D. RULES ESTABLISHED IN RESPONSE TO THE ECONOMIC AND FINANCIAL CRISIS
Communication from the Commission — The recapitalisation of financial institutions (1) in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition

(Text with EEA relevance)

(2009/C 10/03)

1. INTRODUCTION

(1) The Commission Communication of 13 October 2008 on The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (2) (the Banking Communication) recognizes that recapitalisation schemes are one of the key measures that Member States can take to preserve the stability and proper functioning of financial markets.

(2) The ECOFIN Council of 7 October 2008 and the Eurogroup meeting of 12 October 2008 addressed recapitalisation in a similar spirit by concluding that ‘Governments commit themselves to provide capital when needed in appropriate volume while favouring by all available means the raising of private capital. Financial institutions should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non-beneficiaries’, and ‘legitimate interest of competitors must be protected, in particular through the State aid rules’.

(3) So far, the Commission has approved recapitalisation schemes in three Member States, as well as individual recapitalisation measures, in line with the principles laid down in the Banking Communication (3). Recapitalisation, notably in the form of ordinary and preferred shares, has been authorized, subject in particular to the introduction of market-oriented remuneration rates, appropriate behavioural safeguards and regular review. However, as the nature, scope and conditions of recapitalisation schemes currently being envisaged vary considerably, both Member States and potential beneficiary institutions have called for more detailed guidance as to whether specific forms of recapitalisation would be acceptable under State aid rules. In particular, some Member States envisage the recapitalisation of banks, not primarily to rescue them but rather to ensure lending to the real economy. The ECOFIN Council of 2 December 2008 recognised the need for further guidance for precautionary recapitalisations to sustain credit, and called for its urgent adoption by the Commission. The present Communication provides guidance for new recapitalisation schemes and opens the possibility for adjustment of existing recapitalisation schemes.

Common objectives: Restoring financial stability, ensuring lending to the real economy and dealing with the systemic risk of possible insolvency

(4) In the context of the current situation in the financial markets, the recapitalisation of banks can serve a number of objectives. First, recapitalisations contribute to the restoration of financial stability and help restore the confidence needed for the recovery of inter-bank lending. Moreover, additional capital provides a cushion in recessionary times to absorb losses and limits the risk of banks becoming insolvent. Under current conditions, triggered in particular by the collapse of Lehman Brothers, fundamentally sound banks may require capital injections to respond to a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk and the increased cost of funding.

(1) For the convenience of the reader, financial institutions are referred to simply as ‘banks’ in this document.
Second, recapitalisations can have as objective to ensure lending to the real economy. Fundamentally sound banks may prefer to restrict lending in order to avoid risk and maintain higher capital ratios. State capital injection may prevent credit supply restrictions and limit the pass-on of the financial markets’ difficulties to other businesses.

Third, State recapitalisation may also be an appropriate response to the problems of financial institutions facing insolvency as a result of their particular business model or investment strategy. A capital injection from public sources providing emergency support to an individual bank may also help to avoid short term systemic effects of its possible insolvency. In the longer term, recapitalisation could support efforts to prepare the return of the bank in question to long term viability or its orderly winding-up.

Possible competition concerns

With these common objectives in mind, the assessment of any recapitalisation scheme or measure must take into account possible distortions of competition at three different levels.

First, recapitalisation by one Member State of its own banks should not give those banks an undue competitive advantage over banks in other Member States. Access to capital at considerably lower rates than competitors from other Member States, in the absence of an appropriate risk-based justification, may have a substantial impact on the competitive position of a bank in the wider single European market. Excessive aid in one Member State could also prompt a subsidy race among Member States and create difficulties for the economies of Member States which have not introduced recapitalisation schemes. A coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalisation, is indispensable to the preservation of a level playing field. Unilateral and uncoordinated action in this area may also undermine efforts to restore financial stability (Ensuring fair competition between Member States).

Secondly, recapitalisation schemes which are open to all banks within a Member State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles may give an undue advantage to distressed or less-performing banks compared to banks which are fundamentally sound and better-performing. This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of European banks (Ensuring fair competition between banks).

Thirdly, public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position. A public scheme which crowds out market-based operations will frustrate the return to normal market functioning (Ensuring a return to normal market functioning).

Any proposed recapitalisation has cumulative competitive effects at each of these three levels. However, a balance must be struck between these competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the one hand, banks must have sufficiently favourable terms of access to capital in order to make the recapitalisation as effective as necessary. On the other hand, the conditions tied to any recapitalisation measure should ensure a level playing field and, in the longer-term, a return to normal market conditions. State interventions should therefore be proportionate and temporary and should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances permit, in order for a competitive and efficient European banking sector to emerge from the crisis. Market-oriented pricing of capital injections would be the best safeguard against unjustified disparities in the level of capitalisation and improper use of such capital. In all cases, Member States should ensure that any recapitalisation of a bank is based on genuine need.

The balance to be achieved between financial stability and competition objectives underlines the importance of the distinction between fundamentally sound, well-performing banks on one hand and distressed, less-performing banks on the other.
In its assessment of recapitalisation measures, whether in the form of schemes or support to individual banks, the Commission will therefore pay particular attention to the risk profile of the beneficiaries (1). In principle, banks with a higher risk profile should pay more. In designing recapitalisation schemes open to a set of different banks, Member States should carefully consider the entry criteria and the treatment of banks with different risk profiles and differentiate in their treatment accordingly (see Annex 1). Account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis.

In addition to indicators such as compliance with regulatory solvency requirements and prospective capital adequacy as certified by the national supervisory authorities, pre-crisis CDS spreads and ratings should, for example, be a good basis for differentiation of remuneration rates for different banks. Current spreads may also reflect inherent risks which will weaken the competitive situation of some banks as they come out of the general crisis conditions. Pre-crisis and current spreads should in any event reflect the burden, if any, of toxic assets and/or the weakness of the bank’s business model due to factors such as overdependence on short-term financing or abnormal leverage.

It may be necessary, in duly justified cases, to accept lower remuneration in the short term for distressed banks, on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures. Financially sound banks may be entitled to relatively low rates of entry to any recapitalisation, and correspondingly significantly reduced conditions on public support in the longer term, provided that they accept terms on the redemption or conversion of the instruments so as to retain the temporary nature of the State’s involvement, and its objective of restoring financial stability/lending to the economy, and the need to avoid abuse of the funds for wider strategic purposes.

Recommendations of the Governing Council of the European Central Bank (ECB)

In the Recommendations of its Governing Council of 20 November 2008, the European Central Bank proposed a methodology for benchmarking the pricing of State recapitalisation measures for fundamentally sound institutions in the Euro area. The guiding considerations underlying these Recommendations fully reflect the principles set out in this introduction. In line with its specific tasks and responsibilities, the ECB places particular emphasis on the effectiveness of recapitalisation measures with a view to strengthening financial stability and fostering the undisturbed flow of credit to the real economy. At the same time, it underlines the need for market-oriented pricing, including the specific risk of the individual beneficiary banks and the need to preserve a level playing field between competing banks.

The Commission welcomes the ECB Recommendations which propose a pricing scheme for capital injections based on a corridor for rates of return for beneficiary banks which, notwithstanding variations in their risk profile, are fundamentally sound financial institutions. This document aims to extend guidance to conditions other than remuneration rates and to the terms under which banks which are not fundamentally sound may have access to public capital.

In addition, while acknowledging that the current exceptional market rates do not constitute a reasonable benchmark for determining the correct level of remuneration of capital, the Commission is of the view that recapitalisation measures by Member States should take into account the underestimation of risk in the pre-crisis period. Without this, public remuneration rates could give undue competitive advantages to beneficiaries and eventually lead to the crowding out of private recapitalisation.

(1) See Annex 1 for more details.
2. PRINCIPLES GOVERNING DIFFERENT TYPES OF RECAPITALISATION

(19) Closeness of pricing to market prices is the best guarantee to limit competition distortions (1). It follows that the design of recapitalisation should be determined in a way that takes the market situation of each institution into account, including its current risk profile and level of solvency, and maintains a level playing field by not providing too large a subsidy in comparison to current market alternatives. In addition, pricing conditions should provide an incentive for the bank to redeem the State as soon as the crisis is over.

(20) These principles translate into the assessment of the following elements of the overall design of recapitalisation measures: objective of recapitalisation, soundness of the beneficiary bank, remuneration, exit incentives, in particular with a view to the replacement of State capital by private investors (2), to ensure the temporary nature of the State’s presence in banks’ capital, safeguards against abuse of aid and competition distortions, and the review of the effects of the recapitalisation scheme and the beneficiaries’ situation through regular reports or restructuring plans where appropriate.

2.1. Recapitalisations at current market rates

(21) Where State capital injections are on equal terms with significant participation (30 % or more) of private investors, the Commission will accept the remuneration set in the deal (3). In view of the limited competition concerns raised by such an operation, unless the terms of the deal are such as to significantly alter the incentives of private investors, in principle there does not appear to be any need for ex ante competition safeguards or exit incentives.

2.2. Temporary recapitalisations of fundamentally sound banks in order to foster financial stability and lending to the real economy

(22) In evaluating the treatment of banks in this category, the Commission will place considerable weight on the distinction between fundamentally sound and other banks which has been discussed in paragraphs 12 to 15.

(23) An overall remuneration needs to adequately factor in the following elements:

(a) current risk profile of each beneficiary (4);
(b) characteristics of the instrument chosen, including its level of subordination; risk and all modalities of payment (5);
(c) built-in incentives for exit (such as step-up and redemption clauses);
(d) appropriate benchmark risk-free rate of interest.

(24) The remuneration for State recapitalisations cannot be as high as current market levels (about 15 %) (6) since these may not necessarily reflect what could be considered as normal market conditions (7). Consequently, the Commission is prepared to accept the price for recapitalisations of fundamentally sound banks in order to foster financial stability and lending to the real economy.

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(1) See point 39 of the Banking Communication.
(2) All the references to exit incentives or incentives to redeem the State in this document have to be understood as aiming at the replacement of State capital by private capital to the extent necessary and appropriate in the context of a return to normal market conditions.
(3) See for example Commission Decision of 27 October 2008 in Case N 512/08 Support measures for financial institutions in Germany, point 54.
(4) See Annex 1 for more details.
(5) For example, a number of parameters increase or decrease the value of preferred shares, depending on their exact definition, such as: convertibility into ordinary shares or other instruments, cumulative or non-cumulative dividends, fixed or adjustable dividend rate, liquidation preference before ordinary shares, participation or not in earnings above dividend rate paid to ordinary shares, put option, redemption clauses, voting rights. The Commission will use the general classification of capital instrument among the different regulatory categories as a benchmark (e.g. core/non core, Tier 1/Tier 2).
(6) For example JP Morgan, Europe Credit Research, 27 October 2008; Merrill Lynch data on euro denominated Tier 1 debt from at least investment grade rated financial institutions, publicly issued in the Eurobond market or in the domestic market of Member States’ having adopted the euro. Data are provided by ECOWIN (ml: et10yld).
(7) Current levels of remuneration may also reflect present relatively high demand for Tier 1 capital, as banks move away from what is now perceived as the undercapitalised business model of the past, combined with relatively small supply and high market volatility.
sound banks at rates below current market rates, in order to facilitate banks to avail themselves of such instruments and to thereby favour the restoration of financial stability and ensuring lending to the real economy.

(25) At the same time, the total expected return on recapitalisation to the State should not be too distant from current market prices because (i) it should avoid the pre-crisis under-pricing of risk, (ii) it needs to reflect the uncertainty about the timing and level of a new price equilibrium, (iii) it needs to provide incentives for exiting the scheme and (iv) it needs to minimise the risk of competition distortions between Member States, as well as between those banks which raise capital on the market today without any State aid. A remuneration rate not too distant from current market prices is essential to avoid crowding out recapitalisation via the private sector and facilitating the return to normal market conditions.

Entry level price for recapitalisations

(26) The Commission considers that an adequate method to determine the price of recapitalisations is provided by the Eurosystem recommendations of 20 November 2008. The remunerations calculated using this methodology represent in the view of the Eurosystem an appropriate basis (entry level) for the required nominal rate of return for the recapitalisation of fundamentally sound banks. This price may be adjusted upwards to account for the need to encourage the redemption of State capital (1). The Commission considers that such adjustments will also serve the objective of protecting undistorted competition.

(27) The Eurosystem recommendations consider that the required rate of return by the government on recapitalisation instruments for fundamentally sound banks — preferred shares and other hybrid instruments — could be determined on the basis of a ‘price corridor’ defined by: (i) the required rate of return on subordinated debt representing a lower bound, and (ii) the required rate of return on ordinary shares representing an upper bound. This methodology involves the calculation of a price corridor on the basis of different components, which should also reflect the specific features of individual institutions (or sets of similar institutions) and of Member States. The application of the methodology by using average (mean or median) values of the relevant parameters (government bond yields, CDS spreads, equity risk premia) determines a corridor with an average required rate of return of 7 % on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9,3 % on ordinary shares relating to Euro area banks. As such, this average price corridor represents an indicative range.

(28) The Commission will accept a minimum remuneration based on the above methodology for fundamentally sound banks (2). This remuneration is differentiated at the level of an individual bank on the basis of different parameters:

(a) the type of capital chosen (3): the lower the subordination, the lower the required remuneration in the price corridor;

(b) appropriate benchmark risk-free interest rate;

(c) the individual risk profile at national level of all eligible financial institutions, (including both financially sound and distressed banks).

(29) Member States may choose a pricing formula that in addition includes step-up or payback clauses. Such features should be appropriately chosen so that, while encouraging an early end to the State's capital support of banks, they should not result in an excessive increase in the cost of capital.

(30) The Commission will also accept alternative pricing methodologies, provided they lead to remunerations that are higher than the above methodology.

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(1) See points 5 to 7 of the ECB Governing Council recommendations on the pricing of recapitalisations of 20 November 2008.

(2) Specific situation of Member States outside the Eurosystem may have to be taken into account.

(3) Such as ordinary shares, non-core Tier 1 capital, or Tier 2 capital.
Incentives for State capital redemption

(31) Recapitalisation measures need to contain appropriate incentives for State capital to be redeemed when the market so allows (1). The simplest way to provide an incentive for banks to look for alternative capital is for Member States to require an adequately high remuneration for the State recapitalisation. For that reason, the Commission considers it useful that an add-on be generally added to the entry price determined (2) to incentivise exit. A pricing structure including increase over time and step-up clauses will reinforce this mechanism to incentivise exit.

(32) If a Member State prefers not increasing the nominal rate of remuneration, it may consider increasing the global remuneration through call options or other redemption clauses, or mechanisms that encourage private capital raising, for instance by linking the payment of dividends to an obligatory remuneration of the State which increases over time.

(33) Member States may also consider using a restrictive dividend policy to ensure the temporary character of State intervention. A restrictive dividend policy would be coherent with the objective of safeguarding lending to the real economy and strengthening the capital basis of beneficiary banks. At the same time, it would be important to allow for dividend payment where this represents an incentive to provide new private equity to fundamentally sound banks (3).

(34) The Commission will assess proposed exit mechanisms on a case-by-case basis. In general, the higher the size of the recapitalization and the higher the risk profile of the beneficiary bank, the more necessary it becomes to set out a clear exit mechanism. The combination of the level and type of remuneration and, where and to the extent appropriate, a restrictive dividend policy, needs to represent, in its entirety, a sufficient exit incentive for the beneficiary banks. The Commission considers, in particular, that restrictions on payment of dividends are not needed where the level of pricing correctly reflects the banks' risk profile, and step-up clauses or comparable elements provide sufficient incentives for exit and the recapitalisation is limited in size.

Prevention of undue distortions of competition

(35) The Banking Communication stresses, in point 35, the need for safeguards against possible abuses and distortions of competition in recapitalisation schemes. Point 38 of the Banking Communication requires capital injections to be limited to the minimum necessary and not to allow the beneficiary to engage in aggressive commercial strategies which would be incompatible with the underlying objectives of recapitalisation (4).

(36) As a general principle, the higher the remuneration the less there is a need for safeguards, as the level of price will limit distortions of competition. Banks receiving State recapitalisation should also avoid advertising it for commercial purposes.

(37) Safeguards may be necessary to prevent aggressive commercial expansion financed by State aid. In principle, mergers and acquisitions can constitute a valuable contribution to the consolidation of the banking industry with a view to achieving the objectives of stabilising financial markets and ensuring a steady flow of credit to the real economy. In order not to privilege those institutions with public support to the detriment of competitors without such support, mergers and acquisitions should generally be organised on the basis of a competitive tendering process.

(1) Taking into account the type of recapitalisation instrument and its classification by supervisory authorities.

(2) This is all the more important as the method presented above may be affected by under-pricing of risk before the crisis.

(3) Taking into account these considerations, restrictions on the payment of dividends could for example be limited in time or to a percentage of the generated profits, or linked to the contribution of new capital, for example by paying out dividends in the form of new shares. Where the redemption of the State is likely to occur in several steps, it could also be envisaged to foresee the gradual relaxation on any restriction on dividends in tune with the progress of redemption.

(4) Given the objectives of ensuring lending to the real economy, balance sheet growth restrictions are not necessary in recapitalisation schemes of fundamentally sound banks. This should in principle apply also to guarantee schemes, unless there is a serious risk of displacement of capital flows between Member States.
The extent of behavioural safeguards will be based on a proportionality assessment, taking into account all relevant factors and, in particular, the risk profile of the beneficiary bank. While banks with a very low risk profile may require only very limited behavioural safeguards, the need for such safeguards increases with a higher risk profile. The proportionality assessment is further influenced by the relative size of the capital injection by the State and the reached level of capital endowment.

When Member States use recapitalisation with the objective of financing the real economy, they have to ensure that the aid effectively contributes to this. To that end, in accordance with national regulation, they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy.

Review

In addition, as indicated in the Banking Communication (1), recapitalisations should be subject to regular review. Six months after their introduction, Member States should submit a report to the Commission on the implementation of the measures taken. The report needs to provide complete information on:

(a) the banks that have been recapitalised, including in relation to the elements identified in point 12 to 15, Annex 1, and an assessment of the bank's business model, with a view to appreciating the banks' risk profile and viability;

(b) the amounts received by those banks and the terms on which recapitalisation has taken place;

(c) the use of the capital received, including in relation to (i) the sustained lending to the real economy and (ii) external growth and (iii) the dividend policy of beneficiary banks;

(d) the compliance with the commitments made by Member States in relation to exit incentives and other conditions and safeguards; and

(e) the path towards exit from reliance on State capital (2).

In the context of the review, the Commission will assess, amongst others, the need for the continuation of behavioural safeguards. Depending on the evolution of market conditions, it may also request a revision of the safeguards accompanying the measures in order to ensure that aid is limited to the minimum amount and minimum duration necessary to weather the current crisis.

The Commission recalls that where a bank that was initially considered fundamentally sound falls into difficulties after recapitalisation has taken place, a restructuring plan for that bank must be notified.

2.3. Rescue recapitalisations of other banks

The recapitalisation of banks which are not fundamentally sound should be subject to stricter requirements.

As far as remuneration is concerned, as set out above, it should in principle reflect the risk profile of the beneficiary and be higher than for fundamentally sound banks (3). This is without prejudice to the possibility for supervisory authorities to take urgent action where necessary in cases of restructuring. Where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. Notwithstanding the need to ensure financial stability, the use of State capital for these banks can only be accepted on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate. Therefore, either a comprehensive restructuring plan or a liquidation plan will have to be presented for these banks within six months of recapitalisation. As indicated in the Banking Communication, such a plan will be assessed according to the principles of the rescue and restructuring guidelines for firms in difficulties, and will have to include compensatory measures.

(1) See points 34 to 42 of the Banking Communication. In line with the Banking Communication, individual recapitalisation measures taken in conformity with a recapitalisation scheme approved by the Commission do not require notification and will be assessed by the Commission in the context of the review and the presentation of a viability plan.

(2) Taking into account the characteristics of the recapitalisation instrument.

(3) See paragraph 28 on the extended price corridor implying increased rates of remuneration for distressed banks.
(45) Until redemption of the State, behavioural safeguards for distressed banks in the rescue and restructuring phases should, in principle, include: a restrictive policy on dividends (including a ban on dividends at least during the restructuring period), limitation of executive remuneration or the distribution of bonuses, an obligation to restore and maintain an increased level of the solvency ratio compatible with the objective of financial stability, and a timetable for redemption of State participation.

2.4. Final remarks

(46) Finally, the Commission takes into account the possibility that banks’ participation in recapitalisation operations is open to all or a good portion of banks in a given Member State, also on a less differentiated basis, and aimed at achieving an appropriate overall return over time. Some Member States may prefer, for reasons of administrative convenience for instance, to use less elaborated methods. Without prejudice to the possibility for Member States to base their pricing on the methodology above, the Commission will accept pricing mechanisms leading to a level of a total expected annualised return for all banks participating in a scheme sufficiently high to cater for the variety of banks and the incentive to exit. This level should normally be set above the upper bound referred to in paragraph 27 for Tier 1 capital instruments (1). This can include a lower entry price and an appropriate step-up, as well as other differentiation elements and safeguards as described above (2).

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(1) The Commission has so far accepted recapitalisation measures with a total expected annualised return of at least 10 % for Tier 1 instruments for all banks participating in a scheme. For Member States with risk-free rates of return significantly divergent from the Eurozone average such a level may need to be adapted accordingly. Adjustments will also be necessary in function of developments of the risk-free rates.

(2) See, as an example of a combination of a low entry price with such differentiation elements, the Commission Decision of 12 November 2008 in Case N 528/08 the Netherlands, Aid to ING Groep N.V. where for the remuneration of a sui generis capital instrument categorized as core Tier 1 capital a fixed coupon (8.5 %) is coupled with over-proportionate and increasing coupon payments and a possible upside, which results in an expected annualised return in excess of 10 %.

