 2009. According to the UK authorities, in the years preceding the take-over of HBOS, Lloyds TSB had pursued a more prudent strategy than other UK banks and as a result its pre-tax income growth between 2003 and 2007 was below the UK average. Lloyds TSB decided to limit its exposure to higher risk business segments such as non-prime mortgage lending, higher risk wholesale segments etc. For this reason Lloyds TSB was resilient to the banking crises: in 2008 Lloyds TSB made a profit of £845 million, while in the same period HBOS recorded a loss of £7.4 billion. The total assets of Lloyds TSB and of HBOS at the end of 2008 amounted to £436 billion and to £690 billion respectively. Lloyds TSB announced the acquisition of HBOS on 18 September 2008. On 19 November 2008 (Lloyds TSB) and on 12 December 2008 (HBOS) the banks' shareholders approved the transaction, which formally took place in January 2009. Although the merger took place only after the end of 2008, the group has published pro-forma figures for the year 2008.

9. LBG is the leading UK retail bank with a pro-forma total balance sheet of £1,114 billion at the end of 2008[3] (£499 billion risk weighted assets - RWA). In 2008, LBG recorded a pro-forma loss of £6.8 billion. The pro-forma capital ratios of LBG at the end of 2008 were 9.5% as regards its Tier 1 ratio and 6.2% for the core Tier 1 ratio.

10. LBG's operations are essentially focussed on the UK with [above 90%][*] of assets being UK-based. It operates in retail banking through various brands, insurance, wholesale banking and wealth and asset management.

11. On 8 October 2008, the UK government announced that it was making available new capital to UK banks. On 13 October 2008, it indicated that it was making capital investments in RBS, and upon successful merger, HBOS and Lloyds TSB, totaling £37 billion[4]. On 19 January 2009 LBG received a £17 billion State recapitalisation split into £4 billion of preference shares and £13 billion of ordinary shares. As a result, the UK government acquired a 43.5 % stake in LBG, with the remaining 56.5% of shares divided between the Lloyds TSB shareholders (36.5%) and the HBOS shareholders (20%).

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3 Proforma balance sheet of Lloyds Banking Group before integration.

* Covered by the obligation of professional secrecy

4 http://www.hm-treasury.gov.uk/press_105_08.htm.

2.2. BUSINESS ACTIVITIES

12. LBG's products and services fall into four divisions: Retail, Wholesale, Insurance (including both life and general insurance) and Wealth and International. LBG's UK share is in excess of 15% in the markets for personal current accounts ("PCAs"), mortgages, savings, credit cards, other personal loans and SME banking.

2.2.1. RETAIL BANKING

13. The retail division includes all the LBG businesses focused on personal customers excluding wealth customers who are served by the Wealth and International Division. LBG offers the full range of retail banking services through the following brands: Lloyds TSB, Bank of Scotland and Halifax. It operates three mortgage and savings brands: Cheltenham & Gloucester (hereinafter referred to as "C&G"), Birmingham Midshires and Scottish Widows Bank. Finally, it has one internet brand: Intelligent Finance (IF). LBG has a joint venture with Sainsbury, a UK supermarket chain, to provide banking services via the Sainsbury brand, and operates a number of other partnerships with third-party brands.

14. It is estimated that in total LBG has around 30 million customers, 2,968 branches and 580 agencies. It operates 74 Retail head office locations and 348 Retail IT platforms. Lloyds TSB has 1,638 branches, Halifax 674 branches, C&G 164 branches, Bank of Scotland 307 branches and Lloyds TSB Scotland 185 branches.

15. Almost all of LBG's PCAs and SME customers are served within the Lloyds TSB, Halifax and Bank of Scotland brands. There are almost no current account or SME customers associated with any other brand, except for some IF-branded current account customers.

16. LBG's market share of PCAs amounts to [20-30]%[5] of the UK market (as a % of the number of accounts). The UK market for PCAs features four traditional banks (Lloyds TSB (now LBG), Royal Bank of Scotland, HSBC and Barclays) and a number of smaller challenger banks (of which the two biggest are Santander and Nationwide, which have rapidly grown in recent years). In the years preceding its acquisition by Lloyds TSB, HBOS was considered to be a challenger. The Office of Fair Trading (OFT) considered in several reports and individual decisions[6] that the challenger banks tend to compete aggressively on price to attract new customers while the traditional banks, including Lloyds TSB (now LBG), tend to focus on their relationship with existing customers. In the PCA market, rates of switching between banks have historically been low.

17. LBG's market share for mortgages amounts to [30-40]% of the UK market. The mortgage market in the UK was assessed by the OFT to be highly competitive with high rates of customers switching and low barriers to entry.

18. LBG's market share for savings amounts to [10-20]%. Here, entry barriers are considered to be low and switching rates to be reasonable. The OFT concluded that the market is contestable. The same applies to personal loans and credit cards, where LBG has a market share of [20-30]% and [10-20]% respectively.

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5 All market shares are as of March 2009.

6 The OFT Market study on the PCAs, July 2008. The OFT report on the SME banking, August 2007. The decision of the Competition Commission on Lloyds TSB/Abbey planned merger of July 2001. The OFT report on the anticipated acquisition by Lloyds TSB of HBOS, 24 October 2008.

19. In SMEs LBG has a market share of [20-30]% (as % of number of accounts). This market is considered to feature primarily branch-based relationship banking, with customers unwilling to switch.

2.2.2. WHOLESALE BANKING

20. The wholesale banking business of LBG is responsible for all corporate and commercial customer activities. This division covers a broad range of customers, from start-ups and small businesses to large corporate customers.

21. It operates primarily through the Bank of Scotland and Lloyds TSB brands. The division also operates a number of more specialist brands, including LTSB Development Capital (a small/mid-cap Private Equity business), Black Horse (a specialist consumer finance business) and Autolease and Lex (both vehicle leasing businesses).

22. The Wholesale division has a number of distinct Business Units.

23. *Commercial Finance* provides banking services to UK-based SMEs with a turnover of around £25 million. It operates under LTSB and BOS brands. Business Banking relationship managers are based in LTSB, BOS and some Halifax branches. This division also includes 'Agricultural Mortgage Corporation' which provides lending facilities specifically to the agricultural sector in the UK.

24. *Asset Finance* includes a retail consumer finance business which operates under the Black Horse brand and provides lending products to non-franchise customers directly (phone and mail) and through a small network of around 90 Black Horse branches. It also includes a motor finance business which provides car loans to customers purchasing vehicles through dealership and a retail point-of-sale finance business which provides loans to customers buying goods through specific retail stores. LBG's vehicle leasing businesses, Autolease and Lex, are also within this business unit.

25. *Corporate Banking* provides large business customers (from mid-cap businesses to multinational corporations, including financial institution clients) with a range of banking services including transaction accounts, savings accounts, term lending, commercial credit cards and international corporate banking. Corporate Banking operates under Lloyds TSB and Bank of Scotland (BOS) business banking brands (Halifax corporate banking is managed by BOS) and also includes the specialist 'Public and Community Sector', active in the social housing sector.

26. *Special Finance Group* provides a number of leveraged finance and investing solutions for corporate clients, sponsor-driven leveraged finance for non-corporate clients, principal investments into funds and principal investments into corporates. This unit also includes non-UK Joint Ventures.

27. *Real Estate and UK Joint Ventures* business arranges financing for investment and development across all types of commercial and residential property developments. The customer base comprises small, medium and large property companies, often refinancing their existing debt with LBG. This business is a HBOS-heritage business.

28. *Wholesale Markets* provides big ticket leasing and financing services for large-scale transport purchases and infrastructure projects and is active in capital markets and various forms of trading. This business operates both LTSB and BOS brands. Leasing is conducted through Structured Credit finance, which supports large infrastructure

leasing and financing in shipping, rail and aircraft. The securitised market business that manages LBG's investments in asset securitisations is managed within the Structured Credit Investments group, composed of portfolio of Asset Backed Securitised and Floating-Rate Notes, with trading in New York, Australia, Ireland and London. An asset-backed financing service is also offered through special purpose vehicles such as Cancara.

29. *Treasury and Trading* manages the core liquidity and hedging positions underpinning day-to-day banking operations. Core liquidity is managed through certificates of deposits, repos and commercial paper and, in response to the new Individual Liquidity Adequacy Standards (ILAS) liquidity regime an increasing holding of gilts. Derivatives trading, stemming from both LTSB and BOS heritage trading, is focused on interest rate swaps, but also includes foreign exchange hedging, cross-currency swaps, foreign exchange (FX) options, and to a lesser extent, interest rate guarantees and equity options.

2.2.3. INSURANCE AND ASSET MANAGEMENT ACTIVITIES

30. The Insurance division provides life assurance, pensions, investments and general insurance. These products are delivered through a number of brands including Scottish Widows, Clerical Medical, Lloyds TSB General Insurance and HBOS General Insurance.

31. Scottish Widows, Clerical Medical, Halifax Life and St Andrews Life are the Life Insurance businesses, providing life, pension, investment and protection products. These products are sold via regulated sales staff operating within LBG's own channels, which are mainly branches, branded Halifax, Lloyds TSB and Scottish Widows, and via independent financial advisors (IFA).

32. LBG has also an international life insurance business in Germany which sells investment products to personal customers mainly through third party sales channels. This business operates under the Clerical Medical and Heidelberger Leben brands.

33. LTSB General Insurance and HBOS General Insurance provide home (buildings and contents), creditor (payment protection) and motor insurance via LTSB, Halifax and BOS branches, via their own direct channels (telephone, mail, internet) and through brokers/partnerships.

2.2.4. WEALTH AND INTERNATIONAL

34. This division consists of three separate businesses.

35. *Asset Management* includes the Group's asset management businesses: Scottish Widows Investment Partnership (SWIP) and Insight Investment. They manage funds for LBG's retail life, pension and investment products as well as for external (i.e. non-LBG) clients in both the retail and institutional segments. The asset management business also includes Invista, a publicly-listed real estate investment management business in which LBG has a 55% stake.

36. *UK Wealth/Private Banking* includes the provision of products and services to affluent and high net worth clients in the UK through a number of specialist sales forces who provide investment and banking services under LTSB and BOS brands.

There are also some dedicated private banking branches across the UK. LBG also owns a 60% stake in St. James's Place, a publicly-listed wealth management business.

37. *International business* includes a number of international retail, private banking and wholesale banking businesses. The largest international operations are: an onshore Islands business (banking services in the Channel Islands and Isle of Man), an International Private Banking business (serving high net worth clients headquartered in Geneva), HBOS Ireland (a full-service bank providing personal, business and corporate banking services throughout the Republic of Ireland and Northern Ireland), HBOS Australia (consisting of BOS International and Capital Finance, providing corporate finance, asset finance and project finance markets), HBOS Netherlands (an online/intermediary mortgage referral business based on largely outsourced operating model), HBOS Germany (a retail deposit/savings business selling mainly direct and through third party channels), Spain (an onshore retail banking business offering banking and investment services to expatriate and local customer segments) and Wholesale Europe (wholesale lending to European corporate clients).

