EUROPEAN COMMISSION

Brussels, 14.12.2012
C(2012) 9657 final

Subject: State Aid SA.35755 (2012/N) – United Kingdom
Second Prolongation of the National Loan Guarantee Scheme

Sir,

I. Procedure

1. On 10 February 2012 the United Kingdom (hereinafter "UK") government notified the original National Loan Guarantee Scheme (hereinafter "NLGS"), which was approved by the European Commission (hereinafter "Commission") in its decision of 14 March 2012 in State aid case SA.34218 (2012/N) (hereinafter the "original decision")[1].
2. On the basis of a subsequent notification, the Commission approved the prolongation of the NLGS until 31 December 2012 in its decision of 26 June 2012 in State aid case SA.34908 (2012/N) (hereinafter "the first prolongation decision")[2].
3. On 29 November 2012, the UK authorities notified a second prolongation of the NLGS.

[1] OJ C 119, 24.4.2012, p. 4.
[2] OJ C 284, 20.09.2012, p. 4.

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II. Description of the NLGS

4. The NLGS is a credit easing scheme introduced by the UK to improve borrowing conditions of middle-caps and small businesses with an annual turnover below £50* million (hereinafter "end-borrowers") in the UK so as to restore stability to the financial system and to remedy a serious disturbance to the economy of the UK. The NLGS is described in detail in the original decision.

2.1. General description of the NLGS

5. The objective of the NLGS is to reduce the cost of finance for end-borrowers via financial institutions.[3] To that end, the NLGS provides government guarantees to participating banks, reducing their funding costs. Banks are contractually obliged to pass on the lower cost of funding to their clients in the form of discounted loans or loans with an up-front cash-back incentive. The total size of the NLGS is up to £20 billion of guarantees.

6. The NLGS approved under the original decision has been modified. The modifications, which took effect as of adoption of the first prolongation decision, are described in detail in recitals 6 to 36 of that decision. All other conditions of the NLGS remain unchanged and all the commitments made in relation to the NLGS as set out in the original and the first prolongation decisions continue to apply.

   In summary, those commitments are as follows:

   Scheme Participants:
   - HM Treasury will grant aid measures under the NLGS only to solvent financial institutions which meet capital requirements;
   - HM Treasury will ensure that the NLGS will be open to all financial institutions that are incorporated in the UK (including UK subsidiaries of foreign institutions), are licensed to take deposits, are regulated by the UK Financial Services Authority or an EU regulator, are considered to be financially viable, have a track record of lending to small businesses and have a significant role in the UK banking system;

   Debt Instruments:
   - HM Treasury will grant the guarantees under the NLGS only for new issuance of commercial bank senior debt (subordinated debt is excluded);
   - HM Treasury will provide guarantees only on debt instruments with maturities from one year up to five years. The minimum fee payable for guarantees on debt instruments with maturity longer than three years will be 10% higher compared

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* Should read £250

3 For the convenience of the reader, financial institutions are simply referred to as "banks".

to the minimum fee applicable to guarantees on comparable debt instruments with a maturity of one to three years;

- HM Treasury will ensure that the guarantee fee on FX issuance will not be lower than the minimum fee, plus 5% of the minimum fee;
- HM Treasury will complement reports on the operation of the NLGS with updated available data on the cost of comparable (by nature, volume, rating, currency) non-guaranteed and guaranteed debt issuances;
- HMT will communicate to the Commission, within three months following each issuance of guaranteed bonds, the actual fee charged; and report on the operation of the NLGS and on guaranteed and non-guaranteed issuance by 15 April 2013 (for the period 1 January 2013 to 31 March 2013) and by 15 July 2013 (for the period 1 January to 30 June 2013) at the latest.

State Aid:

- HM Treasury commits to determine the minimum level of State guarantee remuneration according to the formula set out in the Commission's Communication on the application, from 1 December 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis (hereinafter "the 2011 Prolongation Communication")[4] and to enable the Commission to assess the effective application of that pricing;

- HM Treasury will submit individual restructuring or liquidation plans, within six month, for banks that default on their liabilities and/or which cause the guarantee to be called upon;

- HM Treasury commits to present a viability review for every financial institution that is granted guarantees on new liabilities or renewed liabilities for which at the time of the granting of new guarantee, the total outstanding guaranteed liabilities (including guarantees accorded before the date of this decision) exceed both a ratio of 5% of total liabilities and the total amount of EUR 500 million. The viability review should be presented on the basis of the parameters established in the Restructuring Communication[5] within three months of the granting of the guarantees;

[4] Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis, OJ C 356, 6.12.2011, p. 7.

[5] Commission communication on the return to viability and the assessment of the restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195 of 19.8.2009, p. 9.

- HM Treasury will ensure that, in line with the point 27 of the Banking Communication[6], the beneficiaries of the NLGS do not engage in a market conduct that would be irreconcilable with the purpose of the guarantee.