D.1.1
ANNEX

Pricing of equity

Equity (ordinary shares, common shares) is the best known form of core Tier 1 capital. Ordinary shares are remunerated by uncertain future dividend payments and the increase of the share price (capital gain/loss), both of which ultimately depend on the expectations of future cash flows/profits. In the current situation, a forecast of future cash flows is even more difficult than under normal conditions. The most noticeable factor, therefore, is the quoted market price of ordinary shares. For non-quoted banks, as there is no quoted share price, Member States should come to an appropriate market-based approach, such as full valuation.

If assistance is given in the issuance of ordinary shares (underwriting), any shares not taken up by existing or new investors will be taken up by the Member State as underwriter at the lowest possible price compared to the share price immediately prior to the announcement of placing an open offer. An adequate underwriting fee should also be payable by the issuing institution (1). The Commission will take into account the influence that previously received State aid may have on the share price of the beneficiary.

Indicators for the assessment of a bank's risk profile

In evaluating a bank's risk profile for the purpose of the appreciation of a recapitalisation measure under State aid rules, the Commission will take into account the bank's position in particular with respect to the following indicators:

(a) capital adequacy: The Commission will value positively the assessment of the bank's solvency and its prospective capital adequacy as a result of a review by the national supervisory authority; such a review will evaluate the bank's exposure to various risks (such as credit risk, liquidity risk, market risk, interest rate and exchange rate risks), the quality of the asset portfolio (within the national market and in comparison with available international standards), the sustainability of its business model in the long term and other pertinent elements;

(b) size of the recapitalisation: The Commission will value positively a recapitalisation limited in size, such as for instance no more than 2 % of the bank's risk weighted assets;

(c) current CDS spreads: The Commission will consider a spread equal or inferior to the average as an indicator of a lower risk profile;

(d) current rating of the bank and its outlook: The Commission will consider a rating of A or above and a stable or positive outlook as an indicator of a lower risk profile.

In the evaluation of these indicators, account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis, as shown, for instance, by the evolution of market indicators such as CDS spreads and share prices.

Table 1

Types of capital

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<th>Tier 2</th>
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<td>Perpetual Subordinated Debt instruments</td>
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<td>Greater loss absorbency</td>
<td>Cumulative preference shares or other similar instruments</td>
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1. INTRODUCTION

1. Since mid-2007, the functioning of wholesale credit markets has been severely disrupted. The result has been a drying up of liquidity in the banking sector and a reluctance of banks to lend to each other and to the broader economy. As the disruption of credit markets has intensified over the past eighteen months, the financial crisis has intensified and the global economy has entered a severe recession.

2. It is difficult to envisage a resolution of the financial crisis and a recovery in the global economy without assured stability in the banking sector and the broader financial system. Only then will investor confidence return and banks resume their normal lending behaviour. Accordingly, Member States have put measures in place to support the stability of their banking sectors and underpin lending, notably the injection of new capital using public funds and the provision of government guarantees for bank borrowing. These measures were announced in October 2008 and have been gradually implemented over the past months.

3. Recently, several Member States have announced their intention to complement their existing support measures by providing some form of relief for impaired bank assets. Those announcements, in parallel with a similar initiative in the United States, have triggered a wider debate within the Community on the merits of asset relief as a government support measure for banks. In the context of that debate, this Communication has been prepared by the Commission, in consultation with the European Central Bank (ECB), and builds on the recommendations issued on 5 February 2009 by the Eurosystem (see Annex I).

4. This Communication focuses on issues to be addressed by Member States in considering, designing and implementing asset relief measures. At a general level, those issues include the rationale for asset relief as a measure to safeguard financial stability and underpin bank lending, the longer-term considerations of banking-sector viability and budgetary sustainability to be taken into account when considering asset relief measures and the need for a common and co-ordinated Community approach to asset relief, notably to ensure a level playing field. In the context of such a Community approach, this Communication also offers more specific guidance on the application of State-aid rules to asset relief, focusing on issues such as (i) transparency and disclosure requirements; (ii) burden sharing between the State, shareholders and creditors; (iii) aligning incentives for beneficiaries with public policy objectives; (iv) principles for designing asset relief measures in terms of eligibility, valuation and management of impaired assets; and (v) the relationship between asset relief, other government support measures and the restructuring of banks.
2. ASSET RELIEF AS A MEASURE TO SAFEGUARD FINANCIAL STABILITY AND UNDERPIN BANK LENDING

5. The immediate objectives of the Member State rescue packages announced in October 2008 are to safeguard financial stability and underpin the supply of credit to the real economy. It is too early to draw definitive conclusions on the effectiveness of the packages, but it is clear that they have averted the risk of financial meltdown and have supported the functioning of important inter-bank markets. On the other hand, the evolution in lending to the real economy since the announcement of the packages has been unfavourable, with recent statistics suggesting a sharp deceleration in credit growth (1). In many Member States, reports of businesses being denied access to bank credit are now widespread and it would seem that the squeeze on credit goes beyond that justified by cyclical considerations.

6. A key reason identified for the insufficient flow of credit is uncertainty about the valuation and location of impaired assets, a source of problems in the banking sector since the beginning of the crisis. Uncertainty regarding asset valuations has not only continued to undermine confidence in the banking sector, but has weakened the effect of the government support measures agreed in October 2008. For example, bank recapitalisation has provided a cushion against asset impairment but much of the capital buffer provided has been absorbed by banks in provisioning against future asset impairments. Banks have already taken steps to address the problem of impaired assets. They have recorded substantial write-downs in asset values (2), taken steps to limit remaining losses by reclassification of assets within their balance sheets and gradually put additional capital aside to strengthen their solvency positions. However, the problem has not been resolved to a sufficient degree and the unexpected depth of the economic slowdown now suggests a further and more extensive deterioration in credit quality of bank assets.

7. Asset relief would directly address the issue of uncertainty regarding the quality of bank balance sheets and therefore help to revive confidence in the sector. It could also help to avoid the risk of repeated rounds of recapitalisation of banks as the extent of asset impairment increases amid a deteriorating situation in the real economy. On this basis, several Member States are actively considering relief for impaired bank assets as a complement to other measures in implementing the strategy agreed by Heads of State and Government in October 2008.

3. LONGER-TERM CONSIDERATIONS: A RETURN TO VIABILITY IN THE BANKING SECTOR AND SUSTAINABILITY OF PUBLIC FINANCES

8. Asset relief measures must be designed and implemented in the manner that most effectively achieves the immediate objectives of safeguarding financial stability and underpinning bank lending. An important issue to be addressed in this context is ensuring an adequate participation in the asset relief measures by setting appropriate pricing and conditions and through mandatory participation if deemed necessary. However, the focus in designing and implementing asset relief measures should not be limited to these immediate objectives. It is essential that longer-term considerations are also taken into account.

9. If asset relief measures are not carried out in such a way as to ring-fence the danger of serious distortions of competition among banks (both within Member States and on a cross-border basis) in compliance with the State aid rules of the Treaty establishing the European Community, including where necessary the restructuring of beneficiaries, the outcome will be a structurally weaker Community banking sector with negative implications for productive potential in the broader economy. Furthermore, it could lead to a recurrent need for government intervention in the sector, implying a progressively heavier burden on public finances. Such risks are serious given the likely scale of State exposure.

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(1) While official data for the euro area suggest that bank lending to businesses is still resilient, the underlying trend is weakening, with month-on-month growth rates in lending slowing markedly toward the end of 2008. In December 2008, bank loans to the private economy (loans to non-MFI excl. governments) fell by 0.4% relative to November.

(2) From mid-2007 to date, there has been a total of USD 1 063 billion in asset write-downs, of which USD 737.6 billion has been reported by US-based banks and USD 293.7 has been reported by European-based banks. Of the latter, USD 68 billion has been reported in Switzerland. Despite the scale of asset write-downs already reported, the IMF currently estimates that the total of bank losses related to asset impairment is likely to reach USD 2 200 billion. This estimate is based on global holdings of U.S.-originated and securitized mortgage, consumer, and corporate debt and has been steadily rising since the beginning of the crisis. Some market commentators suggest that total losses may be substantially higher. For example, Nouriel Roubini who has consistently argued that official estimates are too low now suggests that total losses could be USD 3 600 billion for the United States alone.

D.1.2
In order to limit the risk of such longer-term damage, government intervention in the banking sector should be appropriately targeted and accompanied by behavioural safeguards that align the incentives of banks with the objectives of public policy. Asset-relief measures should form part of an overall effort to restore the viability of the banking sector, based on necessary restructuring. The need for restructuring in the banking sector as a counterpart of government support is discussed in more detail in the context of State aid rules in Sections 5 and 6.

10. In considering the design and implementation of asset relief measures, it is also essential that Member States take account of the budgetary context. Estimates of total expected asset write-downs suggest that the budgetary costs — actual, contingent or both — of asset relief could be substantial — both in absolute terms and relative to gross domestic product (GDP) in Member States. Government support through asset relief (and other measures) should not be on such a scale that it raises concern about the sustainability of public finances such as over-indebtedness or financing problems. Such considerations are particularly important in the current context of widening budget deficits, rising public debt levels and challenges facing sovereign bond issuance.

11. More specifically, the budgetary situation of Member States will be an important consideration in the choice of management arrangement for assets subject to relief, namely asset purchase, asset insurance, asset swap or a hybrid of such arrangements (1). The implications for budgetary credibility may not differ significantly between the various approaches to asset relief, as financial markets are likely to discount potential losses on a similar basis (2). However, an approach requiring the outright purchase of impaired assets would have a more immediate impact on budgetary ratios and government financing. While the choice of management arrangement for impaired assets is the responsibility of each Member State, hybrid approaches whereby bad assets are segregated from the balance sheet of banks in a separate entity (either within or outside the banks) which benefits in some way from a government guarantee could be considered. Such an approach is attractive as it provides many of the benefits of the asset purchase approach from the perspective of restoring confidence in the banking system, while limiting the immediate budgetary impact.

12. In a context of scarce budgetary resources, it may be appropriate to focus asset relief measures on a limited number of banks of systemic importance. For some Member States, asset relief for banks may be severely constrained, due to their existing budgetary constraints and/or the size of their banks' balance sheet relative to GDP.

4. NEED FOR A COMMON AND CO-ORDINATED COMMUNITY APPROACH

13. In considering some form of asset relief measures, there is a need to reconcile the immediate objectives of financial stability and bank lending with the need to avoid longer-term damage to the banking sector within the Community, to the single market and to the broader economy. This can be achieved most effectively by a common and co-ordinated Community approach, with the following broad objectives:

(a) boosting market confidence by demonstrating a capacity for an effective Community-level response to the financial crisis and creating the scope for positive spillovers among Member States and on the wider financial markets;

(b) limiting negative spillovers among Member States, where the introduction of asset relief measures by a first-mover Member State results in pressure on other Member States to follow suit and risks launching a subsidy race between Member States;

(1) These arrangements are discussed in more detail in Annex II.

(2) Asset purchases by government need not imply heavy budgetary costs in the longer term if a sufficient portion of the acquired assets can be subsequently sold at a profit (see US and Swedish examples in Annex II). However, they imply an upfront budgetary outlay which would increase gross public debt and the government's gross financing requirements. An approach based on swapping government debt for impaired assets could be used to ease the operational problems relating to issuance, but would not avoid the impact on the budgetary ratios nor an increase in the supply of government debt in the market.
(c) protecting the single market in financial services by ensuring consistency in asset relief measures introduced by the Member States and resisting financial protectionism;

(d) ensuring compliance with State-aid control requirements and any other legal requirements by further ensuring consistency among asset relief measures, and by minimising competitive distortions and moral hazard.

14. Co-ordination among Member States would only be necessary at a general level and could be achieved while retaining sufficient flexibility to tailor measures to the specific situations of individual banks. In the absence of sufficient coordination ex ante, many of those objectives will only be met by additional State aid control requirements ex post. Common guidance on the basic features of relief measures would, therefore, help to minimise the need for corrections and adjustments as a result of assessment under the State aid rules. Such guidance is provided in the following Sections.

5. GUIDELINES ON THE APPLICATION OF STATE AID RULES TO ASSET RELIEF MEASURES

15. It is the normal duty of banks to assess the risk of the assets they acquire and to make sure they can cover any associated losses (1). Asset relief may, however, be considered to support financial stability. Public asset relief measures are State aid inasmuch as they free the beneficiary bank from (or compensate for) the need to register either a loss or a reserve for a possible loss on its impaired assets and/or free regulatory capital for other uses. This would notably be the case where impaired assets are purchased or insured at a value above the market price, or where the price of the guarantee does not compensate the State for its possible maximum liability under the guarantee (2).

16. Any aid for asset relief measures should, however, comply with the general principles of necessity, proportionality and minimisation of the competition distortions. Such assistance implies serious distortions of competition between beneficiaries and non-beneficiary banks and among beneficiary banks with different degrees of need. Non-beneficiary banks that are fundamentally sound may feel obliged to consider seeking government intervention to preserve their competitive position in the market. Similar distortions in competition may arise among Member States, with the risk of a subsidy race between Member States (trying to save their banks without regard to the effects on banks in other Member States) and a drift towards financial protectionism and fragmentation of the internal market. Participation in the asset relief scheme should therefore be conditioned upon clearly defined and objective criteria, in order to avoid that individual banks take unwarranted advantage.

17. The principles governing the application of the State aid rules and, in particular, Article 87(3)(b) of the Treaty to any support measure for banks in the context of the global financial crisis in were established in the Communication from the Commission — The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (3). More detailed guidance on the practical implementation of these principles to recapitalisation was subsequently provided in the Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (4). In the same vein, the guidelines set out in this Communication, based on the same principles, identify the key features of asset relief measures or schemes, which determine their effectiveness as well as their impact on competition. These guidelines apply to all banks that are granted asset relief, irrespective of

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(1) Banks typically hold a variety of assets, including: cash, financial assets (treasury bills, debt securities, equity securities, traded loans, and commodities), derivatives (swaps, options), loans, financial investments, intangible assets, property, plant and equipment. Losses may be incurred when assets are sold below their book value, when their value is decreased and reserves are created on possible loss or ex post when the revenue streams at maturity are lower than the book value.

(2) A guarantee is presumed to constitute State aid when the beneficiary bank cannot find any independent private operator on the market willing to provide a similar guarantee. The amount of State aid is set at the maximum net liability for the State.


their individual situation, but the practical implications of their application may vary depending on the risk profile and viability of a beneficiary. The principles of these guidelines apply mutatis mutandis where two or more Member States coordinate measures to provide asset relief to cross-border banks.

18. This Communication aims to establish coordinated principles and conditions to ensure the effectiveness of asset relief measures in the single market as far as possible, taking account of the long-term objective of a return to normal market conditions, while remaining flexible enough so as to cater for specific features or provide additional measures or procedures at individual or national levels for reasons of financial stability. Effective asset relief measures should have as a consequence the maintenance of lending to the real economy.

5.1. **Appropriate identification of the problem and options for solution: full ex ante transparency and disclosure of impairments and an upfront assessment of eligible banks**

19. Any asset relief measure must be based on a clear identification of the magnitude of the bank's asset-related problems, its intrinsic solvency prior to the support and its prospects for return to viability, taking into due consideration all possible alternatives, in order to facilitate the necessary restructuring process, prevent distortion in the incentives of all players and avoid waste of State resources without contributing to resumption in the normal flow of credit to the real economy.

20. Therefore, in order to minimise the risk of a recurrent need for State interventions in favour of the same beneficiaries, the following criteria should be satisfied as a prerequisite for benefitting from asset relief:

(a) applications for aid should be subject to full ex ante transparency and disclosure of impairments by eligible banks on the assets which will be covered by the relief measures, based on adequate valuation, certified by recognised independent experts and validated by the relevant supervisory authority, in line with the principles of valuation developed in Section 5.5 (1); such disclosure of impairments should take place prior to government intervention; this should lead to the identification of the aid amount and of the incurred losses for the bank from the asset transfer (2);

(b) an application for aid by an individual bank should be followed by a full review of that bank's activities and balance sheet, with a view to assessing the bank's capital adequacy and its prospects for future viability (viability review); that review must occur in parallel with the certification of the impaired assets covered by the asset relief programme but, given its scale, could be finalised after the bank enters into the asset relief programme; the results of the viability review must be notified to the Commission and will be taken into account in the assessment of necessary follow-up measures (see Section 6).

5.2. **Burden-sharing of the costs related to impaired assets between the State, shareholders and creditors**

21. As a general principle, banks ought to bear the losses associated with impaired assets to the maximum extent. This requires, firstly, full ex ante transparency and disclosure, followed by the correct valuation of assets prior to government intervention and a correct remuneration of the State for the asset relief measure, whatever its form, so as to ensure equivalent shareholder responsibility and burden-sharing.

(1) Without prejudice to the necessity of making public the impact on the balance sheet of an asset relief measure implying appropriate burden-sharing, the terms 'transparency' and 'full disclosure' should be understood as meaning transparency vis-à-vis the national authorities, the independent experts involved and the Commission.

(2) The aid amount corresponds to the difference between the transfer value of the assets (normally based on their real economic value) and the market price. In this paper, the incurred losses correspond to the difference between the transfer value and the book value of the assets. Actual losses will normally only be known ex post.
irrespective of the exact model chosen. The combination of those elements should lead to overall coherence concerning burden-sharing across various forms of State support, having regard to the specific distinctive features of different types of assistance (1).

22. Once assets have been properly evaluated and losses are correctly identified (2), and if this would lead to a situation of technical insolvency without State intervention, the bank should either be put into administration or be wound up, according to Community and national law. In such a situation, with a view to preserving financial stability and confidence, protection or guarantees to bondholders (3) may be appropriate.

23. Where putting a bank into administration or its orderly winding up appears unadvisable for reasons of financial stability (4), aid in the form of guarantee or asset purchase, limited to the strict minimum, could be awarded to banks so that they can continue to operate for the period necessary to allow to devise a plan for either restructuring or orderly winding-up. In such cases, shareholders should also be expected to bear losses at least until the regulatory limits of capital adequacy are reached. Nationalisation options may also be considered.

24. Where it is not possible to achieve full burden-sharing ex ante, the bank should be requested to contribute to the loss or risk coverage at a later stage, for example in the form of claw-back clauses or, in the case of an insurance scheme, by a clause of 'first loss', to be borne by the bank (typically with a minimum of 10 %) and a clause of 'residual loss sharing', through which the bank participates to a percentage (typically with a minimum of 10 %) of any additional losses (5).

25. As a general rule, the lower the contribution upfront, the higher the need for a shareholder contribution at a later stage, either in the form of a conversion of State losses into bank shares and/or in the form of additional compensatory measures to limit the distortion of competition when assessing necessary restructuring.

5.3. Aligning incentives for banks to participate in asset relief with public policy objectives

26. As a general feature, impaired asset relief programmes should have an enrolment window limited to six months from the launch of the scheme by the government. This will limit incentives for banks to delay necessary disclosures in the hope of higher levels of relief at a later date, and facilitate a rapid resolution of the banking problems before the economic downturn further aggravates the situation. During the six-month window, the banks would be able to present eligible assets baskets to be covered by the asset relief measures, with the possibility of rollover (6).

27. Appropriate mechanisms may need to be devised so as to ensure that the banks most in need of asset relief participate in the government measure. Such mechanisms could include mandatory participation in the programme, and should include at least mandatory disclosure to the supervisory authorities. The obligation for all banks to reveal the magnitude of their asset-related problems will contribute to the clear identification of the need and necessary scope for an asset relief scheme at the Member State level.

(1) Asset relief measures are somewhat comparable to capital injections insofar as they provide a loss absorption mechanism and have a regulatory capital effect. However, with the former the State generally incurs a larger risk, related to a specific portfolio of impaired assets, with no direct contribution of other bank's income generating activities and funds, and beyond its possible stake into the bank. In view of the larger down-side and more limited up-side remuneration for asset relief should normally be higher than for capital injections.

(2) Comparing the book value of the assets with their transfer value (i.e. their real economic value).

(3) Shareholder protection should, however, normally be excluded. See Decisions NN 39/08 (Denmark, Aid for liquidation of Roskilde Bank) and NN 41/08 (United Kingdom, Rescue aid to Bradford & Bingley).

(4) That may be the case where the bank's size or type of activity would be unmanageable in an administrative or judiciary procedure or via an orderly winding-up without having dangerous systemic implications on other financial institutions or on lending to the real economy. A justification by the monetary and/or supervisory authority would be necessary in this respect.

(5) Other factors, for example higher remuneration, may influence the appropriate level. Moreover, it has to be noted that ex post compensations may only occur several years after the measure has been introduced and may therefore unsatisfactorily prolong the uncertainty linked to the valuation of the impaired assets. Claw-back clauses based on ex ante valuation would not have this problem.

(6) Case of enrolled assets that may mature afterwards.
28. Where participation is not mandatory, the scheme could include appropriate incentives (such as the provision of warrants or rights to existing shareholders so that they may participate in future private capital-raising at preferential terms) to facilitate take-up by the banks without derogating from the principles of transparency and disclosure, fair valuation and burden sharing.

29. Participation after the expiration of the six month enrolment window should be possible only in exceptional and unforeseeable circumstances for which the bank is not responsible (\(1\)), and subject to stricter conditions, such as higher remuneration to the State and/or higher compensatory measures.

30. Access to asset relief should always be conditional on a number of appropriate behavioural constraints. In particular, beneficiary banks should be subject to safeguards which ensure that the capital effects of relief are used for providing credit to appropriately meet demand according to commercial criteria and without discrimination and not for financing a growth strategy (in particular acquisitions of sound banks) to the detriment of competitors.

31. Restrictions on dividend policy and caps on executive remuneration should also be considered. The specific design of behavioural constraints should be determined on the basis of a proportionality assessment taking account of the various factors that may imply the necessity of restructuring (see Section 6).