2.2.5. GROUP OPERATIONS

38. This division provides LBG with shared services support in IT, Operations, Procurement and Property Services. LBG operates a "shared service" model for most of its IT and Operations activities – i.e. these activities are managed centrally on behalf of all UK divisions. The underlying IT infrastructure has many different IT systems in operation across different businesses, geographical regions and brands.

2.3. THE DIFFICULTIES OF THE COMPANY

39. LBG's need for State aid is largely due to the acquisition of HBOS and the latter's specific difficulties. In particular, three aspects of HBOS's business model left it more exposed than Lloyds TSB. Firstly, HBOS took a more aggressive approach to credit risk policies across its retail and commercial lending portfolios and had less stringent risk management governance and controls. It was willing to lend to significantly risky personal and commercial customers through sub-prime, high loan-to-value and self-certified mortgages. Secondly, HBOS expanded into high risk structured finance and other trading activities. Finally, HBOS relied heavily on wholesale funding, with retail funding accounting for only 43% of HBOS total funding at the end of 2007.

40. As a result, when the wholesale funding market dried up in September 2008 following the collapse of Lehman Brothers, HBOS faced a liquidity crisis and would have been unable to meet its liabilities without the support of Lloyds TSB and HM Treasury. Moreover, as the economy worsened, the market's attitude to structured finance investments and asset-backed securities soured, causing impairments for HBOS's assets in those categories (i.e. marked to market). Finally, as the property market stalled and values started to fall, HBOS's mortgage and commercial loan book also suffered impairments. The net effect was that by September 2008 HBOS was in urgent need of rescue.

41. As the fifth largest high street bank in the UK, HBOS was of critical importance to the entire UK financial system. In spite of a negative opinion by the OFT on a takeover of HBOS by Lloyds TSB due to competition concerns[7], the UK government decided to facilitate the Lloyds TSB/HBOS transaction as a private sector solution, and on the

[7] See footnote 6.

grounds of financial system stability. Lloyds TSB was supposed to impose its prudent risk management philosophy and infrastructure on HBOS to help restore HBOS to viability. However, the problems of HBOS were so severe that it required additional State support in the form of recapitalisation, funding guarantees and, as it seemed in February 2009, asset protection measures.

2.4. THE AID MEASURES

42. Prior to its takeover by Lloyds TSB, HBOS was on the brink of collapse because of its high risk lending practices and excessive use of leverage. The takeover offer was conditional upon the receipt of the large government aid necessary to rescue HBOS. Without the receipt of state aid, Lloyds TSB would not have been able to complete the takeover of HBOS.

43. In January 2009, LBG received a State recapitalisation of £17 billion as described below.

44. In addition, in March 2009, it was announced that further aid would be granted via LBG's participation in the UK Assets Protection Scheme (APS), covering a portfolio of £260 billion, whereby the State would cover 90% of the losses in excess of the first loss tranche of 13% to be borne by the bank. Subsequently LBG decided not to participate in the APS.

45. Instead of participating in the APS, LBG decided to implement the so-called Seaview project (described in part 2.4.3 below), i.e. to raise up to £[20-30] billion of capital through the combination of capital market operations and additional management measures. This project will be financed in part by State resources.

46. The State support measures relating to LBG are described in detail in the following paragraphs.

2.4.1. THE CAPITAL INJECTION

47. On 12 October 2008 the UK notified a package of measures designed to ensure the stability of the financial system. The proposed measures fell into three parts:

    A. Bank Recapitalisation Scheme (hereinafter "The Recapitalisation Scheme"): Making available new Tier 1 capital for banks and building societies to strengthen their balance sheets and allow them to restructure their finances, while maintaining their support for the economy as a whole.
    B. Wholesale Funding Guarantee Scheme (hereinafter "The Guarantee Scheme"): Providing a State guarantee for short- and medium-term debt designed to reopen the market for short-and medium-term wholesale funding.
    C. Short-Term Liquidity Measures (hereinafter "The STL-Measure"): the provision of short-term liquidity, mainly by broadening the range of collateral accepted for sterling and US dollar money market operations.

48. The UK scheme was approved by the Commission in its decision of 13 October 2008[8].

[8] State aid N 507/2008 "Financial Support Measure to the Banking Industry in the UK", OJ C 290, 13.11.2008, p. 4. The amendments to the scheme were introduced and approved by the Commission's decision State aid N 650/2008 "Modification of the Financial Support Measure to the Banking Industry

49. Following its assessment of the capital position of Lloyds TSB and HBOS, the Financial Services Authority (FSA) decided that they would require additional capital to provide a buffer against worsening market conditions and to ensure their ability to continue lending to the real economy. Therefore, LBG (which is the successor of Lloyds TSB and HBOS) needed to participate in the recapitalisation scheme in order to respond to the FSA requirement.

50. The recapitalisation was completed on 19 January 2009 with £13 billion in ordinary shares and £4 billion in preference shares. In total LBG received £17 billion of government funds which resulted in the UK government having an equity ownership of LBG of 43.5%.

51. On 7 March 2009, HM Treasury announced that there was an agreement with the bank to redeem the £4 billion preference shares by issuing new ordinary shares. It further indicated that "*the Treasury will take up its pro-rata share of the open offer and so maintain its minimum voting share at 43.5 per cent. The Treasury will also subscribe for any additional shares not taken up by existing shareholders.*"[9] On 20 May 2009, LBG announced the launch of a placing and open offer of ordinary shares to redeem the £4 billion of preference shares. As the result of the transactions, which was completed in June 2009, LBG redeemed the £4 billion of HM Treasury-held preference shares but at the same time HM Treasury participated in the shares offer up to its 43.5% stake in LBG, i.e. for an amount of £1.7 billion. As a consequence, the net injection of capital by HM Treasury in LBG was reduced from £17 billion to £14.7 billion.

2.4.2. THE ANNOUNCED BUT EVENTUALLY WITHDRAWN IMPAIRED ASSETS MEASURE

52. On 7 March 2009, HM Treasury and LBG jointly announced the participation of the bank in the APS. The APS is an unfunded guarantee scheme whereby the UK government commits to cover 90% of the losses in excess of an initial amount ("the first loss position") arising from a defined portfolio of assets. The first loss was to be borne by LBG which was also supposed to support the remaining 10% of losses on the covered portfolio.

53. The terms of LBG's participation in the APS announced on 7 March 2009 were for the bank to transfer the risk of a £260 billion portfolio of loans assets above a first loss position of £ 35.2 billion (13.5% of the portfolio amount). The initial fee had been set at £15.6 billion and was to be payable in B shares and amortised over a seven-year period. The B shares rank *pari passu* with ordinary shares but do not carry voting rights. They were convertible into ordinary shares. The subscription to the B shares would have taken the government's ownership of LBG to 62.0%.

54. The participation in the APS served two objectives, with the return to long-term viability as the ultimate target: (i) to provide coverage against losses on impaired assets in particular in case of a continuation of the economic stress period and (ii) to provide regulatory capital relief in the form of an increased Core-Tier 1 ratio through

in the UK, OJ C 54, 7.3.2009, p. 3. The prolongation of the scheme was first approved by the Commission decision N 193/2009, OJ C 145, 25.6.2009 p.3 (until 13 October 2009) and then by the Commission decision of 13 October 2009 State aid N 537/2009 – until the end of 2009 (not yet published).

9 http://www.hm-treasury.gov.uk/press_23_09.htm

the reduction in RWA. The payment of the fee in the form of B shares would also have contributed to improving this ratio by increasing Tier 1 capital.

55. Over the course of summer 2009, LBG started to explore alternative solutions to participation in the APS. The LBG's management claimed that (i) the impact on capital would be less efficient than initially thought (as a result of a combination of a reduction in covered assets and a likely increase in the required first loss position), (ii) the administrative and logistic constraints to participating in the APS were heavier than initially contemplated and (iii) a limitation of the amount of State aid and State involvement would give the management greater flexibility to run the bank's restructuring process.

56. Non-participation in the APS had to be vetted by the FSA as the APS was the key measure to help the bank meet the FSA-required capital framework both in a base and stress case scenarios. In September 2009 it was determined by the FSA that in the absence of any participation in the APS, LBG would need to increase its total capital by £[20-30] billion to meet the regulator's requirements (see below the Seaview project).

57. Although the bank finally decided not to participate in the APS, the UK authorities consider that it has benefited from its announced participation in the scheme. For this benefit over the period from March 2009 to September 2009 LBG will have to pay a £ 2.5 billion exit fee to the government[10]. The exit fee is payable in cash.

2.4.3. THE PARTICIPATION OF THE STATE IN THE SEAVIEW PROJECT

58. On 3 November 2009, LBG announced a rights issue of £13.5 billion, in which the UK government has announced its participation to maintain its 43.5% stake, adding about £5.9 billion to the net amount of £14.7 billion it has injected into the bank since January 2009.

59. This operation known as the Seaview project is the alternative solution to LBG's participation in the APS.

60. The Seaview project is made up of two types of measures: (i) a fully underwritten capital increase for a cumulative amount of £20.5 billion and (ii) a range of additional measures aimed at increasing the Core-Tier 1 capital by another £[…] billion. In total the Seaview project aims at generating £[20-30] billion of capital necessary to meet the FSA rules.

61. The underwritten capital increase operation itself is made up of (i) a £13.5 billion fully underwritten rights issue and (ii) a minimum of £7.5 billion Exchange Offers[11] exchanging existing capital securities into either contingent Core-Tier 1 instruments (the Enhanced Capital Notes – "ECN") and / or ordinary shares. The State will participate only in the rights issue, but not in the exchange of these instruments.

62. In the framework of the £13.5 billion rights issue, new shares will be issued at a deep discount to current stock market price[12].

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10 See footnote 28 for the methodology used leading to the above fee.

11 The investment banks have committed to underwrite the Exchange Offers of £7.5 billion of the enhanced capital notes, irrespectively of the response of the bond holders.

12 The rights issue is offered to the existing shareholders. The issue price will be determined at a discount to the Theoretical Ex-Rights Price (TERP), which is basically a calculated price for the shares after

63. The entire issue is underwritten by the six investment banks charged with managing the issue. The UK government has announced its intention to take up its share of the right issue in order to maintain its shareholding of 43.5%. The State will receive an underwriting fee, in line with the other underwriters. The State's participation corresponds to an approximately additional £5.9 billion (net of underwriting fees) to be injected by the government in the bank. It is anticipated that the rights issue alone will improve the Core-Tier 1 ratio by about 2.3% and help the bank meet the […] capital requirements.

64. In the Exchange Offers, the holders of 52 existing securities , which have a nominal value of approximately £16 billion, will be invited to exchange these instruments against ECN and / or new ordinary shares. It is anticipated that over a half of the existing holders will exercise the exchange offer resulting in a total amount of new "converted capital" of a minimum £7.5 billion in ECN of which a maximum of £1.5 billion in new ordinary shares.

65. ECN will be exchanged on a par-for-par basis with an enhanced coupon. They will be new lower Tier 2 instruments which will automatically convert into ordinary shares if LBG's published consolidated Core-Tier 1 ratio falls below a 5% trigger at any time. The conversion price will be the ordinary share's market price at the time of exchange of the securities (i.e. approx. December 2009). Unlike the existing securities against which they are exchanged, the new ECN will have non-discretionary coupon payment provisions and a fixed maturity date.