De minimis aid to end-borrowers:

- HM Treasury will ensure that the actual selection of end-borrowers by participating banks is in line with the principle that the NLGS is operated in a fair and non-discriminatory way;
- HM Treasury commits to ensure that the benefit will be passed on end-borrowers in compliance with the de minimis Regulation[7] and that all the benefit will be passed through within ten years of the last date of issuance under the NLGS;

In addition, HM Treasury commits:

- to ensure and monitor that the set-up and on-going costs are confined to additional administrative costs directly incurred by the operation of the NLGS and do not exceed what is necessary to cover those costs;
- to ensure that the above expenses incurred under the NLGS charged by the institutions will be subject to audit by the banks‘ own internal audit and signed by an authorised signatory;
- to report to the Commission on the level of costs above after they have received and validated each set of claims from each bank.

III. Delivery of the NLGS since the launch of the scheme

7. The UK authorities submitted along, with to the notification of 29 November 2012 and in line with previous commitments, a report that outlines the delivery of the NLGS since the scheme's launch.
8. According to that report, four banks formally joined the NLGS at the time of its launch – Barclays plc, Lloyds Banking Group plc, the Royal Bank of Scotland plc and Santander UK plc. So far none of the smaller UK lenders has joined the scheme.
9. Only two banks have so far issued NLGS-guaranteed debt, Barclays plc in the amount of £1.5 billion and Lloyds Banking Group in the amount of £1.4 billion. The fees that Barclays and Lloyds paid to HM Treasury for the guarantees were calculated according to the pricing mechanism described in the original decision in recitals 21 to 24 and in recitals 13 to 18 of the first prolongation decision. Consequently those banks passed through the benefit of lower funding costs to end-

[6] Communication from the Commission – The application of the State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis OJ C 270, 25.10.2008, p. 8.

[7] Commission Regulation (EU) No 360/2012 of 25.4.2012 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid granted to undertakings providing services of general economic iinterest, OJ L 114, 26.4.2012, p.8.

borrowers in the UK in the form of either loans with an up-front cash-back incentive (Barclays) or in the form of reduced-rate loans (Lloyds).

10. The report furthermore describes that Barclays and Lloyds have put processes and controls in place to deliver the NLGS interest rate reduction and that the scheme participation is assessed by external auditors, and it sets out the interim results as regards the banks' progress in passing through the guarantee benefit to end-borrowers.

IV. Position of the UK

11. In line with the original decision, the UK authorities accept that the NLGS constitutes State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (hereinafter "TFEU").

12. The UK authorities seek the prolongation of the NLGS for further six months until 30 June 2013 on terms notified under the original and first prolongation decisions. The UK confirms that the budget of the amended NLGS will remain at the original level of £ 20 billion.

13. The UK authorities repeat the justification for a financial support scheme as set in the original notification of 10 February 2012 and reiterate that it still remains valid because of a continuing serious financial disturbance in the UK's economy.

14. The Bank of England publication of 29 November 2012[8] revealed that UK banks remain highly sensitive to developments in the euro area‖ and that short-term risks to financial stability remain significant. Furthermore, in its latest Inflation Report of 14 November 2012, the Bank of England concludes, among others, that the UK economy has barely grown over the past two years and that, even though some pickup in domestic productivity growth seems likely, its timing and strength cannot be assessed with any precision. It further stated that the pace of the recovery will also depend on the extent to which the recent reductions in bank funding costs spur an increase in lending.[9]

15. The UK authorities further highlight that there is also an international consensus on the existence of a long-standing structural problem of a financing gap for smaller businesses. They note that smaller businesses in the UK are particularly reliant on bank lending as they do not have access to alternative funding sources, such as capital markets, and thus any reductions in the supply of credit affect them significantly more than larger businesses. They stress that credit conditions for end-

[8] Financial Stability Review available on: http://www.bankofengland.co.uk/publications/Documents/fsr/2012/fsrfull1211.pdf

[9] Available on: http://www.bankofengland.co.uk/publications/Documents/inflationreport/ir12nov.pdf

borrowers in the UK remain challenging as the stock of bank lending to smaller businesses continues to contract at a significant rate.[10]

16. The UK points out that the recent introduction of the Funding for Lending Scheme (hereinafter "the FLS") by the Bank of England, which provides funding to banks secured against a range of collateral, and at a price typically cheaper than the NLGS, has significantly limited interest of banks in the NLGS. Nevertheless, the UK authorities submit that it should remain in place as it has a positive effect on financial institutions and smaller businesses. More specifically, it is part of set of measures that ensure the stability of the UK financial sector, which still faces the increased volatility of global financial markets and the uncertainty related to the extent and pace of the economic recovery. Last but not least, it enables banks to diversify their funding sources. Therefore, in order to avoid any negative spill-over effects to the financial sector, the NLGS continues to be needed.

17. The UK authorities claim that the second prolongation, like the original scheme, is compatible with the internal market, because due to the on-going crisis it is necessary to remedy a serious disturbance in the UK economy pursuant to Article 107(3)(b) TFEU.