5.4. Eligibility of assets

32. When determining the range of eligible assets for relief, a balance needs to be found between meeting the objective of immediate financial stability and the need to ensure the return to normal market functioning over the medium turn. Assets commonly referred to as ‘toxic assets’ (for example, US mortgage backed securities and associated hedges and derivatives), which have triggered the financial crisis and have largely become illiquid or subject to severe downward value adjustments, appear to account for the bulk of uncertainty and scepticism concerning the viability of banks. Restricting the range of eligible assets to such assets would limit the State’s exposure to possible losses and contribute to the prevention of competition distortions (\(2\)). However, an overly narrow relief measure would risk falling short of restoring confidence in the banking sector, given the differences between the specific problems encountered in different Member States and banks and the extent to which the problem of impairment has now spread to other assets. This would plead in favour of a pragmatic approach including elements of flexibility, which would ensure that other assets also benefit from relief measures to an appropriate extent and where duly justified.

33. A common and coordinated Community approach to the identification of the assets eligible for relief measures is necessary to both prevent competitive distortions among Member States and within the Community banking sector, and limit incentives for cross-border banks to engage in arbitrage among different national relief measures. To ensure consistency in the identification of eligible assets across Member States, categories of assets (‘baskets’) reflecting the extent of existing impairment should be developed. More detailed guidance on the definition of those categories is provided in Annex III. The use of such categories of assets would facilitate the comparison of banks and their risk profiles across the Community, Member States would then need to decide which category of assets could be covered and to what extent, subject to the Commission’s review of the degree of impairment of the assets chosen.

34. A proportionate approach would need to be developed to allow a Member State whose banking sector is additionally affected by other factors of such magnitude as to jeopardise financial stability (such as the burst of a bubble in their own real estate market) to extend eligibility to well-defined categories of assets corresponding to the systemic threat upon due justification, without quantitative restrictions.

(\(1\)) An ‘unforeseeable circumstance’ is a circumstance that could in no way be anticipated by the company’s management when making its decision not to join the asset relief programme during the enrolment window and that is not a result of negligence or error on the part of the company’s management or decisions of the group to which it belongs. An ‘exceptional circumstance’ is to be understood as exceptional beyond the current crisis. Member States wishing to invoke such circumstances shall notify all necessary information to the Commission.

(\(2\)) This would seem the approach chosen in the US for Citigroup and Bank of America.
35. Additional flexibility could further be envisaged by allowing for the possibility for banks to be relieved of impaired assets outside the scope of eligibility set out in paragraphs 32, 33 and 34 without the necessity of a specific justification for a maximum of 10-20% of the overall assets of a given bank covered by a relief mechanism in view of the diversity of circumstances of different Member States and banks. However, assets that cannot presently be considered impaired should not be covered by a relief programme. Asset relief should not provide an open-ended insurance against future consequences of recession.

36. As a general principle, the wider the eligibility criteria, and the greater the proportion which the assets concerned represent in the portfolio of the bank, the more thorough the restructuring and the remedies to avoid undue distortions of competition will have to be. In any case, the Commission will not consider assets eligible for relief measures where they have entered the balance sheet of the beneficiary bank after a specified cut-off date prior to the announcement of the relief programme (1). To do otherwise could result in asset arbitrage and would give rise to inadmissible moral hazard by providing incentives for banks to abstain from properly assessing risks in future lending and other investments and thus repeat the very mistakes that have brought about the current crisis (2).

5.5. Valuation of assets eligible for relief and pricing

37. A correct and consistent approach to the valuation of assets, including assets that are more complex and less liquid, is of key importance to prevent undue distortions of competition and to avoid subsidy races between Member States. Valuation should follow a general methodology established at the Community level and should be closely co-ordinated ex ante by the Commission across the Member States in order to ensure maximum effectiveness of the asset relief measure and reduce the risk of distortions and damaging arbitrage, notably for cross-border banks. Alternative methodologies may need to be employed to take account of specific circumstances relating to, for example, timely availability of relevant data, provided they attain equivalent transparency. In any case, eligible banks should value their portfolios on a daily basis and make regular and frequent disclosures to the national authorities and to their supervisory authorities.

38. Where the valuation of assets appears particularly complex, alternative approaches could be considered such as the creation of a ‘good bank’ whereby the State would purchase the good rather than the impaired assets. Public ownership of a bank (including nationalisation) could be an alternative option, with a view to carrying out the valuation over time in a restructuring or orderly winding-up context, thus eliminating any uncertainty about the proper value of the assets concerned (3).

39. As a first stage, assets should be valued on the basis of their current market value, whenever possible. In general, any transfer of assets covered by a scheme at a valuation in excess of the market price will constitute State aid. The current market value may, however, be quite distant from the book value of those assets in the current circumstances, or non-existent in the absence of a market (for some assets the value may effectively be as low as zero).

40. As a second stage, the value attributed to impaired assets in the context of an asset relief program (the ‘transfer value’) will inevitably be above current market prices in order to achieve the relief effect. To ensure consistency in the assessment of the compatibility of aid, the Commission would consider a transfer value reflecting the underlying long-term economic value (the ‘real economic value’) of the assets, on the basis of underlying cash flows and broader time horizons, an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary. Uniform hair-cuts applicable to certain asset categories will have to be considered to approximate the real economic value of assets that are so complex that a reliable forecast of developments in the foreseeable future would appear impracticable.

(1) Generally, the Commission considers that a uniform and objective cut-off date, such as the end of 2008, will ensure a level playing field among banks and Member States.

(2) Where necessary, State support in relation to the risks of future assets can be tackled on the basis of the guarantee notice and the temporary framework.

(3) This would be the case, for example, if the State swapped assets for government bonds in the amount of their nominal value but received contingent warrants on bank capital, the value of which depends on the eventual sales price of the impaired assets.
41. Consequently, the transfer value for asset purchase or asset insurance (1) measures should be based on their real economic value. Moreover, adequate remuneration for the State must be secured. Where Member States deem it necessary — notably to avoid technical insolvency — to use a transfer value of the assets that exceeds their real economic value, the aid element contained in the measure is correspondingly larger. It can only be accepted if it is accompanied by far-reaching restructuring and the introduction of conditions allowing the recovery of this additional aid at a later stage, for example through claw-back mechanisms.

42. The valuation process both with regard to the market value and the real economic value, as well as the remuneration of the State, should follow the same guiding principles and processes listed in Annex IV.

43. When assessing the valuation methods put forward by Member States for asset relief measures, and their implementation in individual cases, the Commission will consult panels of valuation experts (2). The Commission will also build on the expertise of existing bodies organised at Community level in order to ensure the consistency of valuation methodologies.

5.6. Management of assets subject to relief measures

44. It is for Member States to choose the most appropriate model for relieving banks from assets, from the range of options set out in Section 3 and Annex II, in the light of the extent of the problem of impaired assets, the situation of the individual banks concerned and budgetary considerations. The objective of State aid control is to ensure that the features of the selected model are designed so as to ensure equal treatment and prevent undue distortions of competition.

45. While the specific pricing arrangements for an aid measure may vary, their distinctive features should not have an appreciable impact on the adequate burden-sharing between the State and the beneficiary banks. On the basis of proper valuation, the overall financing mechanism of an asset management company, an insurance or a hybrid solution should ensure that the bank will have to assume the same proportion of losses. Claw-back clauses can be considered in this context. In general, all schemes must ensure that the beneficiary banks bear the losses incurred in the transfer of assets (see further paragraph 50 and footnote 10).

46. Whatever the model, in order to facilitate the bank’s focus on the restoration of viability and to prevent possible conflicts of interest, it is necessary to ensure clear functional and organisational separation between the beneficiary bank and its impaired assets, notably as to their management, staff and clientele.

5.7. Procedural aspects

47. Detailed guidance on the implications of these guidelines on State aid procedure with regard to both the initial notification of aid and the assessment of restructuring plans, where necessary, is provided in Annex V.

6. FOLLOW-UP MEASURES — RESTRUCTURING AND RETURN TO VIABILITY

48. The principles and conditions in Section 5 set the framework for designing asset relief measures in compliance with State aid rules. State aid rules aim, in the present context, at ensuring the minimum and least distortive support for a removal of risks related to a separate category of assets from the beneficiary banks in order to prepare a solid ground for return to long-term viability without State support. While the treatment of impaired assets along the above principles is a necessary step for a return to viability for the banks, it is not in itself sufficient to achieve that goal. Depending on their particular situation and characteristics, banks will have to take appropriate measures in their own interest in order to avoid a recurrence of similar problems and to ensure sustainable profitability.

(1) In the case of an insurance measure, the transfer value is understood as insured amount.
(2) The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may have recourse to external expertise.
49. Under State aid rules and notably those for rescue and restructuring aid, asset relief amounts to a structural operation and requires a careful assessment of three conditions: (i) adequate contribution of the beneficiary to the costs of the impaired assets programme; (ii) appropriate action to guarantee the return to viability; and (iii) necessary measures to remedy competition distortions.

50. The first condition should normally be achieved by fulfilling the requirements set out in the Section 5, notably disclosure, valuation, pricing and burden-sharing. This should ensure a contribution by the beneficiary of at least the entirety of the losses incurred in the transfer of assets to the State. Where this is materially not possible, aid may still be authorised, by way of exception, subject to stricter requirements as to the other two conditions.

51. Requirements to return to viability and the need for remedies for competition distortion will be determined on a case-by-case basis. As regards the second condition, the need to return to long-term viability, it should be noted that asset relief may contribute to that objective. The viability review should certify the actual and prospective capital adequacy of the bank after a complete assessment and consideration of the possible factors of risk (1).

52. The Commission’s assessment of the extent of necessary restructuring, following the initial authorisation of the asset relief measures, will be determined on the basis of the following criteria: criteria outlined in 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 proportion of the bank’s assets subject to relief, the transfer price of such assets compared to the market price, the specific features of the impaired asset relief granted, the total size of State exposure relative to a bank’s risk-weighted assets, the nature and origin of the problems of the beneficiary bank, and the soundness of the bank’s business model and investment strategy. It will also take into account any additional granting of State guarantee or State recapitalisation, in order to draw a complete picture of the situation of the beneficiary bank (2).

53. Long-term viability requires that the bank is able to survive without any State support, which implies clear plans for redeeming any State capital received and renouncing State guarantees. Depending on the outcome of that assessment, restructuring will have to comprise an in-depth review of the bank’s strategy and activity, including, for example, focusing on core business, reorientation of business models, closure or divestment of business divisions/subsidiaries, changes in the asset-liability management and other changes.

54. The need for in-depth restructuring will be presumed where an appropriate valuation of impaired assets according to the principles set out in Section 3.5 and Annex IV would lead to negative equity/technical insolvency without State intervention. Repeated requests for aid and departure from the general principles set out in Section 5, will normally point to the need for such in-depth restructuring.

55. In-depth restructuring would also be required where the bank has already received State aid in whatever form that either contributes to coverage or avoidance of losses, or altogether exceeds 2% of the total bank’s risk weighted assets, while taking the specific features of the situation of each beneficiary in due consideration (3).

56. The timing of any required measures to restore viability will take account of the specific situation of the bank concerned, as well as the overall situation in the banking sector, without unduly delaying the necessary adjustments.

57. Thirdly, the extent of necessary compensatory measures should be examined, on the basis of distortions of competition resulting from the aid. This may involve downsizing or divestment of profitable business units or subsidiaries, or behavioural commitments to limit commercial expansion.

(1) Compliance with the criteria set in paragraph 40 of 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 would also need to be ensured as far as applicable.

(2) For those banks already subject to the obligation of a restructuring plan, following the granting of previous State aid, such a plan would need to duly take into consideration the new aid and envisage all options from restructuring to orderly winding-up.

(3) Participation in an authorised credit guarantee scheme, without the guarantee having had to be invoked to cover losses, are not to be taken into consideration for the purposes of this paragraph.
58. The need for compensatory measures will be presumed if the beneficiary bank does not fulfil the conditions set out in Section 5 and notably those of disclosure, valuation, pricing and burden sharing.

59. The Commission will assess the scope of the compensatory measures required, depending on its assessment of competition distortions resulting from the aid, and notably on the basis of the following factors: total amount of aid, including from guarantee and recapitalisation measures, volume of impaired assets benefiting from the measure, proportion of losses resulting from the asset, general soundness of the bank, risk profile of the relieved assets, quality of risk management of the bank, level of solvency ratios in the absence of aid, market position of the beneficiary bank and distortions of competition from the bank's continued market activities, and impact of the aid on the structure of the banking sector.

7. FINAL PROVISION

60. The Commission applies this Communication from 25 February 2009, the date on which it agreed in principle its content, having regard to the financial and economic context which required immediate action.
ANNEX I

Eurosystem guidance on asset support measures for banks

The Eurosystem has identified seven guiding principles for bank asset support measures:

1. **eligibility of institutions**, which should be voluntary, with possible priority for institutions with large concentrations of impaired assets in case of constraints;

2. relatively broad **definition of assets** eligible for support;

3. **valuation of eligible assets** which is transparent, preferably based on a range of approaches and common criteria to be adopted across Member States, based on independent third-party expert opinions, use of models which use micro-level inputs to estimate the economic value of, and probabilities attached to, the expected losses, and of asset-specific haircuts on book values of assets when the assessment of market value is particularly challenging, or when the situation requires swift action;

4. an adequate degree of **risk sharing** as a necessary element of any scheme in order to limit the cost to the government, provide the right incentives to the participating institutions and maintain a level playing field across these institutions;

5. sufficiently long **duration** of the asset-support schemes, possibly matching the maturity structure of the eligible assets;

6. **governance of institutions** which should continue to be run according to business principles, and favouring of schemes that envisage well defined exit strategies; and

7. **conditionality** of public support schemes to some measurable yardsticks, such as commitments to continue providing credit to appropriately meet demand according to commercial criteria.
ANNEX II

The different approaches to asset relief and experience with the use of bad-bank solutions in the United States, Sweden, France, Italy, Germany, Switzerland and the Czech Republic

I. Possible approaches

In principle, two broad approaches to managing assets subject to relief measures can be considered:

1. the segregation of impaired assets from good assets within a bank or in the banking sector as a whole. Several variants of this approach can be considered. An asset management company (bad bank or risk shield) could be created for each bank, whereby the impaired assets would be transferred to a separate legal entity, with the assets still managed by the ailing bank or a separate entity and possible losses shared between the good bank and the State. Alternatively, the State could establish a self-standing institution (often called an ‘aggregator bank’) to purchase the impaired assets of either an individual bank or of the banking sector as a whole, thereby allowing banks to return to normal lending behaviour unencumbered by the risk of asset write-downs. This approach could also involve prior nationalisation, whereby the State takes control of some or all banks in the sector before segregating their good and bad assets;

2. an asset insurance scheme whereby banks retain impaired assets on their balance sheets but are indemnified against losses by the State. In the case of asset insurance, the impaired assets remain on the balance sheet of banks, which are indemnified against some or all losses by the State. A specific issue concerning asset insurance is setting the appropriate premium for heterogeneous and complex assets, which should in principle reflect some combination of valuation and risk characteristics of the insured assets. Another issue is that insurance schemes are technically difficult to operate in a situation where the insured assets are spread across a large number of banks rather than concentrated in a few larger banks. Finally, the fact that the insured assets remain on the balance sheets of banks will allow for the possibility of conflicts of interest and remove the important psychological effect of clearly separating the good bank from the bad assets.

II. Experience with bad banks

In the United States, the Resolution Trust Corporation (RTC) was created as a government-owned asset-management company in 1989. The RTC was charged with liquidating assets (primarily real estate-related assets, including mortgage loans) that had been assets of savings and loan associations (S&Ls) declared insolvent by the Office of Thrift Supervision, as a consequence of the Savings and Loan crisis (1989-1992). The RTC also took over the insurance functions of the former Federal Home Loan Bank Board. Between 1989 and mid-1995, the Resolution Trust Corporation closed or otherwise resolved 747 thrifts with total assets of USD 394 billion. In 1995, its duties were transferred to the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation. Overall, the cost to the taxpayers was estimated at USD 124 billion in 1993 dollars.

The RTC operated via so-called ‘equity partnership programs’. All equity partnerships involved a private sector partner acquiring a partial interest in a pool of assets. By retaining an interest in asset portfolios, the RTC was able to participate in the extremely strong returns being realized by portfolio investors. Additionally, the equity partnerships enabled the RTC to benefit from the management and liquidation efforts of their private sector partners, and the structure helped assure an alignment of incentives superior to that which typically exists in a principal/contractor relationship. The various forms of equity partnerships are the following: Multiple Investment Fund (limited and selected partnership, unidentified portfolio of assets), N-series and S-series Mortgage Trusts (competitive bid for identified portfolio of assets), Land fund (to take profit from longer-term recovery and development of land), and JDC Partnership (selection of general partner on a beauty-contest basis for claims unsecured or of questionable value).

In Sweden, two bank asset management corporations (AMCs), Securum and Retriva, were set up to manage the non-performing loans of financial institutions as part of the resolution policy for the financial crisis in 1992/1993. The assets of an ailing bank were split into ‘good’ and ‘bad’ assets, with the bad assets then transferred to one of the asset management corporations, mainly to Securum. An important feature of the Swedish programme was to force banks to disclose expected loan losses in full and assign realistic values to real estate and other assets. For this, the Financial Supervisory Authority tightened its rules for the definition of probable loan losses as well as for the valuation of real estate. In order to obtain uniform valuation of the real estate holdings of banks applying for support, the Authority set up a Valuation Board with real estate experts. The low market values assigned to the assets in the due diligence process, effectively helped setting a floor for asset values. As market participants did not expect prices to fall below that level, trading was
In France, a public body enjoying an institutional unlimited State guarantee was created in the 1990s to take over and liquidate over time the bad assets of Credit Lyonnais. The bad bank financed the acquisition of the assets by means of a loan from Credit Lyonnais. The latter, therefore, could avoid recording losses on the assets and free capital for an equivalent amount of risk-weighted assets, as the loan to the bad bank could enjoy a 0 % risk weight in view of the State guarantee. The Commission approved the bad bank as restructuring aid. A feature of the model was the neat separation between the good and the bad bank in order to prevent conflicts of interest and the ‘better fortunes clause’ on the good bank’s profit to the benefit of the State. After a few years, the bank was successfully privatised. However, transfer of the assets to the bad bank at book value sheltered the shareholders from responsibility for the losses and implied high cost for the State over time.

A few years later in Italy, Banco di Napoli was split into a bad bank and a good bank after the absorption of the losses by existing shareholders and a Treasury recapitalisation to the extent necessary to keep the bank afloat. Banco Napoli financed the bad bank’s acquisition of the discounted but still impaired assets via a subsidised loan of the Central Bank counter-guaranteed by the Treasury. The cleaned bank was privatised one year later. In neither the case of Credit Lyonnais nor that of Banco di Napoli was there an immediate budgetary outlay for the Treasury for the acquisition of the bad assets, over and above the provision of capital to the banks.

In Switzerland, the government has created a new fund to which UBS has transferred a portfolio of toxic assets that was valued by a third party prior to the transfer. To ensure financing of this fund, Switzerland first injected capital into UBS (in the form of notes convertible into UBS shares), which UBS immediately wrote off and transferred to the Fund. The remainder of the financing of the Fund was ensured by a loan from the Swiss National Bank.

In the late 1990s, the Czech banks’ lending conditions to corporations were very loose. The Czech banks were severely damaged by that and they had to be bailed out in the late 1990s by the government. Major rounds of cleaning up banks’ balance sheets were undertaken in order to establish a healthy banking industry.

In February 1991, the Czech government created a consolidation bank (Konsolidace banka, KOB), established in order to take on bad loans from the banking sector accumulated before 1991 — such as debts inherited from the centrally planned economy, especially those related to trading within the Soviet bloc. In September 2001, the special bank turned into an agency that also had to absorb bad loans connected to ‘new innovative’ loans (especially so-called privatization loans, nonperforming loans and fraudulent loans).

Starting in 1991, larger banks were freed from bad loans and as of 1994 emphasis shifted to smaller banks. In particular, the failure of Kreditní banka in August 1996, and a subsequent partial run on Agrobanka, caused some strain on the Czech banking system. The programmes concerned led only to a temporary increase of State ownership in banking in 1995, and again in 1998, due to the revocation of the license of Agrobanka. Overall, the government share in banking rose to 32 % at the end of 1995 from 29 % in 1994.

Moreover, to support the small banks, another programme — the Stabilisation Programme — was approved in 1997. This essentially consisted of replacing poor-quality assets with liquidity of up to 110 % of each participating bank’s capital through the purchase of poor-quality assets from the bank by a special company called Česká finanční, with subsequent repurchase of the residual amount of these assets within 5 to 7-year horizon. Six banks joined the programme, but five of these were excluded after failing to comply with its criteria and subsequently went out of business. Thus, the Stabilisation Programme was not successful and was halted.

(1) This is in sharp contrast to the Japanese policy setting too high values for ‘bad’ assets, thus freezing the real estate market for about a decade.
By the end of 1998, 63 banking licences had been granted (60 of these before the end of 1994). As of end-September 2000, 41 banks and branches of foreign banks remained in business, 16 were under extraordinary regimes (8 in liquidation, 8 involved in bankruptcy proceedings), 4 had merged with other banks, and the licence of one foreign bank had been revoked because it had failed to start its operations. Out of the 41 remaining institutions (including CKA) 15 were domestically controlled banks and 27 foreign-controlled banks, including foreign subsidiaries and foreign branches.

In May 2000, the amended Act on Bankruptcy and Settlement and the Act on Public Auctions became effective, which aimed at accelerating bankruptcy proceedings and balancing creditors' and debtors' rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements.
ANNEX III

The definition of categories (‘baskets’) of eligible assets and full disclosure concerning the impaired assets as well as the entire business activities of a bank

1. The definition of categories (‘baskets’) of eligible assets

The definition of baskets of impaired financial assets of banks should be a common denominator based on categories that are already used for:

1. prudential reporting and valuation (Basel pillar 3 = CRD Annex XII; FINREP and COREP);
2. financial reporting and valuation (IAS 39 and IFRS 7 in particular);
3. Specialised ad hoc reporting on the credit crisis: IMF, FSF, Roubini and CEBS work on transparency.