66. ECN will provide an additional 1.5% buffer of Core-Tier 1 capital which will only materialise in times of stress and allow Core-Tier 1 ratio to remain above 5% under the FSA stress test scenario. This means that these securities will contribute to loss absorption in a stress scenario.

67. The entire capital raising operation is expected to be closed by the end of 2009 and fully settled by February 2010. The rights issue and the exchange offers are expected to be fully committed and placed by end of November and early December 2009 respectively. Only the portion of the exchange offer to be converted into ordinary shares is expected to settle by the end of January 2010[13].

68. In addition to the £20.5 billion of capital raising measures, LBG will also commit to further management actions aimed at creating an additional […] capital in times of stress. Such additional measures have been reviewed by the FSA which has given credit in its stress case to about £[…] billion of additional capital. These management actions include cost-cutting measures, securitisation operations and other RWA reductions.

issuing new rights-shares with the assumption that all these newly-issued shares are taken up by the existing shareholders. The discount is expected to be between 38% and 42% to TERP. The issue price is subject to a floor of 15 pence. Any left-over unsold shares through the rights issue will be underwritten at the same issue price by the underwriters. The price at which they will then decide to sell the shares to new investors will be a matter for them.

[13] The ordinary shares that will form part of the exchange offers might not be exchanged on the same terms and price as the new ordinary shares issued through the rights issue. To avoid jeopardising the outcome of the rights issue, these shares will only settle in January 2009. The total amount of ordinary shares to be received via the exchange offers is limited to £ 1.5 billion.

2.4.4. THE GUARANTEES

69. LBG is also a significant user of the UK Credit Guarantee Scheme (CGS), which was approved by the Commission decision of 13 October 2008 and prolonged until the end of 2009 by the Commission decision of 13 October 2009. As of September 2009, LBG had issued around £[…] billion of State-guaranteed debt under the CGS. Since the guarantees have already been definitely approved the Commission will not reassess their compatibility in this decision. However, since they were granted in the context of the current crisis the Commission will take this aid into account when assessing the restructuring plan.

3. THE RESTRUCTURING PLAN

3.1. DESCRIPTION OF THE PLAN

70. To ensure that LBG re-emerges as a stable, profitable bank, measures will be undertaken to re-focus on core activities within the historical risk profile of Lloyds TSB. Such measures will concentrate on reducing the balance sheet of LBG, reducing the risk profile of the business and the funding gap of the bank.

71. These measures will result in the disposal or run-down of non-core businesses and activities. Within the corporate and wholesale segments, it will imply a £[…] billion asset reduction. Within the personal and small business segment, a £[…] billion asset reduction programme is planned. This represents a total reduction of around £181 billion.

72. The current pool of assets in which LBG plans the asset reduction is presented in Table 1 below. The table indicates the assets' value in 2008. Following the planned reductions this pool of assets will be reduced to £[…] billion at the end of 2013 (£[…] billion (in 2008) – £181.5 billion (the planned reduction) = £[…] billion (in 2013)).

Table 1. LBG Asset Reduction Programme.

Asset pool	Proposed measure	Assets 2008
[…]	Dispose	£[…] billion
[…]	Dispose	£[…] billion
[…]	Dispose	£[…] billion
[…]	Dispose	£[…] billion
[…]	Dispose or reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion

[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
[…]	Reduce	£[…] billion
Total		**£[…] billion**

73. Furthermore, in October 2008 HBOS being under considerable pressure decided to sell its Australian retail and business banking operations, i.e. Bank of Western Australia and St Andrew's. This resulted in an asset reduction of £33.2 billion. Thus in total the asset reduction would amount to £ 214.2 billion.

74. In addition, an important element of LBG's "forward plan" is the delivery of at least £1.5 billion in cost synergies through the integration of HBOS.

75. Finally, LBG has adopted additional measures since the acquisition of HBOS to reduce the risk of the business, with:

- the replacement of the senior management responsible for the collapse of HBOS: No ex-HBOS executives are on the new LBG Board; of the 9 senior executives reporting to the CEO, only 1 is ex-HBOS; further down the organisation, ex-HBOS managers now make-up only around 30% of the top two layers of management;

- the extension of Lloyds TSB's prudent risk management philosophy, governance and infrastructure across LBG;

- LBG's risk processes have passed an external review by PwC;

- Significant impairments have already been provisioned for in half-year 2009 interim results.

76. Besides the measures described above, whose main goal is to reduce the risk inherent in the lending business and reduce the size of the balance sheet, LBG also plans to create a ring-fenced entity of approximately £71 billion of assets to be sold to address the impact of LBG's State aid on competition in the UK retail markets. LBG has committed to divest a package made of the following assets: the TSB brand, a branch network of at least 600 branches (together with the associated staff), over […] of retail and SME customers, and an existing internet and telephone bank (i.e. IF). The package will have the following characteristics: (i) a 4.6% market share in personal current accounts (with a potential further 2% market share growth in personal current accounts if the purchaser extends the C&G product range to current accounts), (ii) an approximately […] in mortgages, […].

77. In detail, LBG plans to dispose of a retail banking business, consisting of the following elements, including its branches, staff, customers, customer accounts and support infrastructure: (i) TSB brand; (ii) C&G branches mortgage and savings network; (iii) Lloyds TSB Scotland retail branches and its banking license; (iv) supplementary branches in England and Wales, selected to provide broad geographical coverage for a potential acquirer; and (v) Intelligent Finance, a direct bank with current account, mortgage and savings customers.

78. LBG considers that the package is a viable and attractive business proposition for a potential new entrant in the UK retail market. LBG believes that a buyer would acquire a critical mass on the retail banking market.

79. LBG highlights, however, the complexity and the execution risk of the ring-fencing and the creation of an effective standalone entity. In particular, carving out the business into a standalone entity requires the design of a separately identifiable platform and distribution channels to deliver customer and non-customer outputs. In this respect, given the scale and the complexity of the divestment, sufficient time is needed to prepare the carve-out of the divested entity. LBG will therefore seek to carve-out the entity and approach potential buyers within a period of […], and sell it within […]. If the divestment has not been completed by 30 November 2013, a divestiture trustee will be appointed to sell the divested entity at no minimum price.

80. The UK authorities have committed to respect a number of conditions in order to ensure the preservation of the value of the carved-out entity so as to ensure the meaningfulness of the above measures. A more detailed description of these commitments is presented in part 3.3 below.

81. The overall LBG plan is the sum of the viability measures plus the divestment of the entity described above. In aggregate, the LBG forward plan forecasts a reduction of approximately £285.2 billion in assets by 2013 (this includes the viability measures described above, and the planned divestments constituting compensatory measures, estimated at £71 billion, and described in part 3.3 below). At the same time, between 2008 and 2013, LBG envisages a £[…] billion growth in assets not targeted by restructuring, partially related to incremental lending commitments made by LBG to the UK government. Thus, on balance the reduction of assets in this period shall amount to £[…] billion.

3.2. Ability to reach viability under a Base and A Stress scenario

82. LBG has submitted a base and a stress scenario with the aim of demonstrating its ability to achieve long-term viability following the implementation of the restructuring plan described above, but without taking into account the impact of the Seaview project. In particular, the objective was to evaluate both the solvency and the liquidity positions of LBG under a base and a stress case, and to validate their compliance with the FSA capital requirement framework in both cases.

83. The scope of the base and stress test scenarios run by LBG includes the impact of the restructuring plan (reduction of £181 billion of assets and measures limiting the distortions of competition resulting in £71 billion reduction in the banking balance sheet). It excludes any participation in the APS and in the Seaview project (described in part 2.4.3 above).

84. The analysis presented shows that without the additional support (either in the form of the participation in the APS or via implementation of the Seaview project) the bank will not be able to restore long-term viability and compete on the market without further State support in the future.

85. Parts 3.2.1 and 3.2.2 below describe the analyses made by the FSA regarding the base case scenario and the stress case scenario prepared by LBG, assuming the implementation of the restructuring plan but excluding APS and any other capital raising actions (such as the Seaview project). FSA has assessed the assumptions made

by LBG and, when necessary, it applied additional haircuts in order to reflect its more conservative approach.

3.2.1. BASE CASE SCENARIO

86. According to the FSA[14], all the banks that have received State aid should maintain, at least, a Core-Tier 1 ratio of 4%, after applying stress tests. This means that under the base case, banks are expected to have a Core-Tier 1 capital above the […] level.

87. The bank has run its base case exercise using its own macroeconomic assumptions and modeling hypotheses. The FSA has assessed the degree of conservatism of this base case and applied haircuts when necessary, to evaluate the capital position of the bank under a base case and check its compliance with the FSA capital framework. According to the LBG exercise, the bank would comply with the framework under the base case as it would be sufficiently capitalized. […].

88. LBG uses for its base case scenario a set of key economic indicators such as GDP, unemployment, house prices, and inflation evolution from 2009 to 2013. The FSA compared LBG's macro-economic assumptions to an FSA-derived consensus of independent forecasters and concluded that the bank's macro-economic assumptions were […].

89. Under its projected base case scenario, LBG forecasts a return to profitability in […]. In the retail division, a return to profitability is envisaged […] by […], albeit with a level of impairments greater than in […]. In the wholesale division, the return to profitability is […] envisaged by […]. In the Wealth and International division after a peak of impairments in […] and […], the division will be profitable again by […]. As for the insurance division, this has been profitable the last couple of years […].

90. According to the LBG base case scenario, its Core-Tier 1 ratio will remain sufficiently above the 4% threshold[15], to meet the FSA rules, without participating in the APS or undertaking any further management actions or capital raising.

91. However, according to the FSA, because of […], it was necessary to apply some haircuts to the LBG's base case projections. As a consequence […].

3.2.2. STRESS CASE SCENARIO

92. LBG has run its stress test exercise using the macroeconomic assumptions given by the UK tripartite authorities (i.e. the Bank of England, the FSA and HM Treasury). This stress test run is based on a '1980s U' shape scenario. Based on the outcome of the LBG exercise, the FSA has used its own detailed stress testing analysis to assess whether the bank met the FSA capital framework requirements under the stress scenario. The stress scenario reflects the restructuring described in part 3 without taking into account the Seaview project.

93. Under the LBG stress case, the group will return to profitability in […], with impairments peaking in […], and remaining at a high level up to […]. It forecasts an average growth of the pre-impairment operating income of […]% per year.

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[14] http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/bank_capital_.shtml.

[15] Between […]% and […]%.

94. In terms of the evolution of RWA, the overall trend in the stress case shows an increase after […] to peak in […] and decline thereafter. The peak in RWA represents an approximate […]% increase above the […] figure. Moving from the base case to the stress case appears to have material impact on total RWA forecast over the five-year horizon. At the peak in […], stress RWA are […]% higher than base case RWA, which in turn leads to a deterioration of the capital ratio.