18. The UK authorities commit to maintain the commitments made since the introduction of the NLGS and confirm that all other conditions as defined by the original and first prolongation decision remain unchanged.

V. Assessment

19. In order to deal with measures taken in the context of the current financial and economic crisis, the Commission adopted four communications[11] which provide detailed guidance on the criteria for the compatibility of State support to banks with the requirements of Article 107(3)(b) TFEU. The the Banking Communication in particular sets out that, in line with the general principles underlying the State aid rules of the Treaty, general support measures have to be well-targeted to effectively achieve the objective, proportionate to the challenge faced, and designed in such a way as to minimize negative spill-over effects on competitors[12].

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[10] Lending to smaller businesses is contracting at an annualised rate of 3.4% per quarter and is declining at a significantly faster rate compared to 12 months ago (source: Bank of England Trends in Lending survey (October 2012)).

[11] 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 (the Banking Communication), OJ C 270, 25.10.2008, p. 8; the 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 (the Recapitalisation Communication), OJ C 10, 15.1.2009, p. 2; the Communication from the Commission on the treatment of impaired assets in the Community banking sector (the Impaired Assets Communication), OJ C 72, 26.3.2009, p. 1, and the Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (the Restructuring Communication), OJ C 195, 19.8.2009, p. 9.

[12] See recital 15 of the Banking Communication, OJ C 270, 25.10.2008, p. 8

20. In the original decision, the Commission concluded that the NLGS constitutes State aid within the meaning of Article 107(1) TFEU. None of the changes which have been made to the Scheme under the first prolongation decision alters that assessment. In addition, in the original decision the Commission found the measure compatible with the internal market under Article 107(3)(b) TFEU because it was apt to remedy a serious disturbance of the UK economy.

21. The Commission first notes that Article 107(3)(b) TFEU remains in principle applicable in the financial sector.[13] The Commission considers that the exceptional circumstances at the origin of the notified measure still persist and therefore recognises the need for the prolongation of such schemes. In particular, the exacerbation of tensions in sovereign debt markets that took place in 2011 and has continued in 2012 has put the banking sector under increasing pressure, particularly in terms of access to term-funding markets.

22. The Commission also observes that the prolongation of the NLGS is a response to the disturbances that the economy in the UK, as in most Member States, continues to experience. The Commission notes in particular that the Bank of England continues to report that access to credit for smaller businesses is more difficult and expensive compared with larger businesses. The FLS introduced by the Bank of England provides funding to banks at a price typically cheaper than the NLGS, making the use of the NLGS less attractive. However, the FLS provides only for a portion of banks' overall funding requirements, and banks will continue to raise funding from other sources (i.e. deposits, money markets, term markets). A prolongation of the NLGS should in particular ensure that banks have access to term-funding at acceptable price levels if banks use all of their FLS allocation, if banks want to diversify their funding sources, or if a sharp deterioration in bank funding market conditions should occur.

23. The data provided by the UK authorities indicate that the methodology which is used to determine the cost to an institution of issuing unguaranteed debt outside of the NLGS is still appropriate, namely using the sum of an institution‘s credit default swap plus the appropriate swap rate as a proxy. If guarantee fees were calculated on the basis of an alternative approach, namely by using secondary market spreads, those fees would be lower than the fees that are currently charged.

24. The Commission has taken note of the report on the delivery of the NLGS since the scheme's launch and has at present no reason to doubt that the UK implemented a control mechanism that is apt to determine to what extent banks have passed through the benefit of lower funding costs to their clients. It has taken into account in that regard the facts that there is a difference between the amount of loans that banks have committed to clients and the amount that was actually drawn, and that banks can

[13] Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis, OJ C 356, 6.12.2011, p. 7.

either pass through a benefit in the form of discounted loans or in the form of loans that come with an up-front cash-back incentive.

25. The UK authorities will monitor compliance with all conditions of the *de minimis* Regulation and ensure respect of all provisions of that Regulation. The Commission reserves the right to carry out its own verifications as provided for in Article 3 of the *de minimis* Regulation.

26. The Scheme thus remains an appropriate, necessary and proportionate measure to remedy a serious disturbance of the UK economy, does not alter the Commission's previous assessment in the original decision of 14 March 2012 and the first prolongation decision of 26 June 2012 and is therefore compatible with the internal market pursuant to Article 107(3)(b) TFEU.

27. In line with the Commission´s decisional practice the NLGS should be prolonged until 30 June 2013. Any further prolongation will require the Commission´s approval and will have to be based on a review of the developments in financial markets and the scheme´s effectiveness.

VI. Decision

The Commission finds that the notified measure is compatible with the internal market under Article 107(3)(b) of the Treaty on the Functioning of the European Union, until 30 June 2013. The Commission has accordingly decided not to raise objections.

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Your request should be sent by registered letter or fax to:

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Yours faithfully,

For the Commission

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