Using a common denominator of existing reporting and valuation categories for defining asset baskets will:

1. prevent any additional reporting burden for banks;
2. make it possible to assess the basket of impaired assets of individual banks to Community and global estimates (which can be relevant for determining the ‘economic value’ at a point in time); and
3. provide objective (certified) starting points for the valuation of impaired assets.

Taking into account the above the Commission suggests the following baskets of financial assets as an entry point for determining the ‘economic value’ and the asset impairment relief:

| Table 1 |
|---|---|---|---|---|
| **I. Structured finance/securitised products** | **Valuation basis for the scheme** | **Comments** |
| **Type of product** | **Accounting category** | **Market value** | **Economic Value** | **Transfer Value** |
| 1 | RMBS | FVPL/AFS (*) | Further refined into: geographic area, seniority of tranches, ratings, sub-prime or Alt-A related, or other underlying assets, maturity/vintage, allowances and write-offs |
| 2 | CMBS | FVPL/AFS |
| 3 | CDO | FVPL/AFS |
| 4 | ABS | FVPL/AFS |
| 5 | Corporate debt | FVPL/AFS |
| 6 | Other loans | FVPL/AFS |
| **Total** | | |

| **II. Non securitised loans** | **Valuation basis for the scheme** | **Comments** |
| **Type of product** | **Accounting category** | **Cost (***)** | **Economic Value** | **Transfer Value** |
| 7 | Corporate | HTM/L&R (*) | Cost (***) | Further refinement on: geographic area, counterparty risk (PD) credit risk mitigation (collateral) and maturity structures; allowances and write-offs |
| 8 | Housing | HTM/L&R | Cost |
| 9 | Other personal | HTM/L&R | Cost |
| **Total** | | |

(*) FVPL = Fair value through profit and loss = trading portfolio + fair value option; AFS = available for sale, HTM = Held to Maturity, L&R = loans and receivables.
(**) Cost means the carrying amount of the loans minus impairment.
II. Full disclosure concerning impaired assets and the related business activities

On the basis of the asset baskets shown in Table 1, the information provided on the impaired assets of a bank which should be covered by an asset relief measure should be presented with a further degree of granularity as suggested in the comment column of Table 1.

On the basis of good practices observed by the Committee of European Banking Supervisors (CEBS) for disclosures on activities affected by the market turmoil, information on the bank’s activities related to the impaired assets that would feed into the viability review referred to in Section 5.1 could be structured as follows:

Table 2

<table>
<thead>
<tr>
<th>CEEB observed good practices</th>
<th>Senior Supervisors Group (SSG): Leading Practice Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business model</strong></td>
<td></td>
</tr>
<tr>
<td>— Description of the business model (i.e. of the reasons for engaging in activities and of the contribution to value creation process) and, if applicable of any changes made (e.g. as a result of crisis).</td>
<td>— Activities (SPE) (*)</td>
</tr>
<tr>
<td>— Description of strategies and objectives.</td>
<td>— Nature of exposure (sponsor, liquidity and/or credit enhancement provider) (SPE).</td>
</tr>
<tr>
<td>— Description of importance of activities and contribution to business (including a discussion in quantitative terms).</td>
<td>— Qualitative discussion of policy (LF).</td>
</tr>
<tr>
<td>— Description on the type of activities including a description of the instruments as well as of their functioning and qualifying criteria that products/investments have to meet.</td>
<td></td>
</tr>
<tr>
<td>— Description of the role and the extent of involvement of the institution, i.e. commitments and obligations.</td>
<td></td>
</tr>
<tr>
<td><strong>Risks and risk management</strong></td>
<td></td>
</tr>
<tr>
<td>— Description of the nature and extent of risks incurred in relation to the activities and instruments.</td>
<td></td>
</tr>
<tr>
<td>— Description of risk management practices of relevance to the activities, of any identified weaknesses of any corrective measures that have been taken to address these.</td>
<td></td>
</tr>
<tr>
<td>— In the current crisis, particular attention should be given to liquidity risk.</td>
<td></td>
</tr>
<tr>
<td><strong>Impact of the crisis on results</strong></td>
<td></td>
</tr>
<tr>
<td>— Qualitative and quantitative description of results, with a focus on losses (where applicable) and write-downs impacting the results.</td>
<td>— Change in exposure from the prior period, including sales and write-downs (CMB/LF).</td>
</tr>
<tr>
<td>— Breakdown of the write-downs/losses by types of products and instruments affected by the crisis (CMBS, RMBS, CDO, ARS and LBO further broken down by different criteria).</td>
<td></td>
</tr>
<tr>
<td>— Description of the reasons and factors responsible for the impact incurred.</td>
<td></td>
</tr>
<tr>
<td>— Comparison of (i) impacts between (relevant) periods and of (ii) income statement balances before and after the impact of the crisis.</td>
<td></td>
</tr>
<tr>
<td>— Distinction of write-downs between realised and unrealised amounts.</td>
<td></td>
</tr>
<tr>
<td>— Description of the influence the crisis had on the firm’s share price.</td>
<td></td>
</tr>
<tr>
<td>— Disclosure of maximum loss risk and description how the institution’s situation could be affected by a further downturn or by a market recovery.</td>
<td></td>
</tr>
<tr>
<td>— Disclosure of impact of credit spread movements for own liabilities on results and on the methods used to determine this impact.</td>
<td></td>
</tr>
</tbody>
</table>

(*) Source: CEBS (Committee of European Banking Supervisors) report on banks’ transparency on activities and products affected by the recent market turmoil, 18 June 2008.
Exposure levels and types

- Nominal amount (or amortised cost) and fair values of outstanding exposures.
- Information on credit protection (e.g., through credit default swaps) and its effect on exposures.
- Information on the number of products
- Granular disclosures of exposures with breakdowns provided by:
  - level of seniority of tranches,
  - level of credit quality (e.g., ratings, investment grade, vintages),
  - geographic origin,
  - whether exposures have been originated, retained, warehoused or purchased,
  - product characteristics: e.g., ratings, share of sub-prime mortgages, discount rates, attachment points, spreads, funding,
  - characteristics of the underlying assets: e.g., vintages, loan-to-value ratios, information on liens, weighted average life of the underlying, prepayment speed assumptions, expected credit losses.
- Movement schedules of exposures between relevant reporting periods and the underlying reasons (sales, disposals, purchases etc.).
- Discussion of exposures that have not been consolidated (or that have been recognised in the course of the crisis) and the related reasons.
- Exposure to monoline insurers and quality of insured assets:
  - nominal amounts (or amortized cost) of insured exposures as well as of the amount of credit protection bought,
  - fair values of the outstanding exposures as well as of the related credit protection,
  - amount of write-downs and losses, differentiated into realised and unrealised amounts,
  - breakdowns of exposures by ratings or counterparty.

Accounting policies and valuation issues

- Classification of the transactions and structured products for accounting purposes and the related accounting treatment.
- Consolidation of SPEs and other vehicles (such as VIEs) and a reconciliation of these to the structured products affected by the sub-prime crisis.
- Detailed disclosures on fair values of financial instruments:
  - financial instruments to which fair values are applied,
  - fair value hierarchy (a breakdown of all exposures measured at fair value by different levels of the fair value hierarchy and a breakdown between cash and derivative instruments as well as disclosures on migrations between the different levels),
  - treatment of day 1 profits (including quantitative information),
  - use of the fair value option (including its conditions for use) and related amounts (with appropriate breakdowns).
- Disclosures on the modelling techniques used for the valuation of financial instruments, including discussions of the following:
  - description of modelling techniques and of the instruments to which they are applied,
  - description of valuation processes (including in particular discussions of assumptions and input factors the models rely on),
  - type of adjustments applied to reflect model risk and other valuation uncertainties,
  - sensitivity of fair values, and
  - stress scenarios.
**CEBS observed good practices**

<table>
<thead>
<tr>
<th>Senior Supervisors Group (SSG): Leading Practice Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other disclosure aspects</strong></td>
</tr>
<tr>
<td>— Description of disclosure policies and of the principles that are used for disclosures and financial reporting.</td>
</tr>
<tr>
<td><strong>Presentation issues</strong></td>
</tr>
<tr>
<td>— Relevant disclosures for the understanding of an institution’s involvement in a certain activity should as far as possible be provided in one place.</td>
</tr>
<tr>
<td>— Where information is spread between different parts or sources clear cross-references should be provided to allow the interested reader to navigate between the parts.</td>
</tr>
<tr>
<td>— Narrative disclosures should to the largest extent possible be supplemented with illustrative tables and overviews to improve the clarity.</td>
</tr>
<tr>
<td>— Institutions should ensure that the terminology used to describe complex financial instruments and transactions is accompanied by clear and adequate explanations.</td>
</tr>
</tbody>
</table>

(*) In the SSG Report, each feature refers to a specific type of SPE, or to all of them as a whole, being SPE (Special Purpose Entities in general), LF (Leveraged Finance), CMB (Commercial Mortgage-Backed Securities), O (Other sub-prime and Alt-A Exposures), CDO (Collateralised Debt Obligations)
ANNEX IV

Valuation and pricing principles and processes

I. Valuation methodology and procedure

For the purposes of asset relief measures, assets should be classified along the lines of the illustrative tables 1 and 2 in
Annex III.

The determination of the real economic value for the purposes of this Communication (see Section 3.5) should be based
on observable market inputs and realistic and prudent assumptions about future cash flows.

The valuation method to be applied to eligible assets should be agreed at the Community level and could vary with the
individual assets or baskets of assets concerned. Whenever possible, such valuation should be re-assessed in reference to
the market at regular intervals over the life of the asset.

In the past, several valuation options have been applied more or less successfully. Simple reverse auction procedures
proved useful in the case of categories of assets where market values are reasonably certain. However, this approach failed
in valuing more complex assets in the United States. More sophisticated auction procedures are more adapted where there
is less certainty about market values and a more exact method of price discovery of each asset would be needed. Unfortu-
nately, their design is not straightforward. The alternative of model-based calculations for complex assets presents the
drawback of being sensitive to the underlying assumptions (1).

The option of applying uniform valuation haircuts to all complex assets simplifies the process of valuation overall,
although it results in less accurate pricing of individual assets. Central banks have substantial experience regarding possible
criteria and parameters for collateral pledged for refinancing, which could serve as a useful reference.

Whatever the model chosen, the valuation process and particularly the assessment of the likelihood of future losses
should be based on rigorous stress-testing against a scenario of protracted global recession.

The valuation must be based on internationally recognised standards and benchmarks. A common valuation methodology
agreed at the Community level and consistently implemented by Member States could greatly contribute to mitigating
concerns regarding threats to a level playing field resulting from potentially significant implications of discrepant valuation
systems. When assessing the valuation methods put forward by Member States for asset relief measures, the Commission
will, in principle, consult panels of valuation experts (2).

II. The pricing of State support on the basis of valuation

The valuation of assets must be distinguished from the pricing of a support measure. A purchase or insurance on the
basis of the established current market value or the ‘real economic value’, factoring in future cash flow projections on a
hold-to-maturity basis, will in practice often exceed the present capacities of beneficiary banks for burden-sharing (3). The
objective of the pricing must be based on a transfer value as close to the identified real economic value as possible. While
implying an advantage as compared to the current market value and thus State aid, pricing on the basis of the ‘real
economic value’ can be perceived as counterbalancing current market exaggerations fuelled by current crisis conditions
which have led to the deterioration or even collapse of certain markets. The greater any deviation of the transfer value
from the ‘real economic value’, and thus the amount of aid, the greater the need for remedial measures to ensure accurate
pricing over time (for example, through better fortune clauses) and for more in-depth restructuring. The admissible devia-
tion from the result of valuation should be more restricted for assets the value of which can be established on the basis of
reliable market input than for those for which markets are illiquid. Non-compliance with these principles would represent
a strong indicator for the necessity of far-reaching restructuring and compensatory measures or even an orderly
winding-up.

In any event, any pricing of asset relief must include remuneration for the State that adequately takes account of the risks
of future losses exceeding those that are projected in the determination of the ‘real economic value’ and any additional
risk stemming from a transfer value above the real economic value.

Such remuneration may be provided by setting the transfer price of assets at below the ‘real economic value’ to a sufficient
extent so as to provide for adequate compensation for the risk in the form of a commensurate upside, or by adapting the
guarantee fee accordingly.

(1) In any case, an auction would only be possible for homogeneous classes of assets and where there exist a sufficiently large number of poten-
tial sellers. In addition a reserve price would need to be introduced to ensure the protection of the interest of the State and claw back
mechanism in case the final losses would exceed the reserve price, so as to ensure a sufficient contribution by the beneficiary bank. In order
to assess such mechanisms, comparative scenarios with alternatives guarantee/purchase schemes will have to be submitted, including stress
tests, in order to guarantee their global financial equivalence.

(2) The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may
have recourse to external expertise.

(3) See Section 5.2.
Identifying the necessary target return could be 'inspired' by the remuneration that would have been required for recapitalisation measures to the extent of the capital effect of the proposed asset relief. This should be in line with the Commission 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, while taking into account the specific features of asset relief measures and particularly the fact that they may involve higher exposure than capital injections (1).

The pricing system could also include warrants for shares in the banks equal in value to the assets (implying that a higher price paid will result in a higher potential equity stake). One model for such a pricing system could be an asset purchase scenario, in which such warrants will be returned to the bank once the assets are sold by the bad bank and if they have earned the necessary target return. If the assets do not yield such a return, the bank should pay the difference in cash to reach the target return. If the bank does not pay the cash, the Member State will sell the warrants to achieve the target return.

In an asset guarantee scenario, the guarantee fee could be paid in the form of shares with a fixed cumulative interest representing the target return. Where the guarantee needs to be drawn upon, the Member State could use the warrants to acquire shares corresponding to the amounts that had to be covered by the guarantee.

Any pricing system would have to ensure that the overall contribution of beneficiary banks reduces the extent of net State intervention to the minimum necessary.

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(1) In an asset guarantee scenario, it would also have to be taken into consideration that in contrast to recapitalisation measures, no liquidity is provided.
ANNEX V

State aid procedure

Member States notifying asset relief measures must provide the Commission with comprehensive and detailed information on all the elements of relevance for the assessment of the public support measures under the State aid rules as set out in this Communication (1). This includes notably the detailed description of the valuation methodology and its intended implementation involving independent third-party expertise (2). Commission approval will be granted for a period of 6 months, and conditional on the commitment to present either a restructuring plan or a viability review for each beneficiary institution within 3 months from its accession to the asset relief programme.

Where a bank is granted aid either as an individual measure or under an approved asset relief scheme, the Member State must provide the Commission, at the latest in the individual notification concerning the restructuring plan or viability review, with detailed information regarding the assets covered and its valuation at the time such individual aid is granted, as well as the certified and validated results of the disclosure of impairments concerning the assets covered by the relief measure (3). The full review of the bank’s activities and balance sheet should be provided as soon as possible to initiate discussions on the appropriate nature and extent of restructuring well in advance of the formal presentation of a restructuring plan with a view to accelerating this process and providing clarity and legal certainty as quickly as possible.

For banks that have already benefited from other forms of State aid, whether under approved guarantee, asset swaps or recapitalisation schemes or individual measures, any assistance granted under the asset relief scheme must be reported first under existing reporting obligations so that the Commission has a complete picture of multiple State aid measures benefiting an individual aid recipient and can better appreciate the effectiveness of the previous measures and the contribution that the Member State proposes to introduce in a global assessment.

The Commission will reassess the aid granted under temporary approval in the light of the adequacy of the proposed restructuring and the remedial measures (4), and will take a view on its compatibility for longer than 6 months through a new decision.

Member States must also provide a report to the Commission every six months on the functioning of the asset relief programmes and on the development of the banks’ restructuring plans. Where the Member State is already subject to a reporting requirement for other forms of aid to its banks, such a report must be complemented with the necessary information concerning the asset relief measures and the banks’ restructuring plans.

(1) Pre-notification contact is encouraged.
(2) See Section 5.5 and Annex IV.
(3) A letter from the head of the supervisory authority certifying the detailed results must be provided.
(4) In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring/winding-up cases. The Commission may consider that there is no need to submit a plan for the pure winding up of an institution, or where the size of the institution is negligible.
Commission 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

(Text with EEA relevance)
(2009/C 195/04)

1. INTRODUCTION

1. At its meetings on 20 March 2009 and on 18 and 19 June 2009, the European Council confirmed its commitment to restoring confidence and the proper functioning of the financial market, which is an indispensable precondition for recovery from the current financial and economic crisis. In view of the systemic nature of the crisis and the interconnectivity of the financial sector, a number of actions have been initiated at Community level to restore confidence in the financial system, preserve the internal market and secure lending to the economy (1).

2. Those initiatives need to be complemented by action at the level of individual financial institutions to enable them to withstand the current crisis and return to long-term viability without reliance on State support in order to perform their lending function on a sounder basis. The Commission is already dealing with a number of State aid cases resulting from interventions by Member States to avoid liquidity, solvency or lending problems. The Commission has provided guidance, in three successive communications, on the design and implementation of State aid in favour of banks (2). Those communications recognised that the severity of the crisis justified the granting of aid, which can be considered compatible pursuant to Article 87(3)(b) of the Treaty establishing the European Community, and provided a framework for the coherent provision of public guarantees, recapitalisation and impaired asset relief measures by Member States. The primary rationale of those rules is to ensure that rescue measures can fully attain the objectives of financial stability and maintenance of credit flows, while also ensuring a level playing-field between banks (3) located in different Member States as well as between banks which receive public support and those which do not, avoiding harmful subsidy races, limiting moral hazard and ensuring the competitiveness and efficiency of European banks in Community and international markets.

3. State aid rules provide a tool to ensure the coherence of measures taken by those Member States which have decided to act. However, the decision whether to use public funds, for example to shelter banks from impaired assets, remains with the Member States. In some instances, financial institutions will be in a position to handle the current crisis without major adjustment or additional aid. In other cases, State aid may be necessary, in the form of guarantees, recapitalization or impaired asset relief.

4. Where a financial institution has received State aid, the Member State should submit a viability plan or a more fundamental restructuring plan, in order to confirm or re-establish individual banks’ long-term viability without reliance on State support. Criteria have already been established to delineate the conditions under which a bank may need to be subject to more substantial restructuring, and when measures are needed to cater for distortions of competition resulting from the aid (4). This Communication does not alter those criteria. It complements them, with a view to enhancing predictability and ensuring a coherent approach, by explaining how the Commission will assess

(1) In its Communication to the European Council of 4 March 2009 on ‘Driving the European Recovery’ COM(2009) 114 final, the Commission announced a reform programme to address more general weaknesses in the regulatory framework applicable to financial institutions which operate in the Community.


(3) The application of this Communication is limited to financial institutions as referred to in the Banking Communication. Guidance provided in this Communication refers to banks for ease of reference. However it applies, mutatis mutandis, to other financial institutions where appropriate.

(4) The criteria and specific circumstances which trigger the obligation to present a restructuring plan have been explained in the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. They refer in particular, but not exclusively, to situations where a distressed bank has been recapitalised by the State, or where a bank benefiting from asset relief has already received State aid in whatever form that contributes to coverage or avoidance of losses (except participation in a guarantee scheme) which altogether exceeds 2 % of the total bank’s risk weighted assets. The degree of restructuring will depend on the seriousness of the problems of each bank. By contrast, in line with those Communications (in particular point 40 of the Recapitalisation Communication and Annex V to the Impaired Assets Communication), where a limited amount of aid has been given to banks which are fundamentally sound, Member States are required to submit a report to the Commission on the use of State funds comprising all the information necessary to evaluate the bank’s viability, the use of the capital received and the path towards exit from reliance on State support. The viability review should demonstrate the risk profile and prospective capital adequacy of these banks and evaluate their business plans.
the compatibility of restructuring aid (1) granted by Member States to financial institutions in the current circumstances of systemic crisis, under Article 87(3)(b) of the Treaty.

5. The Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication recall the basic principles set out in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (2). Those principles require, first and foremost, that restructuring aid should lead to the restoration of viability of the undertaking in the longer term without State aid. They also require restructuring aid to be accompanied, to the extent possible, by adequate burden sharing and by measures to minimise distortions of competition, which would in the longer term fundamentally weaken the structure and the functioning of the relevant market.

6. The integrity of the internal market and the development of banks throughout the Community must be a key consideration in the application of those principles; fragmentation and market partitioning should be avoided. European banks should be in a strong global position on the basis of the single European financial market, once the current crisis has been overcome. The Commission also reaffirms the need to anticipate and manage change in a socially responsible way and underlines the need to comply with national legislation implementing Community Directives on information and consultation of workers that apply under such circumstances (3).

7. This Communication explains how the Commission will examine aid for the restructuring of banks in the current crisis, taking into account the need to modulate past practice in the light of the nature and the global scale of the crisis, the systemic role of the banking sector for the whole economy, and the systemic effects which may arise from the need of a number of banks to restructure within the same period:

— The restructuring plan will need to include a thorough diagnosis of the bank’s problems. In order to devise sustainable strategies for the restoration of viability, banks will therefore be required to stress test their business. This first step in the restoration of viability should be based on common parameters which will build to the extent possible on appropriate methodologies agreed at Community level. Banks will also be required, where applicable, to disclose impaired assets (4).

— Given the overriding goal of financial stability and the prevailing difficult economic outlook throughout the Community, special attention will be given to the design of a restructuring plan, and in particular to ensuring a sufficiently flexible and realistic timing of the necessary implementation steps. Where the immediate implementation of structural measures is not possible due to market circumstances, intermediate behavioural safeguards should be considered.

— The Commission will apply the basic principle of appropriate burden sharing between Member States and the beneficiary banks with the overall situation of the financial sector in mind. Where significant burden sharing is not immediately possible due to market circumstances at the time of the rescue, this should be addressed at a later stage of the implementation of the restructuring plan.