95. In conclusion, according to the FSA's assessment […] LBG had to envisage further management actions to raise sufficient capital. The FSA […] has indicated how much additional capital LBG needed to comply with the FSA framework. The Seaview project, through which the bank will raise £[20-30] billion, £20.5 billion in the form of capital raising and management actions of £[…] billion comprising the rest, addresses LBG's need for capital as identified by FSA and is therefore according to the UK authorities essential for the long-term viability of the bank.

3.2.3. CONCLUSION

96. As presented above, the FSA analyses of the base case scenario and the stress scenario for LBG, assuming the implementation of the viability measures (as described in part 3.1 above) and compensatory measures (as described in part 3.3 below) but without the participation in the APS, have indicated that the bank's capital ratios would fall below the minimum level required by the FSA. Therefore LBG decided to implement the Seaview project (as described in part 2.4.3 above), which is supposed to address the deficiencies identified by the FSA in its analyses and should assure that, after its implementation and in conjunction with all the other restructuring measures, LBG will be able to pass the FSA's base case and stress case tests.

3.3. COMMITMENTS OF THE UK AUTHORITIES

97. The UK authorities have undertaken a number of commitments related to the scope of the divested entity on the UK retail market as well as regarding behavioural measures to ensure the preservation of the value of the activities to be divested. These commitments also aim at addressing the issues of burden-sharing and limitation of the distortion of competition resulting from the State support. These commitments are supposed to ensure that planned restructuring measures, including the divestiture on the UK retail market, would be meaningful and that they will be implemented in a most efficient way and as quickly as possible, without harming the financial standing of LBG. The commitments by the UK authorities have been presented in the document called *Term sheet for UK state aid commitments in respect of LBG,* (hereinafter referred to as "the term sheet").

Commitments related to the Disposal of the Divestment Business

98. The Divestment Business is a retail banking business consisting of:

- The TSB brand;
- The banking licence of Lloyds TSB Scotland;
- The branches, including the banking business associated with all branch-based retail personal and SME customers and all branch employees, of Lloyds TSB

Scotland[16], (the Divestment Business shall not include the Lloyds TSB or Lloyds TSB Scotland brands);

- The C&G branches and branch employees, all C&G savings accounts and those C&G mortgages associated with C&G branch-based customers[17] (the C&G brand is not part of the Divestment Business);

- Supplementary branches (as described in the following recital), including the Banking Business associated with all branch-based retail personal customers and their associated SME business and including all branch employees;

- Intelligent Finance, including its brand, customer service agents, business specific systems, customers and accounts[18];

- Sufficient mortgages so that the Divestment Business accounts for 19.2% of LBG's retail mortgage assets at the time at which LBG commences the tender process for the sale of the Divestment Business or, as the case may be, announces its intention to dispose of the Divestment Business by way of an initial public offering (hereinafter referred to as "the Relevant Date");

- Where necessary, sufficient additional savings accounts so that the loan to deposit ratio for the Divestment Business, is not more than the relevant funding gap[19];

- Such back office functions (e.g. HR, risk control) as reasonably required by the buyer, together with an IFA sales team.

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16 The term sheet describes in more detail the Lloyds TSB Scotland component of the Divestment Business in Schedule 3 annexed to the term Sheet. It specifies that this component will include its branches, branch-based employees, branch-based Retail personal customers and branch-based SME customers. The key assets will include the head office in Scotland, 9 network offices (as listed in Schedule 3), 185 branches (80 freehold and 105 leasehold premises); around 200 branch-based Automated Teller Machines, local hardware, the associated fixture and fittings. The schedule describes the related directors, managers and personnel, description of the support functions, organisational structure and services offered by the LTSB Scotland component.

17 The term sheet describes in more detail the C&G component of the Divestment Business in Schedule 4 annexed to the term sheet. The C&G component will include its branches, branch-based employees, savings customers and balances, branch-based mortgage customers and assets. The C&G branch network consists of 164 branches (15 freehold- and 149 leasehold premises) – the UK authorities submitted the list thereof. The schedule describes in detail the personnel of C&G, its organisational structure as well as services it offers.

18 The IF component of the Divestment Business is described in detail in Schedule 5 annexed to the Terms Sheet. It will consists of a direct (internet and telephony) bank that is currently open for business in savings accounts, the Intelligent Finance brand, Stand alone infrastructure, customer service employees and existing savings, mortgage and other customers. Key assets of this component include the specific IF infrastructure (savings and mortgages platform, offset engine and internet services for customers and intermediaries), IF employees (currently operating out of two LBG sites that are shared with other LBG functions; LBG will include one site – not necessarily one of the current IF sites – including telephony capability, and all on-site fixtures and fittings). The schedule clarifies the practicalities related to the IF component, such as its personnel and the offered services (e.g. as for the credit cards and loans servicing – it would be provided through an outsourcing agreement with LBG).

19 The Relevant Funding Gap means the applicable ratio of loans to deposits determined on the basis of Schedule 1 (attached to the Terms Sheet) for the Relevant Date. According to the Schedule the Funding Gap of the Divestment Business will amount to […]% in December 2009, […]% in December 2010, […]% in December 2011, […]% in December 2012, […]% in December 2013 and […]% in December 2014.

99. The supplementary branches shall be those selected by LBG and notified to the Commission at the Relevant Date. The UK authorities commit that these branches will satisfy the following criteria:

- They must be sufficient to ensure that the Divestment Business consists of at least 600 branches in total;

- They must be branches located in England and Wales;

- They must in combination with the rest of the Divestment Business amount to at least a 4,6% share of the PCA market in the UK at the Relevant Date (on a stock basis by reference to the number of accounts), calculated by reference to the market size;

- Their inclusion in the Divestment Business must result in the average retail income per retail customer less impairments per retail customer of the Divestment Business being no less than the average customer retail net Income at the Relevant Date[20];

- The coverage of the supplementary branches shall be such that the Divestment Business has a Reach[21] of at least 43% at the Relevant Date;

- They must be such that the average gross ground floor area of all branches in the Divestment Business is at least $220m^2$ at the Relevant Date.

100. The UK authorities have committed that LBG will identify the Divestment Business and approach potentially interested buyers by no later than 30 November 2011 and it will complete the disposal of the Divestment Business by no later than 30 November 2013. In the event that any of the above deadlines are missed through no fault of LBG (e.g. because of a serious dislocation in the market) the Commission may allow an appropriate extension[22]. However, if the disposal of the Divestment Business has not been completed by 30 November 2013, the UK government will appoint a Divestiture Trustee that will dispose of the Divestment Business at no minimum price[23].

101. Should a buyer of the Divestment Business wish to reduce the funding gap to a level below the relevant funding gap but no less that the retail funding gap, LBG shall to this end (i) reduce the amount of mortgages included in the Divestment Business or, if the buyer prefers, (ii) exercise best efforts to assist the buyer by way of other capital markets transactions, for example by the securitisation of mortgages.

20 The Average Customer Retail Net Income at the Relevant Date means the average income per Retail customer less the average impairments per Retail customer as shown in Retail's most recently available quarterly management accounts.

21 "Reach" means the proportion of the Great Britain population that lives within 2 miles of a branch as defined on a „crow flies" basis. Great Britain population is sourced from the 2001 census, with updates from Office of National Statistics.

22 In such case, the UK authorities will need to obtain an approval following an official notification of a proposed modification of the restructuring plan approved by present decision.

23 To this end the UK Government will propose to the Commission for approval, no later than one month before 30 November 2013 a list of one or more persons whom it proposes to appoint as Divestiture Trustee. The Divestiture Trustee will be appointed within one week of the Commission's approval in accordance with the mandate approved by the Commission. LBG will grant comprehensive powers of attorney to the Divestiture Trustee.

102. The UK authorities commit that the average quality of the mortgages included in the Divestment Business shall be no worse than the average quality of all retail mortgages at the Relevant Date.

103. LBG shall agree with the buyer of the Divestment Business that following a reasonable transitional period after the disposal of the Divestment Business, LBG shall not use the brands of the Divestment Business (including as part of the name of another brand) and the buyer of the Divestment Business shall not use the brands of LBG (including as part of the name of another brand).

104. LBG shall conduct a tendering procedure for the sale of the Divestment Business, which will be adequately publicised. As far as the law permits, bidders will be granted direct access to all appropriate information in the due-diligence procedure.

105. The UK authorities commit that the buyer(s) must:

- together with the rest of the buyer's group, in combination with the Divestment Business have a PCA market share of no more than 14% in the UK at the Relevant Date (on a stock basis by reference to the number of accounts). The buyer(s) must be independent of LBG and must not be connected to LBG within the meaning of Article 11 of Commission Regulation (EC) No 2790/1999 on the application of Article 81(3) of the EC Treaty to categories of vertical agreements and concerted practices[24].

- satisfy the relevant competition authorities that it is in a reasonable position to satisfy all the necessary conditions imposed by the relevant competition authorities as part of any merger control process and by other authorities for the acquisition of the Divestment Business or relevant part thereof.

- satisfy the FSA as to the adequacy of its financial resources (both in respect of liquidity and capital), the competency and experience of the leadership, the adequacy of its risk and control standards, the adequacy of its attitude to customers in terms of fair customer treatment, adequate service and fair pricing, and the long term viability, success and sustainability of the entity, assessed by reference to (amongst other things) its business plan.

106. As an alternative to the sale of the Divestment Business by tender, LBG may at its sole discretion choose to dispose the Divestment Business by way of an initial public offering for all of the shares in an entity that owns the entirety of the Divestment Business.

107. LBG shall exercise best efforts to support the buyer(s) of the Divestment Business in migrating to appropriate infrastructure for the ongoing operation of the business. This support will include reasonable transition support agreements (including an agreement to provide clearing services on market terms and the right to use existing sort codes and account numbers to the buyer for such duration as the buyer may request), covering ongoing operations, customer and product migration and staff training.

108. It is the expected that LBG will dispose of the Divestment Business as a single entity. However, if the Commission is satisfied[25] that the disposal of the Divestment

[24] OJ L 336, 29.12.1999, p. 21.
[25] In such case, the UK authorities will need to obtain an approval following an official notification of a proposed modification of the restructuring plan approved by present decision.

Business in parts will achieve a greater improvement in competition than would have achieved by the disposal of the Divestment Business as a whole, LBG may dispose the Divestment Business in such parts rather than as a whole.

109. For a period of two years following the completion of the disposal of the Divestment Business LBG shall not initiate directed and targeted contact for the purposes of marketing in relation to any Banking Business products with customers of the Divestment Business as at completion of the disposal of the Divestment Business. This prohibition will not apply in relation to customers of the Divestment Business who are also customers of LBG at the time of that contact.

110. Between the Relevant Date and completion of the disposal of the Divestment Business:

- LBG shall carry on the Divestment Business as a going concern in the ordinary and usual course as carried on prior to the Relevant Date.

- LBG shall not initiate any programmes involving directed and targeted contact with customers of the Divestment Business for the purpose of encouraging said customers to leave the Divestment Business.

- Between the date of the decision and the Relevant Date, LBG shall not initiate any programmes involving direct and targeted contact with savings customers of C&G for the purpose of encouraging those customers to leave C&G and to join another part of Retail.