— Measures to limit distortion of competition by a rescued bank in the same Member State or in other Member States should be designed in a way that limits any disadvantage to other banks while taking into account the fact that the systemic nature of the current crisis has required very widespread State intervention in the sector.

(1) That is to say, aid which was temporarily authorised by the Commission as rescue aid under the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (4). Where temporary aid was notified as needed for restructuring, this should be based on common parameters which will build to the extent possible on appropriate methodologies agreed at Community level.


(4) In accordance with the Impaired Assets Communication.
In accordance with the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication, Member States are required to submit a viability review to demonstrate viability of the beneficiary bank. In the latter case, and save situations where there are doubts, the Commission will normally request less detailed information (2). In case of doubt, the Commission will, in particular, seek evidence of adequate stress testing, in accordance with point 13, and of validation of the results of the stress testing by the competent national authority. Sections 3, 4 and 5 only apply to cases where the Member State is under an obligation to notify a restructuring plan. Section 6 deals with the temporal scope of this Communication and applies both to Member States required to notify a restructuring plan for the aid beneficiary and to Member States required only to demonstrate the viability of aid beneficiaries.

2. RESTORING LONG-TERM VIABILITY

9. Where, on the basis of previous Commission guidance or decisions, a Member State is under an obligation to submit a restructuring plan (4) that plan should be comprehensive, detailed and based on a coherent concept. It should demonstrate how the bank will restore long-term viability without State aid as soon as possible (5). The notification of any restructuring plan should include a comparison with alternative options, including a break-up, or absorption by another bank, in order to allow the Commission to assess (6) whether more market oriented, less costly or less distortive solutions are available consistent with maintaining financial stability. In the event that the bank cannot be restored to viability, the restructuring plan should indicate how it can be wound up in an orderly fashion.

10. The restructuring plan should identify the causes of the bank’s difficulties and the bank’s own weaknesses and outline how the proposed restructuring measures remedy the bank’s underlying problems.

11. The restructuring plan should provide information on the business model of the beneficiary, including in particular its organisational structure, funding (demonstrating viability of the short and long term funding structure (7)), corporate governance (demonstrating prevention of conflicts of interest as well as necessary management changes (8)), risk management (including disclosure of impaired assets and prudent provisioning for expected non-performing assets), and asset-liability management, cash-flow generation (which should reach sufficient levels without State support), off-balance sheet commitments (demonstrating their sustainability and consolidation when the bank bears a significant exposure (9)), leveraging, current and prospective capital adequacy in line with applicable supervisory regulation (based on prudent valution and adequate provisioning), and the remuneration incentive structure (10), (demonstrating how it promotes the beneficiary’s long-term profitability).

12. The viability of each business activity and centre of profit should be analysed, with the necessary breakdown. The return to viability of the bank should mainly derive from internal measures. It may be based on external factors such as variations in prices and demand over which the undertaking has no great influence, but only if the market assumptions made are generally acknowledged. Restructuring requires a withdrawal from activities which would remain structurally loss making in the medium term.

13. 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 into account the risk profile of the bank. The restructured bank should be able to compete in the marketplace for capital on its own merits in compliance with relevant regulatory requirements. The expected results of the planned restructuring need to be demonstrated under a base case scenario as well as under ‘stress’ scenarios. For this, restructuring plans need to take account, inter alia, of the current state and future prospects of the financial markets, reflecting base-case and worst-case assumptions. Stress testing should consider a range of scenarios, including a combination of stress events and a protracted global recession. Assumptions should be compared with appropriate sector-wide benchmarks, adequately amended to take account of the new elements of the current crisis in financial markets. The plan should include measures to

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(1) In accordance with the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. See point 4 of this Communication.

(2) In accordance with the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication, where a limited amount of aid is granted to fundamentally sound banks, Member States are required to submit a viability review to the Commission.

(3) In accordance, in particular, with point 40 of the Recapitalisation Communication and Annex V to the Impaired Assets Communication.

(4) As explained in point 8 of this Communication, where section 2 refers to a restructuring plan, the principles underlying section 2 apply by analogy also to viability reviews.

(5) An indicative model for a restructuring plan is reproduced in the Annex.

(6) Where appropriate the Commission will ask for the advice of an external consultant to examine the notified restructuring plans in order to assess viability, burden sharing and minimising competition distortions. It may also request certification of various elements by supervisors.

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(8) See Decision 2009/341/EC in Case C 9/2008 Sachsen LB.


address possible requirements emerging from stress testing. The stress testing should, to the extent possible, be based on common parameters agreed at Community level (such as a methodology developed by the Committee of European Banking Supervisors) and, where appropriate, adapted to cater for country- and bank-specific circumstances.

14. In the current crisis governments have recapitalised banks on terms chosen primarily for reasons of financial stability rather than for a return which would have been acceptable to a private investor. Long-term viability therefore requires that any State aid received is either redeemed over time, as anticipated at the time the aid is granted, or is remunerated according to normal market conditions, thereby ensuring that any form of additional State aid is terminated. As the Treaty is neutral as to the ownership of property, State aid rules apply irrespective of whether a bank is in private or public ownership.

15. While the restructuring period should be as short as possible so as to restore viability quickly, the Commission will take into account the current crisis conditions and may therefore allow some structural measures to be completed within a longer time horizon than is usually the case, notably to avoid depressing markets through fire sales (1). However, restructuring should be implemented as soon as possible and should not last more than five years (2) to be effective and allow for a credible return to viability of the restructured bank.

16. Should further aid not initially foreseen in the notified restructuring plan be necessary during the restructuring period for the restoration of viability, this will be subject to individual ex ante notification and any such further aid will be taken into account in the Commission's final decision.

Viability through sale of a bank

17. The sale of an ailing bank to another financial institution can contribute to the restoration of long-term viability, if the purchaser is viable and capable of absorbing the transfer of the ailing bank, and may help to restore market confidence. It may also contribute to the consolidation of the financial sector. To this end, the purchaser should demonstrate that the integrated entity will be viable.

In the case of a sale, the requirements of viability, own contribution and limitations of distortions of competition also need to be respected.

18. A transparent, objective, unconditional and non-discriminatory competitive sale process should generally be ensured to offer equal opportunities to all potential bidders (3).

19. Furthermore, without prejudice to the merger control system that may be applicable, and while recognising that the sale of an aided ailing bank to a competitor can both contribute to the restoration of long-term viability and result in increased consolidation of the financial sector, where such a sale would result prima facie in a significant impediment of effective competition, it should not be allowed unless the distortions of competition are addressed by appropriate remedies accompanying the aid.

20. The sale of a bank may also involve State aid to the buyer and/or to the sold activity (4). If the sale is organised via an open and unconditional competitive tender the assets go to the highest bidder, the sale price is considered to be the market price and aid to the buyer can be excluded (5). A negative sale price (or financial support to compensate for such a negative price) may exceptionally be accepted as not involving State aid if the seller would have to bear higher costs in the event of liquidation (6). For the calculation of the cost of liquidation in such circumstances, the Commission will only take account of those liabilities which would have been entered into by a market economy investor (7). This excludes liabilities stemming from State aid (8).

21. An orderly winding-up or the auctioning off of a failed bank should always be considered where a bank cannot credibly return to long-term viability. Governments should encourage the exit of non-viable players, while allowing for the exit process to take place within an appropriate time frame that preserves financial stability. The Banking Communication provides for a procedure in the

(1) Understood as selling large quantities of assets at current low market prices which could lower the prices further.

(2) The Commission practice has been to accept two to three years as the duration of a restructuring plan.

(3) See also point 20.

(4) See for example Decision 2009/341/EC in Case C 9/2008 Sadsten LB.

(5) The absence of the tender as such does not automatically mean that there is State aid to the buyer.

(6) This would normally result in an aid to the sold economic activity.


framework of which such orderly winding up should take place (3). Acquisition of the ‘good’ assets and liabilities of a bank in difficulty may also be an option for a healthy bank as it could be a cost effective way to expand deposits and build relationships with reliable borrowers. Moreover, the creation of an autonomous ‘good bank’ from a combination of the ‘good’ assets and liabilities of an existing bank may also be an acceptable path to viability, provided this new entity is not in a position to unduly distort competition.

3. OWN CONTRIBUTION BY THE BENEFICIARY (BURDEN SHARING)

22. In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour.

Limitation of restructuring costs

23. Restructuring aid should be limited to covering costs which are necessary for the restoration of viability. This means that an undertaking should not be endowed with public resources which could be used to finance market-distorting activities not linked to the restructuring process. For example, acquisitions of shares in other undertakings or new investments cannot be financed through State aid unless this is essential for restoring an undertaking’s viability (4).

Limitation of the amount of aid, significant own contribution

24. In order to limit the aid amount to the minimum necessary, banks should first use their own resources to finance restructuring. This may involve, for instance, the sale of assets. State support should be granted on terms which represent an adequate burden-sharing of the costs (5).

This means that the costs associated with the restructuring are not only borne by the State but also by those who invested in the bank, by absorbing losses with available capital and by paying an adequate remuneration for State interventions (6). Nonetheless, the Commission considers that it is not appropriate to fix thresholds concerning burden-sharing ex ante in the context of the current systemic crisis, having regard to the objective of facilitating access to private capital and a return to normal market conditions.

25. Any derogation from an adequate burden-sharing ex ante which may have been exceptionally granted in the rescue phase for reasons of financial stability must be compensated by a further contribution at a later stage of the restructuring, for example in the form of claw-back clauses and/or by farther-reaching restructuring including additional measures to limit distortions of competition (7).

26. Banks should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities. However, banks should not use State aid to remunerate own funds (equity and subordinated debt) when those activities do not generate sufficient profits. Therefore, in a restructuring context, the discretionary offset of losses (for example by releasing reserves or reducing equity) by beneficiary banks in order to guarantee the payment of dividends and coupons on outstanding subordinated debt, is in principle not compatible with the objective of burden sharing (8). This may need to be balanced with ensuring the refinancing capability of the bank and the exit incentives (7).

In the interests of promoting refinancing by the beneficiary bank, the Commission may favourably regard the payment of coupons on newly issued hybrid capital instruments with

(4) See points 43 to 50 of the Banking Communication. In order to enable such orderly exit, liquidation aid may be considered compatible, when for instance needed for a temporary recapitalisation of a bridge bank or structure or satisfying claims of certain creditor classes if justified by reasons of financial stability. For examples of such aid and conditions under which it was found compatible, see Commission Decision of 1 October 2008 in case N 41/2008 UK, Rescue aid to Bradford & Bingley (OJ C 290, 13.11.2008, p. 2) and the Commission Decision of 5 November 2008 in case NN 39/2008 DK, Aid for liquidation of Roskilde Bank (OJ C 12, 17.1.2009, p. 3).


(6) As already developed in previous Commission Communications, in particular the Impaired Assets Communication, see points 21 et seq.

(7) The Commission has provided detailed guidance regarding the pricing of State guarantees, recapitalisations and asset relief measures respectively in the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. To the extent that such a price is being paid, the shareholders of the bank see their position diluted in a financial sense.

(8) Impaired Asset Communication, points 24 and 25. See also Section 4 of this Communication.

(9) See Commission Decision of 18 December 2008 in case N 615/2008 Bayern LB (OJ C 80, 3.4.2009, p. 4). However, this does not prevent the bank from making coupon payments when it is under a binding legal obligation to do so.

See Impaired Asset Communication, point 31, and the nuanced approach to dividend restrictions in the Recapitalisation Communication, points 33, 34 and 45, reflecting that although temporary dividend or coupon bans may retain capital within the bank and increase the capital cushion and hence improve the solvency of the bank, they may equally impede the bank’s access to private finance sources, or at least increase the cost of new future financing.
greater seniority over existing subordinated debt. In any case, banks should not normally be allowed to purchase their own shares during the restructuring phase.

27. Provision of additional aid during the restructuring period should remain a possibility if justified by reasons of financial stability. Any additional aid should remain limited to the minimum necessary to ensure viability.

4. LIMITING DISTORTIONS OF COMPETITION AND ENSURING A COMPETITIVE BANKING SECTOR

Types of distortion

28. Whilst State aid can support financial stability in times of systemic crisis, with wider positive spillovers, it can nevertheless create distortions of competition in various ways. Where banks compete on the merits of their products and services, those which accumulate excessive risk and/or rely on unsustainable business models will ultimately lose market share and, possibly, exit the market while more efficient competitors expand on or enter the markets concerned. State aid prolongs past distortions of competition created by excessive risk-taking and unsustainable business models by artificially supporting the market power of beneficiaries. In this way it may create a moral hazard for the beneficiaries, while weakening the incentives for non-beneficiaries to compete, invest and innovate. Finally, State aid may undermine the single market by shifting an unfair share of the burden of structural adjustment and the attendant social and economic problems to other Member States, whilst at the same time creating entry barriers and undermining incentives for cross-border activities.

29. Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to State aid play an important role, inter alia for the following reasons. First, banks across the Community have been hit by the crisis to a very varying degree and State aid to rescue and restructure distressed banks may harm the position of banks that have remained fundamentally sound, with possible negative effects for financial stability. In a situation of financial, economic and budgetary crisis, differences between Member States in terms of resources available for State intervention become even more pronounced, and harm the level-playing field in the single market. Second, national interventions in the current crisis will, by their very nature, tend to focus on the national markets and hence seriously risk leading to retrenchment behind national borders and to a fragmentation of the single market. Market presence of aid beneficiaries needs to be assessed with a view to ensuring effective competition and preventing market power, entry barriers and disincentives for cross-border activities to the detriment of European businesses and consumers. Third, the current scale of the public intervention necessary for financial stability and the possible limits to normal burden sharing are bound to create even greater moral hazard that needs to be properly corrected to prevent perverse incentives and excessively risky behaviour from reoccurring in the future and to pave the way for a rapid return to normal market conditions without State support.

Applying effective and proportionate measures limiting distortions of competition

30. Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Commission takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in section 2. Depending on the nature of the distortion of competition, it may be addressed through measures in respect of liabilities and/or in respect of assets (1). The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

31. As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. In this context, the amount of State aid will be assessed both in absolute terms (amount of capital received, aid element in guarantees and asset relief measures) and in relation to the bank's risk-weighted assets. The Commission will consider the total amount of aid granted to the beneficiary including any kind of rescue aid. In the same vein, the Commission will take into account the extent of the beneficiary's own contribution and burden sharing over the restructuring period. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard. Therefore, the need for further measures is reduced (2).

(1) See point 21.
(2) If the Commission has, pursuant to Banking Communication, the Recapitalisation Communication or the Impaired Assets Communication, exceptionally accepted aid that departed from the principles required by those communications, the resulting additional distortion of competition will require additional structural or behavioural safeguards; see point 58 of the Impaired Assets Communication.
32. As regards the second criterion, the Commission will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. If the restructured bank has limited remaining market presence, additional constraints, in the form of divestments or behavioural commitments, are less likely to be needed. The measures will be tailored to market characteristics (1) to make sure that effective competition is preserved. In some areas, divestments may generate adverse consequences and may not be necessary in order to achieve the desired outcomes, in which case the limitation of organic growth may be preferred to divestments. In other areas, especially those involving national markets with high entry barriers, divestments may be needed to enable entry or expansion of competitors. Measures limiting distortions of competition should not compromise the prospects of the bank’s return to viability.

33. Finally, the Commission will pay attention to the risk that restructuring measures may undermine internal market and will view positively measures that help to ensure that national markets remain open and contestable. While aid is granted to maintain financial stability and lending to the real economy in the granting Member State, where such aid is also conditional upon the beneficiary bank respecting certain lending targets in Member States other than the State which grants the aid, this may be regarded as an important additional positive effect of the aid. This will particularly be the case where the lending targets are substantial relative to a credible counterfactual, where achievement of such targets is subject to adequate monitoring (for example, through cooperation between the home and host State supervisors), where the banking system of the host State is dominated by banks with headquarters abroad and where such lending commitments have been coordinated at Community level (for example, in the framework of liquidity assistance negotiations).

**Setting the appropriate price for State aid**

34. Adequate remuneration of any State intervention generally is one of the most appropriate limitations of distortions of competition, as it limits the amount of aid. Where the entry price has been set at a level significantly below the market price for reasons of financial stability, it should be ensured that the terms of the financial support are revised in the restructuring plan (2) so as to reduce the distorting effect of the subsidy.

35. On the basis of an assessment in accordance with the criteria of this Section, banks benefiting from State aid may be required to divest subsidiaries or branches, portfolios of customers or business units, or to undertake other such measures (3), including on the domestic retail market of the aid beneficiary. In order for such measures to increase competition and contribute to the internal market, they should favour the entry of competitors and cross-border activity (4). In line with the requirement of restoration of viability, the Commission will take a positive view of such structural measures if they are undertaken without discrimination between businesses in different Member States, thus contributing to the preservation of an internal market in financial services.

36. A limit on the bank’s expansion in certain business or geographical areas may also be required, for instance via market-oriented remedies such as specific capital requirements, where competition in the market would be weakened by direct restrictions on expansion or to limit moral hazard. At the same time, the Commission will pay particular attention to the need to avoid retrenchment within national borders and a fragmentation of the single market.

37. Where finding a buyer for subsidiaries or other activities or assets appears objectively difficult, the Commission will extend the time period for the implementation of those measures, if a binding timetable for scaling down businesses (including segregation of business lines) is provided. However, the time period for implementing those measures should not exceed five years.

38. In assessing the scope of structural remedies required to overcome distortions of competition in a given case, and with due regard to the principle of equal treatment, the Commission will take into account the measures provided for in cases relating to the same markets or market segments at the same time.


(2) For example by favouring early redemption of State aid.

(3) In particular, concentration levels, capacity constraints, the level of profitability, barriers to entry and to expansion will be taken into account.

(4) It should be noted that balance-sheet reductions due to asset write-offs, which are partly compensated with State aid, do not reduce the bank’s actual market presence and cannot therefore be taken into account when assessing the need for structural measures.
Avoiding the use of State aid to fund anti-competitive behaviour

39. State aid must not be used to the detriment of competitors which do not enjoy similar public support (1).

40. Subject to point 41, banks should not use State aid for the acquisition of competing businesses (2). This condition should apply for at least three years and may continue until the end of the restructuring period, depending on the scope, size and duration of the aid.

41. In exceptional circumstances and upon notification, acquisitions may be authorised by the Commission where they are part of a consolidation process necessary to restore financial stability or to ensure effective competition. The acquisition process should respect the principles of equal opportunity for all potential acquirers and the outcome should ensure conditions of effective competition in the relevant markets.

42. Where the imposition of divestitures and/or the prohibition of acquisitions are not appropriate, the Commission may accept the imposition by the Member State of a claw-back mechanism, for example in the form of a levy on the aid recipients. This would allow recovery of part of the aid from the bank after it has returned to viability.

43. Where banks receiving State support are requested to fulfil certain requirements as to lending to the real economy, the credit provided by the bank must be on commercial terms (3).

44. State aid cannot be used to offer terms (for example as regards rates or collateral) which cannot be matched by competitors which are not in receipt of State aid. However, in cases where limitations on the pricing behaviour of the beneficiary may not be appropriate, for example because they may result in a reduction of effective competition, Member States should propose other, more suitable, remedies to ensure effective competition, such as measures that favour entry. In the same vein, banks must not invoke State support as a competitive advantage when marketing their financial offers (4). These restrictions should remain in place, depending on the scope, size and duration of the aid, for a period ranging between three years and the entire duration of the restructuring period. They would then also serve as a clear incentive to repay the State as soon as possible.

45. The Commission will also examine the degree of market opening and the capacity of the sector to deal with bank failures. In its overall assessment the Commission may consider possible commitments by the beneficiary or commitments from the Member State concerning the adoption of measures (5) that would promote more sound and competitive markets, for instance by favouring entry and exit. Such initiatives could, in appropriate circumstances, accompany the other structural or behavioural measures that would normally be required of the beneficiary. The Member State's commitment to introduce mechanisms to deal with bank difficulties at an early stage may be regarded positively by the Commission as an element promoting sound and competitive markets.

5. MONITORING AND PROCEDURAL ISSUES

46. In order to verify that the restructuring plan is being implemented properly, the Commission will request regular detailed reports. The first report will normally have to be submitted to the Commission not later than six months after approval of the restructuring plan.

47. Upon notification of the restructuring plan the Commission has to assess whether the plan is likely to restore long term viability and to limit distortions of competition adequately. Where it has serious doubts as to the compliance of the restructuring plan with the relevant requirements, the Commission is required to open a formal investigation procedure, giving third parties the possibility to comment on the measure and thereby ensuring a transparent and coherent approach while respecting the confidentiality rules applicable in State aid proceedings (6).


(2) It is recalled that restructuring costs have to be limited to the minimum necessary for the restoration of viability. See point 23.

(3) Credit provided on non-commercial terms might constitute State aid and might be authorised by the Commission, upon notification, if it is compatible with the common market, for example under the Communication from the Commission — Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis (OJ C 81, 7.4.2009, p. 1).


48. Nevertheless the Commission does not have to open formal proceedings where the restructuring plan is complete and the measures suggested are such that the Commission has no further doubts as to compatibility in the sense of Article 4(4) of Council Regulation EC No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty (1). This might, in particular, be the case where a Member State has notified the Commission of an aid accompanied by a restructuring plan which meets all of the conditions set out in this Communication, in order to obtain legal certainty as to the necessary follow-up. In such cases the Commission might adopt a final decision stating that rescue aid as well as restructuring aid is compatible under Article 87(3)(b) of the Treaty.

6. TEMPORARY SCOPE OF THE COMMUNICATION

49. This Communication is justified by the current exceptional financial sector crisis and should therefore only be applied for a limited period. For the assessment of restructuring aid notified to the Commission on or before 31 December 2010, the Commission will apply this Communication. As regards non-notified aid, the Commission notice on the determination of the applicable rules for the assessment of unlawful State aid (2) will apply. The Commission will therefore apply this Communication when assessing the compatibility of non-notified aid granted on or before 31 December 2010.