- LBG shall ensure that from the date of the decision to the time at which a sale and purchase agreement has been signed with respect to the Divestment Business (or, in the case of an initial public offering, until the time the prospectus has been issued), its management of C&G, LTSB Scotland and IF is consistent with the commitments ensuring the value preservation of the Divestment Business[26] and that LBG will not actively encourage employees working in C&G, LTSB Scotland or IF to transfer to roles outside of C&G, LTSB Scotland and IF. In particular LBG has to comply with the commitments regarding the policy versus personnel (staffing, training etc.), incentives (e.g. staff recognition), branches maintenance, marketing and products (marketing spending per branch, product availability), sales and services target model and risk, in a way ensuring the preservation of the value of the Divestment Business.

Commitments related to the asset reduction programme

111. The UK authorities have committed that in addition to any asset reduction arising out of the disposal of the Divestment Business, LBG shall undertake an asset reduction programme to achieve a £181 billion reduction in a specified pool of assets by 31 December 2014. The asset pool, proposed asset reduction measures and the related balance sheet amounts as at 31 December 2008 are set out in Table 1 above[27]. Although LBG intends to achieve the asset reduction through the proposed measures specified in this table, the obligation in this paragraph may be satisfied by any combination of measures that has the effect of reducing the asset pool by £181 billion by 31 December 2014.

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[26] These commitments are described in detail in Schedule 6 annexed to the term Sheet.

[27] Presented in the Schedule 2 attached to the term sheet.

Commitments related to behavioural measures

112. The UK authorities have committed that neither LBG nor any of its direct or indirect subsidiaries (save for direct or indirect subsidiaries in LBG's insurance group) shall pay investors any coupon on capital instruments (including preference shares) or exercise any call option rights in relation to the same between 31 January 2010 and 31 January 2012 unless there is a legal obligation to do so. However, the payment of a sum in respect of accrued interest up to the date of settlement for securities exchanged as part of the Seaview project shall be exempted from this prohibition. Furthermore, new capital instruments, i.e. capital instruments issued after 3 November 2009, shall not be subject to the ban on coupons or call options, save for new instruments that are issued in exchange for existing securities where those new securities are not mandatorily convertible into ordinary shares in regulatory stress scenarios. For the avoidance of doubt, the new securities issued as part of the Seaview project (as described in part 2.4.3 above) shall not be subject to the ban on coupons or call options as they convert mandatorily into ordinary shares in regulatory stress scenarios. LBG certifies that the payment of coupons on new instruments will not create a legal obligation to make any coupon payments on LBG's existing lower Tier 2, upper Tier 2 or Tier 1securities and therefore that the payment of coupons on the new instruments will not reduce the effect of the commitment not to pay discretionary coupons on such existing securities.

113. The UK authorities have committed that LBG (i) shall not acquire any financial institutions and (ii) shall not make any other acquisitions whose purpose is to expand LBG's activities outside of its business model, until 31 December 2012 or the date of […] whichever is the later. However, LBG shall be permitted to make such acquisitions if the cumulative purchase price excluding the assumption of debt paid by LBG for all such acquisitions in this period is less than £[between 0-1,500] million.

114. LBG shall not refer to the fact that it enjoys any State support or to the fact that the UK is a shareholder in LBG in any of its advertising.

Fee for the benefits of the announcement of APS availability to LBG

115. LBG has undertaken to pay (or procure that a member of the LBG Group pays) a fee to the UK government of £ 2.5 billion for the benefits to the LBG Group's trading operations arising as a result of the UK government proposing to make the APS available to LBG (or a member of the Group).

Commitments related to the Monitoring

116. The UK authorities have committed that LBG shall appoint, subject to Commission's approval, a monitoring trustee in charge of the overall task of monitoring and ensuring, under Commission's instructions, compliance with the commitments. For that purpose the UK shall propose to the Commission for approval, no later than three months from the date of this decision, a list of one or more persons whom it proposes to appoint as monitoring trustee. The monitoring trustee shall be appointed within one week of the Commission's approval in accordance with the mandate approved by the Commission.

117. LBG shall provide and cause its advisors to provide to the monitoring trustee all such cooperation, assistance and information as it may reasonably require to perform its tasks, including the possibility to appoint advisors. The monitoring trustee shall be remunerated in a way that does not impede the independent and effective fulfilment of its mandate.

118. The UK authorities have also committed to submit regular reports on the measures taken to comply with this decision. The first report will be submitted to the Commission not later than six months after the adoption of this decision. Thereafter, the UK authorities will report at six months intervals.

4. ASSESSMENT OF THE AID

4.1. EXISTENCE OF AID

119. Article 87(1) of the EC Treaty provides that 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.

The capital injection

120. The Commission observes that the State recapitalisation of £17 billion completed in January 2009 was granted in the framework of a scheme. The Commission has already concluded that this scheme constituted State aid in its decision of 13 October 2008 authorising this scheme[28]. The recapitalisation of £17 billion therefore constitutes state aid.

121. As indicated above, in June 2009 LBG raised £4 billion of capital in ordinary shares to reimburse the preference shares held by the State following the January recapitalisation. The State participated in this £4 billion capital raising pro-rata to its 43% shareholding in the bank, namely for an amount of £1.7 billion. The other ordinary shares were subscribed by private investors. In order to determine whether the State participation in this capital raising constitutes aid, it should be assessed whether the State behaved as a market economy investor. The Commission observes that the State has fully underwritten the new shares offered. Indeed, the HM Treasury press release of 7 March 2009 indicated that, in adition to its commitment to subscribe to £1.7 billion of share, the State would subscribe for any additional shares not taken up by existing shareholders. Thus at the beginning of March 2009, at the moment when risk aversion on the markets was at its height and when LBG would not have found investment banks ready to underwrite a new share offer, the State stepped in. It should therefore be concluded that the State's behaviour would not have been acceptable to a private investor in similar circumstances. The risks related to the commitment to purchase £ 1.7 billion of shares and to the commitment to underwrite any part of the remaining £ 2.3 billion capital injection were clearly financed by State resources, selectively granted to LBG, which is a company present in other Member States than the UK and in competition with subsidiaries of banks of other Member States active in the UK market. By underwriting the issue the State enabled the capital raising to take place. The Commission therefore considers that both the £1.7 billion capital injection and the underwriting of the remaining amount of the issue of £ 2.3 billion constitute aid.

[28] See footnote 8.

122. The Commission also notes that £4 billion of preference shares held by the State were reimbursed less than six months after they were issued, i.e. within the rescue period. Rescue recapitalisation granted to LBG being partially repaid (£17 billion less £4 billion), LBG continues to benefit beyond the rescue period from aid amounting to £ 14.7 billion (£ 13 billion plus £1.7 billion). This corresponds to 3% of the RWA at the end of 2008.

The announced but eventually withdrawn asset relief measure

123. Regarding the APS, since the bank decided to abstain from participating in the scheme, the Commission does not have to assess the compatibility of the planned terms of LBG's participation in the APS with the common market.

124. However, the Commission notes that the bank has benefited from the announcement of its participation in the APS jointly made by the bank and HM Treasury on 7 March 2009 by issuing detailed and coordinated press releases. The announcement of this large asset relief measure, which would have had the effect of significantly increasing the bank's capital ratios, reassured the markets regarding the capability to absorb the large impairments expected at the time on its loan portfolio. It is difficult to quantify the advantage received by LBG thanks to this announcement. However, based on the information it has received and building on previous case practice, the Commission considers that the £2.5 billion exit fee which will be paid by LBG to the government is a larger than a standard quantification of the advantage under the State aid practice[29]. The Commission therefore considers that the advantage stemming from the announcement will be offset by the payment of the exit fee. There is therefore no need to take a final view on whether the announcement was an aid or not since, if it was the case, the Commission considers that any aid would be fully recovered[30].

125. As a consequence of the foregoing conclusion, the Commission will not further discuss that measure in this decision.

The State participation in the Seaview project

126. As regards the Seaview project, which is described in part 2.4.3 above, the Commission notes that out of the £13.5 billion rights issue the UK government has committed to provide £5.9 billion in order to maintain its current shareholding of 43.5%. This capital clearly originates from State resources and constitutes a selective measure granted only to LBG.

127. As regards the existence of an advantage stemming from the State's participation in that capital increase, the Commission observes that in the current market circumstances the State participation will significantly facilitate the raising of the £13.5 billion of capital. Without State participation, LBG would have had to raise the

[29] The UK authorities have explained the methodology leading to the above fee, as follows. LBG had announced to investors on 7 March that it would receive a capital benefit, stemming from £15.6 billion in B Shares and a £194 billion reduction of RWA. Assuming a core tier 1 ratio of 8%, the net capital benefit after the regulatory first loss deduction was £7.9 billion. LBG announced that it would not participate in the APS on 2 November, 235 days later. […]. The Commission notes that the cost of capital used to arrive at this fee is much higher than the one laid down in the Recapitalisation Communication. The Commission also considers that counting the entire period until the 2 Nov 2009 is a conservative assumption as during the course of the summer it became public that LBG was considering other options than participating in the APS, thus, the market had less reason to take into account the capital effect of the APS, which became uncertain.

[30] As it is established in the State aid case law, the recovery of the aid eliminates the distortion of competition created by the aid.

whole amount of £13.5 billion on the market instead of having to raise only £7.6 billion. Raising the entire £13.5 billion on the markets in the current circumstances would have been possible, but it would have depressed significantly more the stock market price As a result, LBG would have had more difficulties to finance itself on the markets in the short- and medium-term since a depressed stock market price is taken as a negative signal by both debt and equity providers. The participation of the State therefore represents an advantage to LBG.

128. In order to determine whether the measure is aid, it is also necessary to verify whether the State acted as a market economy investor. In this respect, the UK authorities and LBG claim that a private investor would have participated in the share offer in similar circumstances since the shares are offered to the existing shareholders at a deep discount to the stock market price. Not participating therefore means foregoing the possibility to purchase these shares at a discounted price. The Commission considers that these considerations advanced by the UK authorities and LBG do not mean that the participation in the share offer is not State aid. Rather, the Commission notes that the State's participation in the Seaview project follows other aid measures granted to LBG in recent months, in particular the £14.7 billion capital injection to LBG completed in January and June 2009, which resulted in the current 43.5% shareholding of HM Treasury in LBG. As established in the case-law of the Community courts[31], when assessing the support provided by the State the Commission should take into account any earlier aid measures provided by the State to the same beneficiary. The Commission considers that the State participation in the Seaview project, intended to avoid the loss of State resources which would result from foregoing the opportunity to buy shares at a deep discount to stock market price, cannot fulfil the market economy operator principle. It cannot be considered as free of aid, because the opportunity to buy shares at a deep discount price exclusively results from an aid measure granted in the prior months, i.e. the £14.7 billion recapitalisation. Thus, the Commission considers that the State's participation in the Seaview project must be seen in the context of the earlier State aid granted to the bank. In other words, a private investor would not find itself in the situation of the State since it would not have granted the £14.7 billion recapitalisation.

129. The Commission observes that this advantage to LBG distorts competition and affects the trade conditions among Member States, since LBG is present in other Member States than the UK and since several of its competitors on the UK market are subsidiaries of banks of other Member States.