50. Bearing in mind that this Communication is based on Article 87(3)(b) of the Treaty, the Commission may review its content and duration according to the development of market conditions, the experience gathered in the treatment of cases and the overriding interest in maintenance of financial stability.


ANNEX

Model restructuring plan

Indicative table of contents for restructuring plan (1)

1. Information on the financial institution (description of its structure etc.)
   (NB: Information previously submitted may be reproduced but shall be integrated into this document and where necessary updated)

2. Market description and market shares
   2.1. Description of the main relevant product markets (distinction at least between: retail, wholesale, capital markets etc.)
   2.2. Calculations of market shares (e.g. national and European wide, depending on the geographical scope of the relevant markets)

3. Analysis of the reasons why the institution run into difficulty (internal factors)

4. Description of the State intervention and assessment of State aid
   4.1. Information on whether the financial institution or its subsidiaries have already received a rescue or restructuring aid in the past
   4.2. Information on form and amount of the State support or financial advantage related to support. Information should contain all State aid received as individual aid or under a scheme during the restructuring period
   (NB: All aid needs to be justified within the restructuring plan as indicated in the following)

4.3. Assessment of State support under the State aid rules and quantification of aid amount

5. Restoration of viability
   5.1. Presentation of the different market assumptions
      5.1.1. Initial situation in the main product markets
      5.1.2. Expected market development in the main product markets
   5.2. Presentation of the scenario without the measure
      5.2.1. Required adjustment to the initial business plan
      5.2.2. Past, current and future capital ratios (tier 1, tier 2)
   5.3. Presentation of the proposed future strategy for the financial institution and how this will lead to viability
      5.3.1. Starting position and overall framework
      5.3.2. Individual frameworks per business line of the financial institution
      5.3.3. Adoptions to changes in regulatory environment (enhancement of risk management, increased capital buffers, etc.)
      5.3.4. Confirmation regarding full disclosure of impaired assets
      5.3.5. If adequate, change in ownership structure

(1) Information required for the viability assessment may comprise bank’s internal data and reports as well as reports prepared by/for the Member State’s authorities, including the regulatory authorities.
5. Description and overview of the different measures planned to restore viability, their costs and their impact on the P&L/balance sheet

5.4. Measures at group level

5.4.1. Measures per business lines

5.4.2. Impact of each measure on the P&L/balance sheet

5.5. Description of effect of the different measures to limit distortions of competition (cf. point 7) in view of their costs and their impact on the P&L/balance sheet

5.5.1. Measures at group level

5.5.2. Measures in the fields of business

5.5.3. Impact of each measure on the P&L/balance sheet

5.6. Comparison with alternative options and brief comparative evaluation of the economic and social effects on the regional, national and Community level (elaboration is mainly required where bank may not meet prudential requirements in the absence of aid)

5.6.1. Alternative options: orderly winding up, break up, or absorption by another bank and resulting effects

5.6.2. General Economic Effects

5.7. Timetable for the implementation of the different measures and the final deadline for implementation of the restructuring plan in its entirety (please indicate issues of confidentiality)

5.8. Description of the repayment plan of the State aid

5.8.1. Underlying assumptions to the exit planning

5.8.2. Description of the State’s exit incentives

5.8.3. Exit or repayment planning until full repayment/exit

5.9. Profit and loss accounts/balance sheets for the last three and next five years including key financial ratios and sensitivity study based on best/worst case

5.9.1. Base case

5.9.1.1. Profit and Loss Statement/balance sheet group level

5.9.1.2. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

5.9.1.3. Profit and Loss Statement/balance sheet per business unit

5.9.1.4. Key Financial ratios per business unit (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

5.9.2. Best case scenario

5.9.2.1. Underlying assumptions

5.9.2.2. Profit and Loss Statement/balance sheet group level

5.9.2.3. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)
5.9.3. Worst case scenario — where a stress test has been performed and/or validated by the national supervisory authorities, the methodologies, the parameters, and the results of such a test will have to be provided (1)

5.9.3.1. Underlying assumptions

5.9.3.2. Profit and Loss Statement/balance sheet group level

5.9.3.3. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

6. Burden sharing — contribution to restructuring by the financial institution itself and other shareholders (accounting and economic value of holdings)

6.1. Limitation of restructuring costs to those necessary for restoring viability

6.2. Limitation of the amount of aid (including information on eventual provisions for limiting dividends and interest payments on subordinated debt)

6.3. Provision of significant own contribution (including information on the size of contribution from shareholders or subordinated creditors)

7. Measures to limit distortion of competition

7.1. Justification of scope of measures in view of the size and effect of the State aid

7.2. Structural measures, including proposal on timing and milestones for divestments of assets or subsidiaries/branches or other remedies

7.3. Behavioral commitments, including to refrain from mass marketing invoking State aid as an advantage in competitive terms

8. Monitoring (possible arrangement of a trustee)

(1) The stress testing should to the extent possible be based on common parameters agreed at Community level (such as a methodology developed by the Committee of European Banking Supervisors) and where appropriate adapted to cater for country- and bank-specific circumstances. Where appropriate, reverse stress tests or other equivalent exercises could also be considered.
Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis

(Text with EEA relevance)

(2010/C 329/07)

1. INTRODUCTION

1. Since the beginning of the global financial crisis in the autumn of 2008, the Commission has issued four communications which provided detailed guidance on the criteria for the compatibility of State support to financial institutions (1) with the requirements of Article 107(3)(b) of the Treaty on the Functioning of the European Union. The communications in question are the 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 (2) (the Banking Communication); 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 (3) (the Recapitalisation Communication); the Communication from the Commission on the treatment of impaired assets in the Community banking sector (4) (the Impaired Assets Communication) 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 (5) (the Restructuring Communication). Three of those four communications, the Banking, Recapitalisation and Impaired Assets Communications, set out the prerequisites for the compatibility of the main types of assistance granted by Member States — guarantees on liabilities, recapitalisations and asset relief measures — while the Restructuring Communication details the particular features that a restructuring plan (or a viability plan) has to display in the specific context of crisis-related State aid granted to financial institutions on the basis of Article 107(3)(b) of the Treaty.

2. All four communications highlight the temporary nature of the acceptability of such aid measures; each states that any such aid measure can only be justified as an emergency response to the unprecedented stress in financial markets and only as long as those exceptional circumstances prevail. The Restructuring Communication is valid for restructuring aid notified by 31 December 2010 whilst the other communications do not have an expiry date.

3. This communication sets out the parameters for the temporary acceptability of crisis-related support measures in favour of banks as from 1 January 2011.

4. The Commission communications on crisis-related aid to banks, as well as all individual decisions on aid measures and schemes falling within the scope of those Communications, are adopted on the legal basis of Article 107(3)(b) of the Treaty, which exceptionally allows for aid to remedy a serious disturbance in the economy of a Member State. In the most acute stage of the crisis, the condition of a serious disturbance was unquestionably met across the Union in view of the extraordinary stress in financial markets, later combined with an exceptionally severe contraction in the real economy.

5. The economic recovery, which has slowly taken hold since the beginning of 2010, has been proceeding at a somewhat faster pace than expected earlier this year. While recovery is still fragile and uneven across the Union, some Member States are showing modest or even more robust growth rates. In addition, despite some pockets of vulnerability, in broad terms, the health of the banking sector has improved compared with the situation one year ago. As a result, the existence of a serious disturbance in the economy of all Member States is no longer as self-evident as in earlier stages of the crisis. While it is aware of those developments, the Commission still considers that the requirements for State aid to be approved pursuant to Article 107(3)(b) of the Treaty are fulfilled in view of the recent reappearance of stress in financial markets and the risk of wider negative spillover effects, for the reasons set out in this communication.

6. The re-emergence of tensions in sovereign debt markets forcefully illustrates the continued volatility in financial markets. The high level of interconnectedness and interdependence within the financial sector in the Union has given rise to market concerns about contagion. The high volatility of financial markets and the uncertainty about the economic outlook justifies maintaining, as a safety net, the possibility for Member States to argue the need to have recourse to crisis-related support measures on the basis of Article 107(3)(b) of the Treaty.

7. Therefore, the Banking, Recapitalisation and Impaired Assets Communications, which provide guidance on the criteria for the compatibility of crisis-related aid to banks on the basis of Article 107(3)(b) of the Treaty — most

(1) For the convenience of the reader, financial institutions are referred to simply as ‘banks’ in this document.
notably in the form of government guarantees, recapitalisations and asset relief measures — need to stay in place beyond 31 December 2010. In the same vein, the Restructuring Communication, which addresses the follow-up to such support measures, also has to remain applicable beyond that date. The temporal scope of the Restructuring Communication — the only one of the four communications with a specified expiry date, 31 December 2010 — should therefore be extended to restructuring aid notified by 31 December 2011.

8. The communications, however, need to be adapted with a view to preparing the transition to the post-crisis regime. In parallel, new, permanent State aid rules for bank rescue and restructuring in normal market conditions will have to be drawn up and should, market conditions permitting, apply as of 1 January 2012. The possible continued need for crisis-induced extraordinary State aid to the financial sector has to be evaluated with that objective in mind. It must be addressed by setting the requirements for the compatibility of such assistance in a way that best prepares for the new regime for the rescue and restructuring of banks based on Article 107(3)(c) of the Treaty.

3. THE ADVANCEMENT OF THE EXIT PROCESS

9. The continued availability of aid measures pursuant to Article 107(3)(b) of the Treaty in the face of exceptional market conditions should not obstruct the process of disengagement from temporary extraordinary support measures for banks. At its meeting on 2 December 2009, the Economic and Financial Affairs Council concluded on the necessity to design a strategy for the phasing out of support measures which should be transparent and duly coordinated among Member States to avoid negative spillover effects but take into account the different specific circumstances across Member States (1). The conclusions further set out that, in principle, the phasing-out process concerning the various forms of assistance to banks should start with the unwinding of government guarantee schemes, encouraging the exit of sound banks and inducing other banks to address their weaknesses.

10. Since 1 July 2010, the Commission has applied tighter conditions for the compatibility of government guarantees under Article 107(3)(b) of the Treaty (2) by introducing an increased guarantee fee and the new requirement of a viability plan for beneficiaries that have recourse to new guarantees and exceed a certain threshold of total outstanding guaranteed liabilities both in absolute terms and in relation to total liabilities (3). The Commission expressly limited the scope of such modified guarantee schemes to the second half of 2010. Considering the current market situation and given the limited time since the introduction of the new pricing conditions, no further adjustment of those conditions appears necessary at present. Government guarantee schemes for which State aid approval expires at the end of 2010 can therefore be authorised for another six months until 30 June 2011 on the basis of the conditions introduced as of July 2010 (4). In line with previous practice, the Commission will reassess the conditions for the compatibility of State guarantees beyond 30 June 2011 in the first half of 2011.

11. In the following paragraphs, the Commission will set out the steps of a gradual phasing out with regard to recapitalisation and impaired asset measures, as, for those measures, no such steps have yet been taken beyond the exit incentives already present through pricing.

4. REMOVAL OF THE DISTINCTION BETWEEN SOUND AND DISTRESSED BANKS FOR THE PURPOSES OF SUBMITTING A RESTRUCTURING PLAN

12. At the beginning of the crisis, the Commission established a distinction between unsound/distressed financial institutions and fundamentally sound financial institutions, that is to say, financial institutions suffering from endogenous, structural problems linked, for instance, to their particular business model or investment strategy and financial institutions whose problems merely and largely had to do with the extreme situation in the financial crisis rather than with the soundness of their business model, inefficiency or excessive risk taking. The distinction is defined in particular on the basis of a number of indicators set out in the Recapitalisation Communication: capital adequacy, current credit default swap (CDs) spreads, current rating of the bank and its outlook as well as, inter alia, the relative size of the recapitalisation. Regarding the latter, the Commission deems aid received under the form of recapitalisation and asset relief measures of more than

(1) These conclusions were endorsed by the European Council at its meeting on 11 December 2009. In the same vein, the European Parliament insisted in its Resolution of 9 March 2010 on the Report on Competition Policy 2008 (http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2010-0050) that State support to financial institutions should not be unduly prolonged and that exit strategies should be elaborated as soon as possible.

(2) See Directorate-General for Competition staff working document of 30 April 2010 on the application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010 (http://ec.europa.eu/competition/state_aid/studies_reports/phase_out_bank_guarantees.pdf)

(3) With a flexibility clause permitting a reassessment of the situation and appropriate remedies in the event of a severe new shock to the financial markets across the Union or in one or more Member States. None of the Member States that have notified an extension of their guarantee schemes until the end of 2010 have invoked this flexibility clause.

(4) The same applies for liquidity schemes.
In order to increase capital buffers, banks have decided to sell non-14. The distinction between sound and distressed banks
13. The original rationale for establishing that distinction and
2 % of the bank's risk weighted assets to be an indicator to
distinguish between fundamentally sound and distressed
banks. The recapitalisation of a distressed bank triggers
the requirement to submit a restructuring plan to the
Commission, while the recapitalisation of a sound bank
triggers the requirement to submit a viability plan.

15. In assessing the restructuring needs of banks, the
Commission will take into consideration the specific
tsituation of each institution, the degree to which such a
restructuring is necessary to restore viability without further
State support as well as prior reliance on State aid. As a
general rule, the more significant the reliance on State aid,
the stronger the indication of a need to undergo in-depth
restructuring in order to ensure long-term viability. In
addition, the individual assessment will take account of
any specific situation on the markets and will apply the
restructuring framework in an appropriately flexible
manner in the event of a severe shock endangering
financial stability in one or more Member States.

14. The distinction between sound and distressed banks
therefore no longer seems relevant in order to determine
which banks should enter into a discussion about their
restructuring with the Commission. As a result, banks
which still have recourse to the State in 2011 for raising
capital or for impaired assets measures should be required
to submit to the Commission a restructuring plan showing
the bank's determination to undertake the necessary
restructuring efforts and return to viability without undue
delay. Thus, as of 1 January 2011, a restructuring plan will
be required from every beneficiary of a new recapitalisation
or an impaired asset measure (\(^5\)).

(1) In order to increase capital buffers, banks have decided to sell non-
strategic assets such as industrial participations, or to focus on
specific geographical sectors. See on this point European Central
Bank, EU Banking Sector Stability, September 2010.

(2) According to the European Central Bank, banks' overall solvency
ratio increased substantially in the course of 2009 in all Member
States. In addition, information for a sample of large banks in the
Union suggests that the improvement in capital ratios continued
into the first half of 2010, supported by an increase in retained
earnings as well as by further private capital raising and public
capital injections for some banks. See European Central Bank: EU
Banking Sector Stability, September 2010.

(3) The future regulatory environment drawn up by the Basel
Committee on Banking Supervision (BCBS), so-called Basel III, sets
a path for the implementation of the new capital rules which should
allow banks to meet the new capital needs over time. In this context,
it is interesting to note that, first, most of the largest banks in the
Union have reinforced their capital buffers over the last two years to
increase their loss absorption capacity and, second, the other banks
in the Union should have sufficient time (up to 2019) to build up
their capital buffer using, inter alia, retained earnings. It should also
be noted that the 'transitional arrangements' provided by the
new regulatory framework have established a 'grandfathering period'
until 1 January 2018 for existing public sector capital injections.
Moreover, a quantitative impact assessment done by the Basel
Committee, confirmed by Commission calculations, points to a
rather moderate impact on bank lending. Therefore, the new
capital requirements are not expected to impact the proposal
outlined in this communication.

(4) This will apply to all recapitalisation or impaired asset measures —
irrespective of whether they are designed as individual measures or
granted in the context of a scheme.

(5) However, the Directorate-General for competition staff working
document on the application of State aid rules to government
guarantee schemes covering bank debt to be issued after 30 June
2010 sets a threshold of 5 % of outstanding guaranteed liabilities
over total liabilities and at a total amount of guaranteed debt of
EUR 500 million above which a viability review is required.
5. TEMPORAL SCOPE, GENERAL OUTLOOK

17. The continued applicability of Article 107(3)(b) of the Treaty and the extension of the Restructuring Communication will be for one year until 31 December 2011 (1). This extension under changed conditions should also be seen in the context of a gradual transition to a more permanent regime of State aid guidelines for the rescue and restructuring of banks based on Article 107(3)(c) of the Treaty which should, market conditions permitting, apply as of 1 January 2012.

(1) Consistent with the Commission's previous practice, existing or new bank support schemes (irrespective of the support instruments they contain: guarantee, recapitalisation, liquidity, asset relief, other) will only be prolonged/approved for a duration of six months to allow for further adjustments, if necessary, in mid-2011.
I. INTRODUCTION

1. Since the beginning of the global financial crisis in the autumn of 2008, the Commission has issued four Communications which provided detailed guidance on the criteria for the compatibility of State support to financial institutions (1) with the requirements of Article 107(3)(b) of the Treaty on the Functioning of the European Union. The Communications in question are the 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 (2) (the Banking Communication); 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 (3) (the Recapitalisation Communication); the Communication from the Commission on the treatment of impaired assets in the Community banking sector (4) (the Impaired Assets Communication) 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 (5) (the Restructuring Communication). Three of those four Communications, the Banking, Recapitalisation and Impaired Assets Communications, set out the prerequisites for the compatibility of the main types of assistance granted by Member States — guarantees on liabilities, recapitalisations and asset relief measures — while the Restructuring Communication details the particular features that a restructuring plan (or a viability plan) has to display in the specific context of crisis-related State aid granted to banks on the basis of Article 107(3)(b) of the Treaty.

2. On 1 December 2010, the Commission adopted a fifth Communication, the Communication on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis (6) (the Prolongation Communication). The Prolongation Communication extended the Restructuring Communication — the only one of the four Communications with a specified expiry date — on amended terms until 31 December 2011. The Commission also indicated in the Prolongation Communication that it considered that the requirements for State aid to be approved pursuant to Article 107(3)(b) of the Treaty, which exceptionally allows for aid to remedy a serious disturbance in the economy of a Member State, were still fulfilled and that the Banking, Recapitalisation and Impaired Assets Communications would remain in place in order to provide guidance on the criteria for the compatibility of crisis-related aid to banks on the basis of Article 107(3)(b) of the Treaty.

3. The exacerbation of tensions in sovereign debt markets that has taken place in 2011 has put the banking sector in the Union under increasing pressure, particularly in terms of access to term funding markets. The ‘banking package’ agreed by the Heads of State or Government at their meeting of 26 October 2011 (7) aims to restore confidence in the banking sector by way of guarantees on medium-term funding and the creation of a temporary capital buffer amounting to a capital ratio of 9 % of the highest quality capital after accounting for market valuation of sovereign debt exposures. Despite those measures, the Commission considers that the requirements for State aid to be approved pursuant to Article 107(3)(b) will continue to be fulfilled beyond the end of 2011.

4. Therefore, the Banking, Recapitalisation and Impaired Assets Communications will remain in place beyond 31 December 2011. In the same vein, the temporal scope of the Restructuring Communication is extended beyond 31 December 2011 (8). The Commission will keep the situation in the financial markets under review and will take steps towards more permanent rules for State aid for rescue and restructuring of banks, based on Article 107(3)(c) of the Treaty, as soon as market conditions permit.

5. To facilitate the implementation of the banking package and to take into account developments in the risk profile of banks since the start of the crisis, it is desirable to further clarify and update the rules in certain respects.

1. For the convenience of the reader, financial institutions are referred to simply as ‘banks’ in this document.
8. In line with the Commission’s previous practice, existing or new bank support schemes (irrespective of the support instruments they contain: guarantee, recapitalisation, liquidity, asset relief, other) will only be prolonged or approved for a duration of six months to allow for further adjustments, if necessary, in mid-2012.
This Communication sets out the necessary amendments to the parameters for the compatibility of crisis-related State aid to banks as from 1 January 2012. In particular, this Communication:

(a) supplements the Recapitalisation Communication, by providing more detailed guidance on ensuring adequate remuneration for capital instruments that do not bear a fixed return;

(b) explains how the Commission will undertake the proportionate assessment of the long-term viability of banks in the context of the banking package; and

c) introduces a revised methodology for ensuring that the fees payable in return for guarantees on bank liabilities are sufficient to limit the aid involved to the minimum, with the aim of ensuring that the methodology takes into account the greater differentiation of bank credit default swap (CDS) spreads in recent times and impact of the CDS spreads of the Member State concerned.

II. PRICING AND CONDITIONS FOR STATE RECAPITALISATIONS

6. The Recapitalisation Communication provides general guidance on the pricing of capital injections. That guidance is geared mainly towards capital instruments bearing a fixed remuneration.

7. In view of the regulatory changes and the changing market environment, the Commission anticipates that State capital injections may in the future more commonly take the form of shares bearing a variable remuneration. Clarification of the rules on pricing of capital injections is desirable given that such shares are remunerated in the form of (uncertain) dividends and capital gains, making it difficult to assess directly ex ante the remuneration on such instruments.

8. The Commission will therefore assess the remuneration of such capital injections on the basis of the issue price of the shares. Capital injections should be subscribed at a sufficient discount to the share price (after adjustment for the ‘dilution effect’ (1)) immediately prior to the announcement of the capital injection to give a reasonable assurance of an adequate remuneration for the State (2).

9. For listed banks, the benchmark share price should be the quoted market price of shares with equivalent rights to those attaching to the shares being issued. For non-listed banks, there is no such market price and Member States should use an appropriate market-based valuation approach (including a peer group P/E approach or other generally accepted valuation methodologies). Shares should be subscribed at an appropriate discount to that market (or market-based) value.

10. If Member States subscribe for shares without voting rights, a higher discount may be required, the size of which should reflect the pricing differential between voting and non-voting shares in the prevailing market conditions.

11. Recapitalisation measures must contain appropriate incentives for banks to exit from State support as soon as possible. In relation to shares with variable remuneration, if exit incentives are designed in a way that limits the upside potential for the Member State, for example by issuing warrants to the incumbent shareholders to allow them to buy back the newly issued shares from the State at a price that implies a reasonable annual return for the State, a higher discount will be required to reflect the capped upside potential.

12. In all cases, the size of the discount must reflect the size of the capital injection in relation to the existing Core Tier 1 capital. A higher capital shortage in relation to existing capital is indicative of greater risk to the State, and therefore requires a higher discount.

13. Hybrid instruments should in principle contain an ‘alternative coupon satisfaction mechanism’ whereby coupons which cannot be paid out in cash would be paid to the State in the form of newly issued shares.

14. The Commission will continue to require Member States to submit a restructuring plan (or an update of the existing restructuring plan) within six months of the date of the Commission decision authorising rescue aid for any bank that receives public support in the form of recapitalisation or impaired asset measures. Where a bank has been the subject of a previous rescue aid decision under the rules governing the compatibility of aid to banks with Article 107(3)(b) of the Treaty, whether as part of the same restructuring operation or not, the Commission may require the submission of the restructuring plan within a period shorter than six months. The Commission will undertake a proportionate assessment of the long term viability of banks, taking full account of elements indicating that banks can be viable in the long term without the need for significant restructuring, in particular where the capital shortage is essentially linked to a confidence crisis on sovereign debt, the public capital injection is limited to the amount necessary to offset losses stemming from marking sovereign bonds of the Contracting Parties to the EEA Agreement to market in banks which are otherwise viable, and the analysis shows that the banks in question did not take excessive risk in acquiring sovereign debt.

(1) The ‘dilution effect’ can be quantified using generally accepted market techniques (for instance, the theoretical ex-rights price (TERP)).

(2) If Member States underwrite the issue of shares, an adequate underwriting fee should be payable by the issuing institution.
III. PRICING AND CONDITIONS FOR STATE GUARANTEES

15. Banks may benefit from a State guarantee for the issuance of new debt instruments, whether secured or unsecured, with the exception of instruments that qualify as capital. Since pressure on the funding of banks is concentrated in the term funding markets, State guarantees should in general only cover debt with a maturity of between one and five years (seven years in the case of covered bonds).

16. Since the start of the crisis, the pricing of State guarantees has been linked to the median CDS spread of the beneficiary over the period from 1 January 2007 to 31 August 2008. That pricing was increased with effect from 1 July 2010 to better reflect the risk profile of individual beneficiaries (1).

17. To take into account the greater differentiation by risk of bank CDS spreads in recent times, that pricing formula should be updated to refer to median CDS spreads over a three-year period ending one month before the grant of guarantees. Since increases in CDS spreads in recent years are partially due to influences that are not specific to individual banks, in particular the growing tensions in sovereign debt markets and an overall increase in the perception of risk in the banking sector, that formula should isolate the intrinsic risk of individual banks from changes in CDS spreads of Member States and of the market as a whole. That formula should also reflect the fact that guarantees on covered bonds expose the guarantor to substantially lower risk than guarantees on unsecured debt.

18. In line with the principles mentioned in paragraph 17, the revised pricing formula set out in the Annex establishes the minimum guarantee fees that should apply where State guarantees are granted on a national basis, without any pooling of guarantees among Member States. The Commission will apply that formula to all State guarantees on bank liabilities with a maturity of one year or more issued on or after 1 January 2012.

19. Where guarantees cover liabilities that are not denominated in the domestic currency of the guarantor, an additional fee should apply to cover the foreign-exchange risk taken by the guarantor.

20. Where it is necessary for guarantees to cover debt with a maturity of less than one year, the Commission will continue to apply the existing pricing formula, which is set out for reference in the Annex. The Commission will not authorise guarantees covering debt with a maturity of less than three months, except in exceptional cases, where such guarantees are necessary for financial stability. In such cases, the Commission will assess the appropriate remuneration taking into account the need for appropriate incentives to exit from State support as soon as possible.

21. If Member States decide to establish pooling arrangements for guarantees on bank liabilities, the Commission will review its guidance accordingly, to ensure in particular that weight is given to CDS spreads of Member States only to the extent that they remain relevant.

22. To enable the Commission to assess the application in practice of the revised pricing formula, Member States should indicate, when notifying new or prolonged guarantee schemes covering bank debt to be issued after 30 June 2010 (http://ec.europa.eu/competition/state_aid/studies_reports/phase_out_bank_guarantees.pdf), an indicative fee for each bank eligible to benefit from those guarantees, based on an application of the formula using recent market data. Member States should also communicate to the Commission, within three months following each issue of guaranteed bonds, the actual guarantee fee charged in relation to each issue of guaranteed bonds.

ANNEX

Guarantees covering debt with a maturity of one year or more

The guarantee fee should as a minimum be the sum of:

1. a basic fee of 40 basis points (bp); and

2. a risk-based fee equal to the product of 40 basis points and a risk metric composed of: (i) one half of the ratio of the beneficiary's median five-year senior CDS spread over the three years ending one month before the date of issue of the guaranteed bond to the median level of the iTraxx Europe Senior Financials five-year index over the same three-year period; plus (ii) one half of the ratio of the median five-year senior CDS spread of all Member States to the median five-year senior CDS spread of the Member State granting the guarantee over the same three-year period.

The formula for the guarantee fee can be written as:

\[ \text{Fee} = 40 \text{bp} \times (1 + (1/2 \times A/B) + (1/2 \times C/D)) \]

where A is the beneficiary's median five-year senior CDS spread, B is the median iTraxx Europe Senior Financials five-year index, C is the median five-year senior CDS spread of all Member States and D is the median five-year senior CDS spread of the Member State granting the guarantee.

The medians are calculated over the three years ending one month before the date of issue of the guaranteed bond.

In the case of guarantees for covered bonds, the guarantee fee may take into account only one half of the risk-based fee calculated in accordance with point 2 above.

Banks without representative CDS data

For banks without CDS data, or without representative CDS data, but with a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of large banks in the Member States. The supervisory authority will assess whether the CDS data of a bank are representative.

For banks without CDS data and without a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the lowest rating category (1), based on a representative sample of large banks in the Member States. The calculated CDS spread, for this category of banks, may be adapted on the basis of a supervisory assessment.

The Commission will determine the representative samples of large banks in the Member States.

Guarantees covering debt with a maturity of less than one year

As CDS spreads may not provide an adequate measure of credit risk for debt with a maturity of less than one year, the guarantee fee for such debt should as a minimum be the sum of:

1. a basic fee of 50 basis points; and

2. a risk-based fee equal to 20 basis points for banks with a rating of A+ or A, 30 basis points for banks with a rating of A–, or 40 basis points for banks rated below A– or without a rating.

(1) The lowest rating category to be considered is A, as there is not sufficient data available for the rating category BBB.
II

(Information)

INFORMATION FROM EUROPEAN UNION INSTITUTIONS, BODIES, OFFICES
AND AGENCIES

EUROPEAN COMMISSION

Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication')

(Text with EEA relevance)

(2013/C 216/01)

1. INTRODUCTION

1. Since the beginning of the financial crisis, the Commission has adopted six communications (‘Crisis Communications’) (1). They have provided detailed guidance on the criteria for the compatibility of State aid with the internal market pursuant to Article 107(3)(b) of the Treaty on the Functioning of the European Union for the financial sector during the financial crisis.

2. The Crisis Communications provide a comprehensive framework for coordinated action in support of the financial sector so as to ensure financial stability while minimising distortions of competition between banks and across Member States in the single market. They spell out the conditions for access to State aid and the requirements which need to be ensured to find such aid compatible with the internal market in light of State aid principles set out in the Treaty. Through the Crisis Communications, State aid rules governing public assistance to the financial sector have been regularly updated where necessary to adapt to the evolution of the crisis. Recent developments require a further update of the Crisis Communications.

Legal basis

3. The Crisis Communications, as well as all individual decisions on aid measures and schemes falling within the scope of those Communications, were adopted on the basis of Article 107(3)(b) of the Treaty, which exceptionally allows for aid to remedy a serious disturbance in the economy of a Member State.

4. Significant action has been taken since the start of the crisis to address the financial sector’s difficulties. The evolution of the crisis has required the adaptation of some provisions of the State aid framework

dealing with the rescue and restructuring of firms in difficulty while not ruling out the possibility of accessing, exceptionally, significant public support. Notwithstanding the exceptional deployment of fiscal and monetary instruments which helped avert further worsening of the crisis, the economic recovery remains very fragile and uneven across the European Union. The financial sectors in some Member States face further challenges in accessing term funding and in asset quality, stemming from the economic recession and public or private debt deleveraging. The stress in financial markets and the risk of wider negative spill-over effects persist.

5. The persistence of tensions in sovereign debt markets forcefully illustrates the continued volatility in financial markets. The high level of interconnectedness and interdependence within the financial sector in the Union continues to give rise to market concerns about contagion. The high volatility of financial markets and the uncertainty in the economic outlook and the resulting persistent risk of a serious disturbance in the economy of Member States justifies maintaining, as a safety net, the possibility for Member States to grant crisis-related support measures on the basis of Article 107(3)(b) of the Treaty in respect of the financial sector.

6. In those circumstances of persisting stress in financial markets and given the risk of wider negative spill-over effects, the Commission considers that the requirements for the application of Article 107(3)(b) of the Treaty to State aid in the financial sector continue to be fulfilled. The application of that derogation remains, however, possible only as long as the crisis situation persists, creating genuinely exceptional circumstances where financial stability at large is at risk.

Financial stability as overarching objective

7. In its response to the financial crisis, and under the Crisis Communications, financial stability has been the overarching objective for the Commission, whilst ensuring that State aid and distortions of competition between banks and across Member States are kept to the minimum. Financial stability implies the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy. Financial stability remains of central importance in the Commission’s assessment of State aid to the financial sector under this Communication. The Commission shall conduct its assessment taking account of the evolution of the crisis from one of acute and system-wide distress towards a situation of more fundamental economic difficulties in parts of the Union, with a correspondingly higher risk of fragmentation of the single market.

8. That overarching objective is reflected not only in the possibility for banks in distress to access State aid when necessary for financial stability, but also in the way restructuring plans are assessed. In that respect it has to be underlined that financial stability cannot be ensured without a healthy financial sector. Capital raising plans must therefore be assessed in close collaboration with the competent supervisory authority with a view to ensuring that viability can be regained within a reasonable time frame and on a solid and lasting basis; otherwise the failing institution should be wound down in an orderly manner.

9. When applying State aid rules to individual cases, the Commission nevertheless takes account of the macroeconomic environment which affects both banks’ viability and the need for the real economy of a given Member State to continue to have access to credit from healthy banks. The Commission will, in its assessment of banks’ restructuring plans, continue to take account of the specificities of each institution and Member State. It will, in particular, undertake a proportionate assessment of the long-term viability of banks where the need for State aid stems from the sovereign crisis and is not a result of excessive risk-taking (\(^2\)), and will reflect in its assessment the need to maintain a level playing field across the single market, having regard in particular to the evolution of burden-sharing in the Union.

10. Moreover, where large parts of a Member State’s financial sector need to be restructured, the Commission endeavours to take a co-ordinated approach in its assessment of individual banks’

\(^{2}\) See 2011 Prolongation Communication, point 14.
Restructuring plans so as provide for a system-wide response. In particular, the Commission has taken that approach for those Member States under an economic adjustment programme. The Commission should thereby take into account specifically the aggregate effects of restructuring of individual institutions at the level of the sector (for example in terms of market structure) and on the economy as a whole, notably as regards the adequate provision of lending to the real economy on a sound and sustainable basis.

11. Furthermore, in its assessment of burden-sharing and measures to limit distortions of competition the Commission assesses the feasibility of the proposed measures, including divestments, and their impact on the market structure and entry barriers. At the same time, the Commission has to ensure that solutions devised in a particular case or Member State are coherent with the goal of preventing major asymmetries across Member States which could further fragment the single market and cause financial instability, impeding recovery within the Union.

Evolution of the regulatory framework and need for revision of the Crisis Communications

12. Since the start of the crisis, the Union has undertaken a number of institutional and regulatory changes aimed at strengthening the resilience of the financial sector and improving the prevention, the management and the resolution of banking crises. The European Council has agreed to undertake further initiatives to put the Economic and Monetary Union on a more solid footing through the creation of a Banking Union, starting with a single supervisory mechanism (SSM) and a single resolution mechanism for credit institutions established in a Member State participating in the SSM. Member States have also agreed to set up a stability mechanism by which financial resources could be provided to members and their banks in case of need.

13. Those measures inevitably involve a degree of phasing-in, for example in order to allow legislation to enter into force or for resolution funds to build up. Some of them remain confined to the euro area. In the meantime an increasing divergence in economic recovery across the Union, the need to reduce and consolidate public and private debt and the existence of pockets of vulnerability in the financial sector have led to persistent tensions in the financial markets and fragmentation with increasing distortions in the single market. The integrity of the single market needs therefore to be protected including through a strengthened State aid regime. Adapting the Crisis Communications can help to ensure a smooth passage to the future regime under the Commission’s proposal for a directive for the recovery and resolution of credit institutions (3) (‘BRRD’) by providing more clarity to markets. The adapted Crisis Communications can also ensure more decisive restructuring and stronger burden-sharing for all banks in receipt of State aid in the entire single market.

14. Exercising State aid control for the financial sector sometimes interacts with responsibilities of supervisory authorities in Member States. For example, in certain cases, supervisory authorities might require adjustments in matters such as corporate governance and remuneration practices which for banks benefitting from State aid are often also set out in restructuring plans. In such cases, whilst fully preserving the Commission’s exclusive competence in State aid control, coordination between the Commission and the competent supervisory authorities is of importance. Given the evolving regulatory and supervisory landscape in the Union and, in particular, in the euro area, the Commission will liaise closely — as it does already today — with supervisory authorities to ensure a smooth interplay between the different roles and responsibilities of all the authorities involved.

Burden-sharing

15. The Crisis Communications clearly spell out that even during the crisis the general principles of State aid control remain applicable. In particular, in order to limit distortions of competition between banks and across Member States in the single market and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources (4). State support should be granted on terms which represent an adequate burden-sharing by those who invested in the bank.


(4) See e.g. Restructuring Communication, point 22.
16. Since the start of the crisis, when examining the compatibility of aid to banks the Commission has required at least a minimum degree of burden-sharing relative to the amount of aid received by those banks, in particular by absorbing losses with available capital and by paying an adequate remuneration for State interventions. Furthermore, in order to prevent the outflow of funds, it has introduced rules on the buyback of hybrid instruments and coupon and dividend bans. However, the Commission did not set \textit{ex ante} thresholds for own contributions or any further requirements \footnote{iid., point 24.}

17. In the first phases of the crisis, Member States did not generally go beyond the minimum requirements set by State aid rules with regard to burden-sharing \textit{ex ante}, and creditors were not required to contribute to rescuing credit institutions for reasons of financial stability.

18. The sovereign crisis has, however, made clear that such a policy could not ensure financial stability in the long term, in particular for Member States in which the cost of bank bail-outs significantly weakened their fiscal position. Indeed some Member States had to go beyond minimum requirements under State aid rules and by introducing new legal frameworks enforce stricter \textit{ex ante} burden-sharing requirements. That development led to diverging approaches to burden-sharing across Member States, namely those that have limited themselves to the minimum requirements under State aid rules and those which have gone beyond those requirements, requiring bail-in of investors or creditors. Such differences in the approach to burden-sharing between Member States have led to divergent funding costs between banks depending on the perceived likelihood of a bail-in as a function of a Member State's fiscal strength. They pose a threat to the integrity of the single market and risk undermining the level playing field which State aid control aims to protect.

19. In the light of the above developments, the minimum requirements for burden-sharing should be raised. Before granting any kind of restructuring aid, be it a recapitalisation or impaired asset measure, to a bank all capital generating measures including the conversion of junior debt should be exhausted, provided that fundamental rights are respected and financial stability is not put at risk. As any restructuring aid is needed to prevent the possible disorderly demise of a bank, in order to reduce the aid to the minimum those burden-sharing measures should be respected regardless of the initial solvency of the bank. Therefore, before granting restructuring aid to a bank Member States will need to ensure that the bank's shareholders and junior capital holders arrange for the required contribution or establish the necessary legal framework for obtaining such contributions.

20. In principle, the application of measures to limit distortions of competition depends on the degree of burden-sharing, and also takes into account the evolving level of burden-sharing of aided banks across the Union. All other matters being equal, enhanced burden-sharing therefore implies a reduced need for measures addressing competition distortions. In any event, measures to limit distortions of competition should be calibrated in such a way so as to approximate as much as possible the market situation which would have materialised if the beneficiary of the aid had exited the market without aid.

\textbf{An effective restructuring procedure and further modernisation of the framework}

21. Whilst it is necessary to retain certain support facilities for banks so as to address continued turmoil on the financial markets, certain procedures and conditions should be improved and further developed. It is also necessary to pursue the process of aligning the legal framework to market evolution, which started in June 2010 with the increase of the guarantee fee \footnote{See DG Competition Staff working document of 30 April 2010 ‘The application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010’.} and continued with the 2010 Prolongation Communication \footnote{That Communication sets out the requirement to submit a restructuring plan for all banks benefitting from State support in the form of capital or impaired asset measures, independent of the aid amount.}.
22. The 2008 Banking Communication enabled Member States to put rescue schemes in place whilst at the same time not excluding the availability of ad hoc interventions. Given the scale of the crisis and the general erosion of confidence within the whole EU financial sector with, inter alia, the drying-up of the interbank market, the Commission decided that it would approve all necessary measures taken by Member States to safeguard the stability of the financial system, including rescue measures and recapitalisation schemes. The temporary approval of rescue aid both in the form of guarantees as well as recapitalisation and impaired asset measures succeeded in averting panic and restoring market confidence.

23. However, in the changed market conditions, there is less need for structural rescue measures granted solely on the basis of a preliminary assessment which is based on the premise that practically all banks need to be rescued and which postpones the in-depth assessment of the restructuring plan to a later stage. Whilst such an approach helped prevent the irremediable collapse of the financial sector as a whole, restructuring efforts of individual beneficiaries were often delayed. Late action to address banks’ problems has resulted in some cases in a higher final bill to the taxpayers. This Communication establishes the principle that recapitalisation and impaired asset measures will be authorised only once the bank’s restructuring plan is approved. This approach ensures that the amount of aid is more accurately calibrated, that the sources of the bank’s problems are already identified and addressed at an early stage and that financial stability is assured. Guarantee schemes will continue to be available in order to provide liquidity to banks. Such schemes can, however, only serve as a means to provide liquidity to banks without a capital shortfall as defined by the competent supervisory authority (8).

24. This Communication sets out the necessary adaptations to the parameters for the compatibility of crisis-related State aid to banks as from 1 August 2013. In particular, this Communication:

(a) replaces the 2008 Banking Communication, and provides guidance on the compatibility criteria for liquidity support;

(b) adapts and complements the Recapitalisation and Impaired Assets Communications;

(c) supplements the Restructuring Communication by providing more detailed guidance on burden-sharing by shareholders and subordinated creditors;

(d) establishes the principle that no recapitalisation or asset protection measure can be granted without prior authorisation of a restructuring plan, and proposes a procedure for the permanent authorisation of such measures;

(e) provides guidance on the compatibility requirements for liquidation aid.

2. SCOPE

25. The Commission will apply the principles set out in this Communication and all Crisis Communications (9) to ‘credit institutions’ (also referred to as ‘banks’) (10). Credit institutions exhibit a high degree of interconnectedness in that the disorderly failure of one credit institution can have a strong negative effect on the financial system as a whole. Credit institutions are susceptible to sudden collapses of confidence that can have serious consequences for their liquidity and solvency. The distress of a single complex institution may lead to systemic stress in the financial sector, which in turn can also have a strong negative impact on the economy as a whole, for example through the role of credit institutions in lending to the real economy, and might thus endanger financial stability.

(8) ‘Competent supervisory authority’ means any national competent authority designated by participating Member States in accordance with Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1) or the European Central Bank in its supervisory tasks as conferred in Article 1 of the Commission proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions for credit institutions established in a Member State participating in the single supervisory mechanism.

(9) See footnote 1.

26. The Commission will apply the principles set out in this Communication and all Crisis Communications where appropriate mutatis mutandis to insurance companies within the meaning of Article 6 of Directive 73/239/EEC (11), Article 4 of Directive 2002/83/EC (12) or Article 1(b) of Directive 98/78/EC (13).

27. All aid to such institutions incorporated in a Member State, including subsidiaries of such institutions, and having significant activities in a Member State will be examined under this Communication.

3. RECAPITALISATION AND IMPAIRED ASSET MEASURES

28. Recapitalisations and impaired asset measures including asset guarantees are typically granted to cover a capital shortfall. A ‘capital shortfall’ for the purposes of this Communication refers to a capital shortfall established in a capital exercise, stress-test, asset quality review or an equivalent exercise at Union, euro area or national level, where applicable confirmed by the competent supervisory authority. Such public support is normally of a permanent nature and cannot be easily undone.

29. Given the irreversibility of such measures in practice and the fiscal implications for the granting Member States and in the light of the Commission’s decisional practice during the crisis, the Commission can in principle only authorise them once the Member State concerned demonstrates that all measures to limit such aid to the minimum necessary have been exploited to the maximum extent. To that end, Member States are invited to submit a capital raising plan, before or as part of the submission of a restructuring plan. A capital raising plan should contain in particular capital raising measures by the bank and potential burden-sharing measures by the shareholders and subordinated creditors of the bank.

30. A capital raising plan, in conjunction with a thorough asset quality review of the bank and a forward looking capital adequacy assessment, should enable the Member State, jointly with the Commission and the competent supervisory authority, to determine precisely the (residual) capital shortfall of a bank that needs to be covered with State aid. Any such residual capital shortfall which needs to be covered by State aid requires the submission of a restructuring plan.

31. The restructuring plan involving restructuring aid will, with the exception of the requirements on capital raising and burden-sharing which must be included in the capital raising plan as set out in points 32 to 34, submitted prior to or as part of the restructuring plan, continue to be assessed on the basis of the Restructuring Communication.