130. The Commission therefore considers that the State participation in the Seaview project is aid. However, the Commission observes that the advantage to the bank is more limited than the advantage LBG drew from the January and June recapitalisations. At the time of the former, LBG could not have found any bank ready to underwrite such an issue and could therefore not have found that capital on the market and at the time of the latter LBG was able to raise private capital only thanks to the prior underwriting undertaken by the State (see recital 121). Conversely to these tow previous recapitalisations, as regards the Seaview project, LBG could have raised the £13.5 billion capital on the markets, as reflected by the fact that six investment banks had indicated their intention, […], to underwrite […] even if the State did not participate in the share offer. As described above, the State participation has only the effect of facilitating the placing and therefore of reducing the depressing effect on the stock market price and thereby to facilitate LBG's access to financing in the future. In conclusion, the aid element in that the State participation in the Seaview project is

31 Case T-11/95, *BP Chemicals Ltd v Commission*, judgment of 15 September 1998.

significantly smaller than the aid element in the recapitalisation completed in January and June 2009.

4.2. COMPATIBILITY OF THE AID WITH THE COMMON MARKET

4.2.1. APPLICATION OF ARTICLE 87(3)(B) OF THE EC TREATY

131. Article 87(3)(b) of the EC Treaty empowers the Commission to decide that aid is compatible with the common market if it is intended *'to remedy a serious disturbance in the economy of a Member State'.*

132. Given the fact that it is the leading retail bank and one of the leading SME and corporate banks in the UK, given the significance of its lending activities for the UK economy and given its intense financial relationships with other banks, the Commission accepts that LBG is a systemically relevant bank. The Commission further notes that the aid measures were in particular intended to allow Lloyds TSB to finance the take-over of HBOS and thereby to prevent the collapse of HBOS, which, as one of the largest retail banks in the UK, was a systemic banking institution. The Commission, therefore, concludes that the collapse of HBOS and *a fortiori* the collapse of LBG would entail a serious disturbance for the UK financial sector and thus the UK economy. The aid must therefore be assessed under Article 87(3)(b) EC.

4.2.2. THE FRAMEWORK FOR EVALUATING COMPATIBILITY

133. As indicated above, the recapitalisation aid was granted in the framework of a scheme. It was therefore authorised as emergency aid. The decision of 13 October 2008 authorising the scheme provides that the beneficiary banks will have to submit a restructuring plan within six months. In line with the Commission's *Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*[32] (the Recapitalisation Communication), paragraph 27 of the decision of 22 December 2008 amending the scheme provides that no restructuring plan needs to be submitted for recapitalisation aid to firms which are fundamentally sound. The Commission considers that this exemption to the obligation to submit a restructuring plan introduced by the decision of 22 December 2008 does not apply to the present case, given the relative amount of aid received (see recital 136) and the scale of the difficulties experienced by HBOS and therefore of LBG. The UK does not invoke that exemption either. It should therefore be concluded that LBG is obliged to submit a restructuring plan. The present decision accordingly assesses whether the recapitalisation aid received is compatible as restructuring aid based on the notified restructuring plan.

134. As regards the June transaction and the State participation in the Seaview project, it has not yet been approved and constitutes therefore new aid granted in the framework of the restructuring plan. The present decision therefore aims at assessing whether it constitutes compatible restructuring aid based on the notified restructuring plan.

135. The Commission has explained how it will assess restructuring aid on the basis of Article 87(3)(b) in its *Communication on the return to viability and the assessment of*

[32] OJ C 10, 15.1.2009, p.2.

restructuring measures in the financial sector in the current crisis under the State aid rules (the Restructuring Communication)[33]. Even if the decision approving the UK recapitalisation scheme made reference to the *Community Guidelines on State aid for rescuing and restructuring firms in difficulty*[34], point 49 of the Restructuring Communication makes clear that all aid notified to the Commission before 31 December 2010 will be assessed as restructuring aid to banks pursuant to the Restructuring Communication instead of those Guidelines.

136. As regards the applicability of the Restructuring Communication, the Commission observes that point 4 of that Communication clarifies that it does not set new criteria which trigger the obligation to submit a restructuring plan but relies on the Commission's previous Communications. As indicated above, LBG was already obliged to submit a restructuring plan on the basis of the decision of 13 October 2008 authorising the UK recapitalisation scheme. Moreover, the Commission considers that LBG should, in line with point 4 of the Restructuring Communication, submit a restructuring plan, since it has received State aid which altogether exceeds 2% of its RWA. The Commission observes that 2% of LBG's total RWA amounted to £9.9 billion, while the recapitalisation of the bank alone amounted to £14.7 billion. In addition to which, LBG will receive further State aid within the Seaview project[35].

137. The Commission will therefore assess the recapitalisation and the State's participation in the Seaview project under the Restructuring Communication.

4.2.3. COMPATIBILITY UNDER THE RESTRUCTURING COMMUNICATION

4.2.3.1. THE RESTORATION OF VIABILITY

138. Section 2 of the Restructuring Communication sets out that the Member State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability.

139. First, point 10 of the Restructuring Communication requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems. In its restructuring plan, LBG spells out the causes of its difficulties, in particular the risky lending and funding practices of HBOS. The plan focuses on running down all risky portfolios, and on extending Lloyds TSB's prudent risk management philosophy, governance and infrastructure across LBG. Since the risk policy of Lloyds TSB in the past has proved to be prudent and efficient, as shown by the good financial results of that bank in 2008 despite the crisis, the Commission considers that this approach gives assurance that LBG should succeed in addressing the weaknesses that led to the difficulties of HBOS. In particular, the Commission notes that LBG will implement a number of measures to reduce its balance sheet and run-off or dispose its risky activities (as described in recitals 71 and 72). This includes reducing exposure to […]. The Commission considers that these actions will help remedy the bank's previous problems, in particular the high funding gap of the bank.

[33] OJ C 195 of 19.08.2009, p. 9.

[34] Cf. OJ C 244 of 1 October 2004, p. 2. Reference to these Guidelines was made in paragraph 54 of the decision of 13 October 2008 on the recapitalisation scheme.

[35] It total the bank will benefit from restructuring recapitalisations of £14.7 billion and £5.9 billion, totalling £20.6 billion, which amounts to 4.1% of the bank's RWA sum.

140. In addition to this commitment to run down £181 billion of risky assets, the plan also indicates that that LBG will focus its strategy on cross-selling rather than gaining market shares with risky lending practices. It will also seek to reduce its funding gap from 166% in 2008 to [110-150]% in 2013. The restructuring plan illustrates that LBG is adapting to the lessons learned from the crisis, in line with point 11 of the Restructuring Communication.

141. These restructuring measures also illustrate that, as envisaged by point 12 of the Restructuring Communication, LBG's plan is mainly based on internal measures and includes withdrawal from activities which would remain structurally loss-making in the medium-term.

142. The Restructuring Communication also provides that the restructuring plan should demonstrate how the bank will restore its long-term viability without State aid as soon as possible. In particular, the bank should be able to generate appropriate return on equity, while covering all costs of its normal operations and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Communication indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.

143. The Commission considers that the plan and the Seaview project demonstrate how LBG will show adequate profitability, allowing it to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of its risk profile. The Commission notes that the projections provided are based on reasonable underlying macroeconomic assumptions. In particular, the Seaview project, together with the restructuring plan will allow LBG to comply with the relevant regulatory requirements even in stress scenarios with a protracted global recession in line with point 13 of the Restructuring Communication.

144. The execution of the Seaview project will ensure the viability of LBG in both base and stress scenarios. As described in part 3.2.2, the FSA's analysis of the stress case scenario concluded that LBG would have had a capital shortfall of up to £[20-30] billion. The Seaview project addresses this shortfall through the raising of £[20-30] billion of equity and through the issue of the instruments, which will automatically convert to loss absorbing or to the equity in the stress scenario (which is triggered by the core capital falling below the 5% level). The Commission considers that the assumptions for these analyses are reliable and that they are sufficiently prudent to allow the conclusion that the restructuring measures undertaken by the bank will be sufficient to ensure its long-term viability.

145. A comparison of the key economic indicators under the base case with other independent projections indicates that LBG's own forecasts are […][36]. […], considering the review made by the FSA and the conservative haircuts it applied to the forecasts, the outcome of the FSA analysis has built up a sufficiently conservative buffer in the LBG base case outcome.

146. As regards the stress test macroeconomic assumptions used, they are deemed to be sufficiently severe to be considered to be a stress scenario. Therefore, the Commission considers that stress scenario presented (as described in part 3.2.2) indeed demonstrates that the bank will be able to compete on the market without State support

[36] For example, the comparison with the actual macroeconomic results observed for the second and third quarter of 2009 shows that the initial forecast was […].

even if the situation on the market deteriorates as compared to generally assumed market conditions.

147. Overall, the information submitted by the UK authorities indicates that the main issue relating to the overall viability of the group remains its […] funding position. Although it represents some improvement from the low point observed during the final months of 2008, the Commission notices that the bank still relies significantly on the UK government-guaranteed debt issuance scheme (Credit Guarantee Scheme, "CGS") and the Bank of England's Special Liquidity Scheme ("SLS"), which respectively provided it with £[…] billion and £[…] billion of funding, according to the information available to the Commission[37]. However, the Commission considers that the implementation of the measures described above, in particular the discontinuation of lending in risky business segments, will reduce the bank's funding needs and therefore the funding gap.

148. However, despite these elements, the thorough analysis run by the supervisory authority and the degree of conservatism built in when assessing the capital needs of LBG to pass the FSA capital framework, give sufficient comfort to the Commission to assure that the implementation of the Seaview project and of the restructuring plan will lead to the restoration of the long-term viability of the bank.

149. In addition, the Commission observes that LBG's year-to-date performance shows that the bank is performing […] forecasts, both in terms of pre-impairment operating income, and RWA consumption. This gives further confidence that the restructuring plan is well on track to restore long-term viability.

150. Taking into account the above elements and the fact that the restructuring plan has been validated by the FSA (the Commission has analysed the review of the plan made by the FSA), the Commission considers that the restructuring plan and LBG's decision to implement the Seaview project will enable the bank to continue to meet the FSA capital requirements.

151. In conclusion, the Commission considers that the restructuring plan of LBG, together with the Seaview project, is necessary and sufficient to ensure the restoration of the long-term viability of the bank.

4.2.3.2. OWN CONTRIBUTION OF THE BENEFICIARY

152. The Restructuring Communication indicates that an appropriate contribution by the beneficiary is necessary in order to limit the aid to a minimum and to address distortions of competition and moral hazard. In particular, it provides that (i) the restructuring costs should be limited while (ii) the aid amount should be limited and a significant own contribution is necessary.

[37] It can not be excluded that the UK authorities will request a prolongation of the CGS and that the Commission would, after an assessment of the situation on the financial markets, authorise this prolongation in a decision. In such a case, the Commission considers that the participation of Lloyds for an additional 6 months for an amount comparable to current use would be covered by the present decision. Any participation of Lloyds beyond end June 2010 or for an amount superior to what has been observed until now is not covered by the present decision and would need to be notified by the UK authorities.

Limitation of the restructuring costs

153. The Restructuring Communication indicates in point 23 that the restructuring aid should be limited to cover the costs which are necessary for the restoration of viability.

154. The Commission considers that this requirement is satisfied in the present case for the reasons set out below.

155. The Commission notes that the first recapitalisations of LBG were necessary to improve the bank's capital ratios and to improve its ability to absorb losses, originating mainly from the HBOS legacy business[38].

156. As regards the Seaview project, the Commission notes that it was actually recommended by the FSA – an independent supervisory authority which concluded that capital raising of that magnitude would be necessary to ensure long-term viability of the bank.

157. Furthermore, the Commission also notes positively the commitment of the UK authorities that the beneficiary will not acquire any financial institutions and shall not make any other acquisitions to expand the LBG's activities until 31 December 2012 or the date of […] whichever is later[39]. This gives additional assurance that the restructuring plan and costs will be focused on restoring the viability of the core existing activities and that the bank will not use its own resources or the State support for external growth.

158. On the basis of the above elements, the Commission concludes that the restructuring costs are limited to the minimum necessary. This ensures that the State aid is not directly or indirectly used to finance market-distorting activities not linked to the restructuring process, such as the acquisition of other undertakings.

Limitation of the amount of aid, significant own contribution

159. The Restructuring Communication indicates that, in order to keep the aid limited to a minimum, the banks should first use their own resources to finance the restructuring. The costs associated with the restructuring should not only be borne by the State but also by those who invested in the bank. This objective is achieved by absorbing losses with available capital and by paying an adequate remuneration for State interventions.

160. First, the Commission has to verify whether the aid amount is limited to the minimum necessary. In this respect, the Commission observes that, as regards the £17 billion recapitalisation completed in January 2009, the shares were offered to the shareholders but were not subscribed. The State only purchased the shares not subscribed by the market. This ensures that the aid is limited to the minimum and that alternative financing could not be found on the market. As regards the £1.7 billion recapitalisation completed in June and the State participation in the Seaview project, the State does not subscribe to shares not taken up by shareholders since these shares were never offered to the shareholders. The State participates in these recapitalisations in order to be able to purchase shares at deep discount to the stock market price, a possibility to which it is entitled as an existing shareholder of the bank following the £17 billion recapitalisation of January 2009. The Commission observes that the UK government will not subscribe to more shares than those to which it is entitled based

[38] See recital 49.
[39] See recital 112, referring to the term sheet listing the commitments by the UK authorities.

on its current shareholding in the bank. In the very specific circumstances of the case, the Commission therefore considers that the aid is limited to the minimum.

161. As regards the contribution of LBG to the financing of the restructuring costs, the Commission observes that, in addition to the divestment of the Australian retail and business banking operations (Bank of Western Australia and St Andrew's) completed by HBOS in October 2008, […]. In addition, as regards its retail activities, the bank will sell the divestment package described previously. The Commission considers that these measures contribute to compliance with point 24 of the Restructuring Communication, which requires that banks should first use their own resources to finance restructuring, by, for instance, the sale of assets.

162. Furthermore, through the Seaview project, the bank will raise £7.6 billion of equity on the markets. Therefore, the Commission considers that this measure will bring in a significant private contribution to the financing of the restructuring costs.

163. As regards the existing shareholders, they have been diluted by the State and private recapitalisations described above. In that way, they bore the consequence of the losses registered by LBG.

164. Finally, as regards the subordinated debt holders, the Commission notes positively that LBG will comply with the Commission's policy on Tier 1 and Tier 2 capital instruments set out in point 26 of the Restructuring Communication[40]. As described in recital 112 above, LBG will shall not pay investors any coupon on capital instruments or exercise any call option rights in relation those instruments between 31 January 2010 and 31 January 2012 unless there is a legal obligation to do so. Furthermore, LBG commits not to pay coupons on any newly issued securities offered in exchange for any existing securities instrument, which the Commission considers necessary to avoid a circumvention of the coupon ban.

165. However, this commitment does not apply for securities issued as part of the Seaview project. The Commission accepts that LBG did not commit not to pay coupons on newly issued instruments (i.e. instruments issued at the earliest in the framework of the Seaview project), considering, in line with point 26 of the Restructuring Communication, that the payment of coupons on new instruments will not create a legal obligation to make any coupon payments on LBG's existing lower Tier 2, upper Tier 2 or Tier 1 securities. Existing securities affected by the coupon ban can be exchanged for newly issued instruments not affected by the coupon ban if the latter are mandatorily convertible into ordinary shares in case of stress. For instance, a majority of the new instruments issued in conjunction with exchange offers in the framework of the Seaview project will provide for non-discretionary coupon payment (i.e. there is a legal obligation to pay the coupon) but they will be mandatorily convertible into ordinary shares in case of the bank's Core-Tier 1 ratio falling below 5%. The conversion price will be the ordinary shares market price at the time of exchange (i.e. end of 2009) which means that the holders are likely to suffer a material loss upon conversion as it is probable that the share price would have dropped upon such a severe deterioration of the capital position of the bank. The Commission believes that this mechanism is an adequate burden sharing mechanism and constitutes a contribution of the existing securities holders to the Core-Tier 1 capital which LBG needs now in order to pass the FSA stress test. For these reasons, the Commission can accept that existing securities subject to the coupon ban can be exchanged for newly issued instruments with mandatory conversion to ordinary shares which are not

[40] Cf. 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.

affected by the coupon ban (i.e. they are not affected since they are newly issued instruments).

166. The Commission notes also that the ban on coupon payments and dividends as well as on calls on securities will only start from 30 January 2010 as opposed to the date of adoption of the present decision. However, the Commission understands that this delay is necessary to allow for the successful closing and settlement of the entire Seaview project[41]. As mentioned before, the Commission believes that a successful completion of the Seaview project is at the core of LBG return to long-term viability. The ban on securities' coupon, dividends and calls will run for a period of two years from 31 January 2010.

167. The insurance business, Clerical Medical and Scottish Widows, is not covered by the commitment not to pay coupon for the following reasons. These are wholly-owned subsidiaries of LBG, profitable and expected to remain profitable for the foreseeable future. Clerical Medical and Scottish Widows are expected to maintain a robust regulatory capital position and to continue pay dividends out of their distributable reserves to LBG. The LBG's forecast capital plan for 2010 and 2011 includes dividends from the insurance subsidiaries to LBG of £[…] million in 2010 and of £[…] million in 2011 respectively, i.e. a total of £[…] billion over the next two years. There are three outstanding securities which have been issued by Clerical Medical and Scottish Widows. The total amount of coupons which would be paid on these securities over the next two years is £[less than 100] million (sterling equivalent). All coupons are cumulative so the obligation to make the payment of £[less than 100] million would remain if a deferral were to be imposed. The contractual terms of the securities include a dividend stopper on the insurance company ordinary shares which are held by the LBG. This dividend stopper would prevent the payment of dividends to LBG in circumstances where there is no payment of coupons on the insurance securities. As a result, if the above commitment not to pay coupon were to apply to the three outstanding securities issued by Clerical Medical and Scottish Widows, then the contractual dividend stopper would prevent the expected dividend flow from those insurance companies to LBG over the next two years. In result LBG would not receive in the next two years expected dividends of £[…] billion. This would have a negative impact on the group's consolidated capital ratios during these years, which are those during which the bank is the most vulnerable. LBG relies on these payments in its restructuring plan. LBG has indicated that the payment of the coupons on the three securities issued by Clerical Medical and Scottish Widows will not trigger any coupon payments in the other entities of the group. Thus, taking into account the above considerations, and in particular that LBG is undertaking an in-depth restructuring and that other burden-sharing measures are put in place, the Commission considers that it is acceptable to exclude these three securities from the above ban on coupon payments, since not paying these coupons represents a danger for the return to viability which, in a restructuring context, needs to be balanced against the need for an adequate burden-sharing.

168. On the basis of the above elements, the Commission concludes that the beneficiary, its shareholders and its debt holders provide for a significant own contribution to the restructuring costs.

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[41] As mentioned in recital 61, a small part of the exchange offer will come in the form of ordinary shares. To physically effect this exchange, LBG will have to buy back to relevant exchanged existing securities and issue new ordinary shares to their holders. Due to contractual provisions in the terms of some of these existing securities, a non-payment of any coupon will prevent any buy back of the relevant securities to be exchanged against ordinary shares.

169. As regards the adequacy of the remuneration of the State interventions, the Commission has reached the following conclusions.

170. First, the Commission considers that the State will receive an adequate remuneration for the capital injected in the bank. This assessment was carried out in the decision of 13 October 2008 approving the UK recapitalisation scheme. The State purchased the shares[42] at a discount to the stock market price prevailing at the time of the announcement of the recapitalisation. As regards the £1.7 billion of shares subscribed in June, they were also purchased at a price lower than the stock market price at the time of the announcement of the shares offer. This ensures that the price paid tends to correctly reflect the market value of the shares and is in line with the requirement laid down in the Annex to the Recapitalisation Communication.

171. Second, the Commission considers that the State participation in the Seaview project will be adequately remunerated. On the one hand, the State will receive an underwriting fee since it committed to participate in the share offer before it was officially launched. On the other, it will purchase the shares at a discount to the stock market price at the time of the announcement and the purchase price will be the same as the other private investors participating to the offer. This ensures that the price paid tends to correctly reflect the market value of the shares and is in line with the requirement laid down in the Annex to the Recapitalisation Communication.

172. Third, the Commission also considers that, as concluded in the decision of 13 October 2008 approving the guarantee scheme, LBG will pay an adequate remuneration for the State guarantees on medium-term liabilities. This fee is also in line with the requirements laid down in 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*[43].

173. The Commission concludes that the State interventions are adequately remunerated. This contributes to ensuring that the aid is limited to the minimum and that the bank and the existing shareholders bear the largest part possible of the restructuring costs.

174. On the basis of the above elements, the Commission concludes that the restructuring plan of LBG ensures that the restructuring costs are limited to the minimum necessary, that the aid is limited to the minimum (notably because it is adequately remunerated) and that the beneficiary, its shareholders and its debt holders provide for a significant own contribution to the restructuring costs. The plan thus complies with section 3 of the Restructuring Communication.

4.2.3.3. MEASURES ADDRESSING DISTORTIONS OF COMPETITION

175. The Restructuring Communication requires that the restructuring plan proposes measures limiting distortions of competition and ensuring a competitive banking sector. In this context, it should also address moral hazard issues and ensure that State aid is not used to fund anti-competitive behaviour.

176. As regards the measures limiting the distortion of competition, the Restructuring Communication indicates that the Commission has to take into account in its assessment the amount of aid, the degree of burden-sharing and the effects the position

[42] Purchase price net of the underwriting fee received by the State.

[43] OJ C270, 25.10.2008

the financial institution will have on the market after the restructuring. On the basis of that analysis, suitable compensatory measures should be put into place.

177. The Restructuring Communication indicates in point 30 that the measures to limit the distortion of competition created by the aid should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability after restructuring. The Commission in its assessment should take as a starting point the size, scale and scope of the activities of the bank. Furthermore, the nature and the form of the measures will depend on the amount of aid and the conditions and circumstances under which it was granted and on the characteristics of the markets on which the bank will operate.

178. The Restructuring Communication notes in point 31 that when assessing the amount of aid and the resulting distortions, the Commission has to take into account both the absolute and relative amount in relation to the beneficiary's RWA. In this respect the Commission notes that, with the £14.7 billion recapitalisation, LBG received an amount of aid equal to 3% of its RWA at the end of 2008. Through the State participation in the Seaview project, it will receive a further £5.9 billion recapitalisation, which will bring the total restructuring aid in the form of recapitalisations to £20.6 billion, which is equal to 4.1% of RWA. Normally, for companies in financial difficulties, which have no access to market funding, and in particular in a situation of a wide-spread crisis, the aid element of State capital injections equals to the nominal value of the recapitalisation. However, considering the specific circumstances of the case, namely the concrete features of the Seaview transaction (clear indication by investment banks of their readiness to underwrite the whole issue independent of the State's participation; State's participation on *pari passu* terms with private investors), the Commission recognises that the distortive effect of the £5.9 billion recapitalisation is more limited than in normal recapitalisations of companies in financial difficulties. In addition the Commission recalls that LBG has also obtained aid in the form of State guarantees. As for companies in financial difficulty, if the bank is not able to raise sufficient non-guaranteed debt to cover all its funding needs, the Commission considers that the aid element of such guarantees might go up to the level of their nominal value[44]. In these circumstances, the distortive effect of such guarantees might be better assessed by comparing the guaranteed debt to the overall funding of the bank, which in case of LBG corresponded on 31 September 2009 to only about [below 5]%[45].

179. As regards the position of LBG on the market, the Commission notes that the bank is the market leader in the UK retail market, and in particular for current accounts and the mortgages. The PCA market is concentrated in the UK, with the four largest banks having together a market share of 76%[46]. LBG has an average market share in PCAs of [20-30]% in Great Britain, but this share varies in the different regions. In 2008, the combined market share of Lloyds TSB and HBOS in Scotland amounted to [40-50]%. In England and Wales, it amounted to [20-30]%. In Northern Ireland only Halifax (one of the brands that belonged to HBOS) was present with a market share of [5-15]%. The market share of LBG on the PCA and mortgage markets in the UK has been strongly reinforced by the acquisition of HBOS, which had respectively a market share

[44] Cf Commission decision Commission Decision in case C 9/2008 of 4 July 2008 *SachsenLB*, not yet published, Commission decision of 29 May 2009 in case N 264/2009; Rescue aid to *HSH Nordbank AG*, OJ C 179, 1.8.2009, p. 1, Commission Decision of 7 May 2009 in case N 244/2009 *Commerzbank*, OJ C 147, 27.6.2009, p. 4.

[45] This represents the amount of the State-guaranteed debt under the UK Credit Guarantee scheme (£[…] billion) over the total liabilities (excluding equity) of LBG's pro-forma balance sheet of December 2008.

[46] 12 months ending March 2009.

close to [10-20]% and close to [20-30]% on these two markets. In this respect, the Commission observes that the successful completion of this merger was made possible only thanks to the State aid. Without this aid, Lloyds TSB would have had to abandon the merger, since the aid was necessary to cover the expected losses of HBOS. Thus, the Commission considers that the merger would not have taken place without the aid and therefore the resulting increased concentration on the PCA and mortgage market would not have taken place.

180. As described in part 2.2 above, LBG's UK share is also in excess of 15% in the following segments of the retail market: savings, credit cards, other personal loans and SME banking.

181. The Commission therefore concludes that the amount of aid to the beneficiary is significant and the position of the bank on the UK market, in particular in certain segments and certain regions, is very significant. Furthermore, the circumstances in which the aid was granted indicate that the aid allowed Lloyds TSB to acquire HBOS and so to significantly increase its market shares and to eliminate a challenger[47], in particular on certain segments of the markets which were already concentrated and featured low switching rates among customers[48]. Consequently, measures are necessary in order to remedy this distortion of competition created by the aid.

182. A second type of distortion of competition is the fact that the aid allows HBOS, which is now part of LBG, to be rescued and to continue to operate on the markets. In this respect, the Restructuring Communication explains that distortions of competition can be created where banks compete on the merits of their products and services, whereas others accumulate excessive risks and/or rely on unsustainable business models. State aid prolongs such distortions of competition by artificially supporting the market presence of beneficiaries. In this way it may create moral hazard for the beneficiaries, while weakening the incentives of the non beneficiaries to compete, invest and innovate. These considerations apply to HBOS, which is now part of LBG.

183. The Commission considers that the restructuring plan by LBG, including the compensatory measures described in part 3.3, entails sufficient structural and behaviour measures to address these two types of distortions of competition.

184. First, the Commission notes that the adequate remuneration of the State support granted to LBG (as assessed in recitals 169 - 173) contributes to limiting the distortion of competition created by the aid.

185. Second, as described in part 3.3 above, the Commission observes that LBG will divest 600 branches in the UK retail market, representing a 4.6% share in the UK PCA market, and 19.2% of LBG's share in the mortgage market[49]. The Commission considers that the carve-out committed by LBG is an appropriate vehicle because with 600 branches, […] customers and assets up to £70 billion the divested entity has a significant size and is likely to constitute a viable business in the future that can compete in the retail banking business in the UK.

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47 The FSA has observed that smaller banks like HBOS tend to behave like challenger, in the sense that they try to increase their market shares by decreasing price. Conversely, the four biggest banks (Barclays, Royal Bank of Scotland, Lloyds TSB and HSBC) tend to behave like harvesters, in the sense that they focus on extracting value from their existing clients.

48 This is the case for the PCA market.

49 Based on the current market share of LBG, this would correspond to a market share of around 5%. However, LBG plans to reduce its presence on that market in the coming years.

186. As regards its market share in the PCA market, the Commission observes that the divested entity has the potential to grow further by broadening the product range offered by the C&G network – until now limited to saving products and mortgages – to current accounts[50].

187. The Commission also notes that the regions where LBG has the strongest position are well targeted by this divested entity. In particular, in Scotland, where the market shares of LBG on the PCA market is around [40-50]%, LBG will divest the Lloyds TSB Scotland branch network, which has a market share of around [10-20]%. Conversely, the divested entity will not include any activity in Northern Ireland, where the market share of LBG is low.

188. The Commission regards that the divested entity adequately addresses the distortion of competition created by the merger between Lloyds TSB and HBOS, which most likely wouldn't have taken place without the State aid. Furthermore, the Commission considers the divested entity as an appropriate means of increasing competition on the concentrated UK retail banking market. With the TSB brand, the Lloyds TSB Scotland branches, the C&G branches, supplementary branches assuring proportional geographical coverage and Intelligent Finance, the carved-out entity will constitute a sufficiently attractive target for some competitors wishing to enter the UK market or expand their presence there.

189. The Commission notes positively the behavioural commitments provided by the UK authorities and described in more detail in part 3.3 above. The commitments such as the appointment of a monitoring trustee and the non-solicitation of the clients of the divested entity will ensure that this entity is not hollowed out and remains viable. Furthermore, in case the business is not sold by 30 November 2013, after that date, the Commission can make sure that the business is sold with the help of a divestiture trustee who can sell the business at no minimum price. All these elements are appropriate to ensure that the entity will be viable and sold, and therefore will add competition to the UK retail banking market.

190. To ensure that such divestment does not result in the strengthening of some of the leading players, the Commission notes the commitment that the buyer's market share in the PCA market may not exceed 14% after the purchase of the divested entity. The Commission also notes positively the condition that the buyer will have to be vetted by the FSA and have the sufficient resources and incentive to maintain and develop the divested entity. The 14% market share ceiling has been based on the OFT analyses. Both, this ceiling as well as the required approval by the FSA ensure that the planned divestment of part of the LBG's business would lead to increased competition on the concentrated UK retail banking sector by introducing a challenger.

191. In addition to the sale of the divested entity, which includes assets accounting for 6% of the LBG balance sheet at the end of 2008, the Commission observes that LBG will also runoff £ 180 billion of assets, which is equivalent to 16% of its balance sheet at the end of 2008. In addition, HBOS already sold its Australian subsidiary in 2008. In total, all these measures cover assets equal to 25% of the LBG balance sheet at the end of 2008.This is a significant reduction in the business activities of LBG (and of its acquired entity HBOS) which, with the measures described in the section "Own contribution of the beneficiary", adequately address the issue of moral hazard and prevent the creation of perverse incentives.

[50] LBG estimates this potential increase to be 2%. The Commission considers that it is a top of the range estimation, based on optimistic assumptions. Indeed, switching rates on this market are very low.

192. Moreover, the UK authorities has also committed to an acquisition ban (as described in recital 113 above)[51]. This prevents LBG from using the State aid and its State-supported operations to purchase competitors or to grow externally at the expense of other financial institutions.

193. Finally, the UK authorities commit that LBG will refrain from referring to the fact that it enjoys any State support or to the fact that the UK government is a shareholder in LBG in any LBG advertising.

194. On the basis of the above elements, the Commission considers that the scale and nature of measures proposed by LBG are sufficient and adequate to address the distortions of competition created by the aid.

195. At the same time, the Commission notes that according to the commitments by the UK authorities the buyer of the divested entity must have sufficient resources and incentive to maintain and develop the divested entity, which gives an assurance that the business will continue to be run as a going concern. Furthermore the Commission notes that the lending commitments given by LBG to the UK government at the beginning of this year regarding the retail and SME customers will be maintained at the same level. To conclude, the Commission considers that sufficient measures have been undertaken to ensure that the divestment would have no negative impact on the supply of lending for the UK retail and SME customers.

4.2.3.4. MONITORING

196. The UK authorities have committed to submit regular reports on the measures taken to comply with this decision. The first report will be submitted to the Commission not later than six months after the adoption of this decision, as sought by point 46 of the Restructuring Communication. Thereafter, the UK authorities will report at six months intervals.

4.2.4. CONCLUSION ON THE COMPATIBILTY UNDER RESTRUCTURING COMMUNICATION

197. The Commission concludes that the restructuring plan and the associated commitments are appropriate to enable LBG to restore its long-term viability, sufficient in respect to burden-sharing and appropriate and proportional to offset the distortions of competition created by the aid measures. The Commission therefore considers that the submitted restructuring plan and the associated commitments fulfil the criteria of the Restructuring Communication. The recapitalisation of £17 billion, which was already approved as emergency aid, the transaction of June 2009 which lead to the net reduction of the aid to £14.7 billion, the State participation in the Seaview project and the guarantees already issued and planned (see footnote 37) in the context of restructuring of LBG can therefore be considered as compatible restructuring aid on the basis of Article 87(3)(b) of the EC Treaty.

5. CONCLUSION

198. The Commission has accordingly decided to consider the State recapitalisation of LBG of £17 billion, the transaction of June 2009, which led to the reduction of aid to

51 Cf Commission Decision of 7 May 2009 in case N 244/2009 Capital injection into Commerzbank, OJ C 147, 27.6.2009, p. 4, at para. 111.

£14.7 billion, the State participation in the Seaview Project and the guarantees already issued and planned (see footnote 37) in the context of the restructuring of LBG to be compatible with the common market.

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