3.1. Addressing a capital shortfall — pre-notification and notification of restructuring aid

32. As soon as a capital shortfall that is likely to result in a request for State aid has been identified, all measures to minimise the cost of remedying that shortfall for the Member State should be implemented. To that end, Member States are invited to enter into pre-notification contacts with the Commission. In the course of those voluntary pre-notification contacts, the Commission will offer its assistance on how to ensure compatibility of the restructuring aid and in particular on how to implement the burden-sharing requirements in accordance with State aid rules. The basis for the pre-notification will be a capital raising plan established by the Member State and the bank and endorsed by the competent supervisory authority. It should:

(a) list the capital raising measures to be undertaken by the bank and the (potential) burden-sharing measures for shareholders and subordinated creditors;

(b) contain safeguards preventing the outflows of funds from the bank which could, for example, occur by the bank acquiring stakes in other undertakings or paying dividends or coupons.

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33. The Member State should provide a detailed methodology and input data used to determine the capital shortfall, validated by the competent supervisory authority. The methodology needs to be presented on a business segment basis.

34. After the submission of the capital raising plan and the incorporation of the results of the asset quality review of the bank and a forward looking capital adequacy assessment, the Member State must determine the residual capital shortfall that has to be covered by State aid. The Commission will offer to the Member State to discuss the restructuring plan before its notification. Once agreement on the restructuring plan has been achieved, the Member State may formally notify the restructuring plan. The Commission will authorise any recapitalisation or impaired asset measure as restructuring aid only after agreement on the restructuring plan has been reached.

3.1.1. Capital raising measures by the bank

35. In the capital raising plan endorsed by the competent supervisory authority, the beneficiary should identify and to the extent possible, without endangering viability, carry out all capital raising measures that can be implemented. Such measures should include in particular:

(a) rights issues;

(b) voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive;

(c) liability management exercises which should in principle be 100 % capital generating if the capital shortfall cannot be overcome in full and therefore State aid is required;

(d) capital-generating sales of assets and portfolios;

(e) securitisation of portfolios in order to generate capital from non-core activities;

(f) earnings retention;

(g) other measures reducing capital needs.

36. If the identified measures are indicated in the capital raising plan as ones that cannot be implemented within six months from the submission of that plan, the Commission will consult the competent supervisory authority to assess whether it should take those proposed measures into account as capital raising measures.

37. There should be incentives for banks’ managements to undertake far-reaching restructuring in good times and, thereby, minimise the need to recourse to State support. Accordingly, if recourse to State aid could have reasonably been averted through appropriate and timely management action, any entity relying on State aid for its restructuring or orderly winding down should normally replace the Chief Executive Officer of the bank, as well as other board members if appropriate.

38. For the same reasons, such entities should apply strict executive remuneration policies. This requires a cap on remuneration of executive pay combined with incentives ensuring that the bank is implementing its restructuring plan towards sustainable, long-term company objectives. Thus, any bank in receipt of State aid in the form of recapitalisation or impaired asset measures should restrict the total remuneration to staff, including board members and senior management, to an appropriate level. That cap on total remuneration should include all possible fixed and variable components and pensions, and be in line with Articles 93 and 94 of the EU Capital Requirements Directive (CRD IV) (14).

The total remuneration of any such individual may therefore not exceed 15 times the national average salary in the Member State where the beneficiary is incorporated (15) or 10 times the average salary of employees in the beneficiary bank.

Restrictions on remuneration must apply until the end of the restructuring period or until the bank has repaid the State aid, whichever occurs earlier.

39. Any bank in receipt of State aid in the form of recapitalisation or impaired asset measures should not in principle make severance payments in excess of what is required by law or contract.

3.1.2. Burden-sharing by the shareholders and the subordinated creditors

40. State support can create moral hazard and undermine market discipline. To reduce moral hazard, aid should only be granted on terms which involve adequate burden-sharing by existing investors.

41. Adequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent. Such contributions can take the form of either a conversion into Common Equity Tier 1 (16) or a write-down of the principal of the instruments. In any case, cash outflows from the beneficiary to the holders of such securities must be prevented to the extent legally possible.

42. The Commission will not require contribution from senior debt holders (in particular from insured deposits, uninsured deposits, bonds and all other senior debt) as a mandatory component of burden-sharing under State aid rules whether by conversion into capital or by write-down of the instruments.

43. Where the capital ratio of the bank that has the identified capital shortfall remains above the EU regulatory minimum, the bank should normally be able to restore the capital position on its own, in particular through capital raising measures as set out in point 35. If there are no other possibilities, including any other supervisory action such as early intervention measures or other remedial actions to overcome the shortfall as confirmed by the competent supervisory or resolution authority, then subordinated debt must be converted into equity, in principle before State aid is granted.

44. In cases where the bank no longer meets the minimum regulatory capital requirements, subordinated debt must be converted or written down, in principle before State aid is granted. State aid must not be granted before equity, hybrid capital and subordinated debt have fully contributed to offset any losses.

45. An exception to the requirements in points 43 and 44 can be made where implementing such measures would endanger financial stability or lead to disproportionate results. This exception could cover cases where the aid amount to be received is small in comparison to the bank’s risk weighted assets and the capital shortfall has been reduced significantly in particular through capital raising measures as set out in point 35. Disproportionate results or a risk to financial stability could also be addressed by reconsidering the sequencing of measures to address the capital shortfall.

46. In the context of implementing points 43 and 44, the ‘no creditor worse off principle’ (17) should be adhered to. Thus, subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted.

(15) As published by the OECD on its website under Average Annual Wages in constant prices for the last available year, http://stats.oecd.org/index.aspx
(17) This can for example be achieved by creating a holding company. The ownership of the bank would be recorded on the asset side of the holding company, whereas the equity, hybrids and subordinated debt existing in the bank prior to the State aid interventions constitute the liability side of the holding company with the same seniority structure as the one existing in the bank prior to the intervention.
3.1.3. Preventing the outflow of funds prior to a restructuring decision

47. In order to limit the aid to the minimum necessary, outflows of funds must be prevented at the earliest stage possible. Therefore, from the time capital needs are known or should have been known to the bank, the Commission considers that the bank should take all measures necessary to retain its funds. In particular, from that moment on, institutions which have identified or should have identified capital needs:

(a) must not pay dividends on shares or coupons on hybrid capital instruments (or any other instruments for which the coupon payment is discretionary);

(b) must not repurchase any of their own shares or call hybrid capital instruments for the duration of the restructuring period without prior approval by the Commission; and

(c) must not buy back hybrid capital instruments, unless such a measure, possibly in combination with others, allows the institution to fully absorb its capital shortfall, and occurs sufficiently close to current market levels (18) and at not more than 10 % above the market price; any buy back is subject to prior approval by the Commission;

(d) must not perform any capital management transaction without prior approval by the Commission;

(e) must not engage in aggressive commercial practices; and

(f) must not acquire a stake in any undertaking, be it a asset or share transfer. That requirement does not cover: (i) acquisitions that take place in the ordinary course of the banking business in the management of existing claims towards ailing firms; and (ii) the acquisition of stakes in undertakings provided that the purchase price paid is less than 0.01 % of the last available balance sheet size of the institution at that moment and that the cumulative purchase prices paid for all such acquisitions from that moment until the end of the restructuring period is less than 0.025 % of its last available balance sheet size at that moment; (iii) the acquisition of a business, after obtaining the Commission’s approval, if it is, in exceptional circumstances, necessary to restore financial stability or to ensure effective competition;

(g) must refrain from advertising referring to State support and from employing any aggressive commercial strategies which would not take place without the support of the Member State.

48. As it needs to be ensured that the aid is limited to the minimum necessary, if a bank undertakes actions which are not in line with the requirements listed in point 47 at a point in time when its need for additional capital should have been evident to a well-run business, the Commission will, for the purpose of establishing the required measures to limit distortions of competition, add an amount equivalent to the outflow of funds to the aid amount.

3.1.4. Covering the residual capital shortfall with restructuring aid

49. If after the implementation of the capital raising and burden-sharing measures a capital shortfall remains, it can in principle be covered by public recapitalisation, impaired asset measures or a combination of the two. In order for such aid to be compatible, a restructuring plan has to be submitted to the Commission which needs to comply with the relevant sections of the Crisis Communications.

3.2. Rescue aid in the form of recapitalisation and impaired asset measures

50. Once the Commission begins to apply the principles set out in this Communication, a Member State will have to notify a restructuring plan to the Commission and obtain State aid approval before any recapitalisation or impaired asset measures are taken. However, such measures can exceptionally be authorised by the Commission to be granted by the Member State on a temporary basis as rescue aid before a restructuring plan is approved, if such measures are required to preserve financial stability. If

(18) For example if the buy-back occurs at a double digit discount in percentage points of nominal value from the market price (or, in the absence of a market, a proxy of the market price) to generate profits, or if the buy-back is part of an exchange providing the credit institution with higher quality capital reducing the shortfall.
a Member State invokes this financial stability clause, the Commission will request an *ex ante* analysis from the competent supervisory authority confirming that a current (not prospective) capital shortfall exists, which would force the supervisor to withdraw the institution’s banking license immediately if no such measures were taken. Moreover, any such analysis will have to demonstrate that the exceptional risk to financial stability cannot be averted with private capital within a sufficiently short period of time or by any other less distorting temporary measure such as a State guarantee.

51. Any rescue measure falling under point 50 has to be notified to the Commission. In order to be temporarily approved by the Commission, such a measure must comply with the rules governing the remuneration and burden-sharing of such measures set out in the Recapitalisation Communication, the 2011 Prolongation Communication and, where applicable, the Impaired Asset Communication.

52. Moreover, rescue aid in the form of recapitalisation and impaired asset measures must not prevent compliance with the burden-sharing requirements set out in this Communication. Consequently, either the required burden-sharing measures must be implemented as part of the rescue aid, or the recapitalisation or impaired asset measures must be arranged in a manner that allows for the implementation of the burden-sharing measures *ex post*. Such *ex post* implementation may be achieved, for example, equity recapitalisation in a form that is senior to existing capital and subordinated debt instruments, whilst being compliant with the applicable regulatory and supervisory framework.

53. Following the authorisation of rescue aid, the Member State must submit a restructuring plan in line with the Restructuring Communication within two months of the date of the decision temporarily approving the aid. The restructuring plan will be assessed on the basis of the Restructuring Communication, taking into account the principles of burden-sharing described in this Communication.

### 3.3. Schemes for recapitalisation and restructuring of small institutions

54. Aid to small banks tends to affect competition less than aid granted to larger banks. For that reason and to ensure a proportionate administrative treatment, it is appropriate to allow for a simpler procedure in relation to small banks whilst ensuring that competition distortions are limited to the minimum. Therefore, the Commission is willing to authorise schemes for recapitalisation and restructuring of small institutions where such schemes have a clear remit and are limited to a six-month period, provided they respect the principles set out in the Crisis Communications and in particular the burden-sharing requirements of this Communication. The application of any such scheme must furthermore be restricted to banks with a balance-sheet total of not more than EUR 100 million. The sum of the balance-sheets of the banks that receive aid under the scheme must not exceed 1.5% of the total assets held by banks in the domestic market of the Member State concerned.

55. The Commission will evaluate any such scheme so as to verify whether it achieves its objective and is implemented correctly. To that end, the Member State must provide a report on the use of the scheme on a six-monthly basis after the scheme’s authorisation.

### 4. GUARANTEES AND LIQUIDITY SUPPORT OUTSIDE THE PROVISION OF CENTRAL BANK LIQUIDITY

56. Liquidity support and guarantees on liabilities temporarily stabilise the liability side of a bank’s balance sheet. Therefore, unlike recapitalisation or impaired asset measures which in principle must be preceded by the notification of a restructuring plan by the Member State concerned and approval by the Commission before they can be granted, the Commission can accept that Member States notify guarantees and liquidity support to be granted after approval on a temporary basis as rescue aid before a restructuring plan is approved.

57. Guarantees and liquidity support can be notified individually to the Commission; in addition the Commission may also authorise schemes providing for liquidity measures for a maximum period of six months.

58. Such schemes must be restricted to banks which have no capital shortfall. Where a bank with a capital shortfall is in urgent need of liquidity, an individual notification to the Commission is required (**9**). In such circumstances, the Commission will apply the procedure set out in points 32 to 34 *mutatis mutandis*, including the requirement for a restructuring or wind-down plan, unless the aid is reimbursed within two months.

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**9** Banks which have already received approved rescue aid at the date of entry into force of this Communication but have not yet obtained a final approval of the restructuring aid may receive support under a liquidity scheme without individual notification.
59. In order to be approved by the Commission, guarantees and liquidity support must meet the following requirements:

(a) guarantees may only be granted for new issues of credit institutions' senior debt (subordinated debt is excluded);

(b) guarantees may only be granted on debt instruments with maturities from three months to five years (or a maximum of seven years in the case of covered bonds). Guarantees with a maturity of more than three years must, except in duly justified cases, be limited to one-third of the outstanding guarantees granted to the individual bank;

(c) the minimum remuneration level of the State guarantees must be in line with the formula set out in the 2011 Prolongation Communication;

(d) a restructuring plan must be submitted to the Commission within two months for any credit institution granted guarantees on new liabilities or on renewed liabilities for which, at the time of the granting of the new guarantee, the total outstanding guaranteed liabilities (including guarantees accorded before the date of that decision) exceed both a ratio of 5% of total liabilities and a total amount of EUR 500 million;

(e) for any credit institution which causes the guarantee to be called upon, an individual restructuring or wind-down plan must be submitted within two months after the guarantee has been activated;

(f) the recipients of guarantees and liquidity support must refrain from advertising referring to State support and from employing any aggressive commercial strategies which would not take place without the support of the Member State.

60. For guarantee and liquidity support schemes, the following additional criteria must be met:

(a) the scheme must be restricted to banks without a capital shortfall as certified by the competent supervisory authority in line with point 28;

(b) guarantees with a maturity of more than three years must be limited to one-third of the total guarantees granted to the individual bank;

(c) Member States must report to the Commission on a three-monthly basis on: (i) the operation of the scheme; (ii) the guaranteed debt issues; and (iii) the actual fees charged;

(d) Member States must supplement their reports on the operation of the scheme with available updated information on the cost of comparable non-guaranteed debt issuances (nature, volume, rating, currency).

61. In exceptional cases guarantees may also be approved covering exposures of the European Investment Bank towards banks for the purpose of restoring lending to the real economy in countries with severely distressed borrowing conditions compared to the Union average. In assessing such measures the Commission will examine in particular whether they do not confer an undue benefit that could for example serve to develop other business activities of those banks. Such guarantees may only cover a period of up to seven years. If approved by the Commission, such guarantees do not trigger an obligation for the bank to present a restructuring plan.

5. **PROVISION OF LIQUIDITY BY CENTRAL BANKS AND INTERVENTION OF DEPOSIT GUARANTEE SCHEMES AND RESOLUTION FUNDS**

62. The ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of the State aid rules. Dedicated support to a specific credit institution (commonly referred to as ‘emergency liquidity assistance’) may constitute aid unless the following cumulative conditions are met (20):

(20) In such cases, the measures will subsequently be assessed as part of the restructuring plan.
(a) the credit institution is temporarily illiquid but solvent at the moment of the liquidity provision which occurs in exceptional circumstances and is not part of a larger aid package;

(b) the facility is fully secured by collateral to which appropriate haircuts are applied, in function of its quality and market value;

(c) the central bank charges a penal interest rate to the beneficiary;

(d) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

63. Interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes (21) do not constitute State aid (22). However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State (23). The Commission will assess the compatibility of State aid in the form of such interventions under this Communication.

64. State aid in the form of interventions by a resolution fund will be assessed under this Communication in order to assess its compatibility with the internal market.

6. SPECIFIC CONSIDERATIONS IN RELATION TO LIQUIDATION AID

6.1. General principles

65. Member States should encourage the exit of non-viable players, while allowing for the exit process to take place in an orderly manner so as to preserve financial stability. The orderly liquidation of a credit institution in difficulty should always be considered where the institution cannot credibly return to long-term viability.

66. The Commission recognises that, due to the specificities of credit institutions and in the absence of mechanisms allowing for the resolution of credit institutions without threatening financial stability, it might not be feasible to liquidate a credit institution under ordinary insolvency proceedings. For that reason, State measures to support the liquidation of failing credit institutions may be considered as compatible aid, subject to compliance with the requirement specified in point 44.

67. The goal of the orderly liquidation must be the cessation of the ailing credit institution's activity over a limited period of time. That goal implies that no new third party business may be undertaken. However, it does not prevent existing business from being executed, if doing so reduces the liquidation costs. Moreover, liquidation must as much as possible aim at selling off parts of the business or assets by means of a competitive process. The orderly liquidation procedure requires that the proceedings of any sale of assets contribute to the liquidation costs.

68. Member States may choose a number of tools for the organisation of the liquidation of ailing credit institutions. Any State aid measures implemented to support such a liquidation must comply with the principles specified in points 69 to 82.

6.2. Conditions for the authorisation of liquidation aid

69. Member States must provide a plan for the orderly liquidation of the credit institution.

70. The Commission will assess the compatibility of aid measures to be implemented with a view to resolving credit institutions on the same lines, mutatis mutandis, as set out in Sections 2, 3 and 4 of the Restructuring Communication for restructuring aid.

(23) See Danish winding-up scheme (OJ C 312, 17.11.2010, p. 5).
71. The particular nature of orderly liquidation gives rise to the considerations set out in points 72 to 78.

6.2.1. Limitation of liquidation costs

72. Member States should demonstrate that the aid enables the credit institution to be effectively wound up in an orderly fashion, while limiting the amount of aid to the minimum necessary to keep it afloat during the liquidation in view of the objective pursued and complying with the burden-sharing requirements of this Communication.

6.2.2. Limitation of competition distortions

73. To avoid undue distortions of competition, the winding-up phase should be limited to the period strictly necessary for the orderly liquidation.

74. As long as the beneficiary credit institution continues to operate, it must not actively compete on the market or pursue any new activities. Its operations must in principle be limited to continuing and completing activities pending for existing customers. Any new activity with existing customers must be limited to changing the terms of existing contracts and restructuring existing loans, provided that such changes improve the respective asset’s net present value.

75. The pricing policy of the credit institution to be wound down must be designed to encourage customers to find more attractive alternatives.

76. Where a banking licence is necessary, for example for a rump bank or a temporary institution created for the sole purpose of orderly liquidation of a credit institution (‘bridge bank’), it should be limited to the activities strictly necessary for the winding up. The banking licence should be withdrawn as soon as possible by the competent supervisory authority.

6.2.3. Burden-sharing

77. In the context of orderly liquidation, care must be taken to minimise moral hazard, particularly by preventing additional aid from being provided to the benefit of the shareholders and subordinated debt holders. Therefore, the claims of shareholders and subordinated debt holders must not be transferred to any continuing economic activity.

78. Sections 3.1.2 and 3.1.3 must be complied with mutatis mutandis.

6.3. Sale of a credit institution during the orderly liquidation procedure

79. The sale of a credit institution during an orderly liquidation procedure may entail State aid to the buyer, unless the sale is organised via an open and unconditional competitive tender and the assets are sold to the highest bidder. Such competitive tender should, where appropriate, allow for sale of parts of the institution to different bidders.

80. In particular, when determining if there is aid to the buyer of the credit institution or parts of it, the Commission will examine whether:

(a) the sales process is open, unconditional and non-discriminatory;

(b) the sale takes place on market terms;

(c) the credit institution or the government, depending on the structure chosen, maximises the sales price for the assets and liabilities involved.

81. Where the Commission finds that there is aid to the buyer, the Commission will assess the compatibility of that aid separately.

82. If aid is granted to the economic activity to be sold (as opposed to the purchaser of that activity), the compatibility of such aid will be subject to an individual examination in the light of this Communication. If the liquidation process entails the sale of an economic entity which holds a significant market share, the Commission will assess the need for measures to limit distortions of competition brought about by the aid to that economic entity and will verify the viability of the entity resulting from the sale. In its viability assessment, the Commission will take into due consideration the size and strength of the buyer relative to the size and strength of the business acquired.
6.4. Conditions for the authorisation of orderly liquidation schemes

83. The implementation by Member States of regimes to deal with distressed credit institutions may include the possibility of granting aid to ensure the orderly liquidation of distressed credit institutions, while limiting negative spillovers on the sector and on the economy as a whole.

84. The Commission considers that liquidation aid schemes for credit institutions of limited size (24) can be approved, provided they are well designed so as to ensure compliance with the requirements on burden-sharing by shareholders and subordinated debt-holders set out in point 44 and to remove moral hazard and other competition concerns.

85. The compatibility of such schemes will be assessed in the light of the conditions set out in Section 3. When notifying a scheme to the Commission, Member States must therefore provide detailed information on the process and on the conditions for the interventions in favour of beneficiary institutions.

86. As the degree to which competition is distorted may vary according to the nature of the beneficiary institution and its positioning in the market, an individual assessment might be necessary to ensure that the process does not lead to undue competition distortions. Therefore, aid measures under an approved scheme in favour of credit institutions with total assets of more than EUR 3 000 million must be individually notified for approval.

6.5. Monitoring

87. Member States must provide regular reports, at least on an annual basis, on the operation of any scheme authorised pursuant to Section 6.4. Those reports must also provide the information for each credit institution being liquidated pursuant to Section 6.4.

88. In order to allow the Commission to monitor the progress of the orderly liquidation process and its impact on competition, Member States must submit regular reports (on at least a yearly basis) on the development of the liquidation process of each bank in liquidation and a final report at the end of the winding-up procedure. In certain cases, a monitoring trustee, a divestment trustee or both may be appointed to ensure compliance with any conditions and obligations underpinning the authorisation of the aid.

7. DATE OF APPLICATION AND DURATION

89. The Commission will apply the principles set out in this Communication from 1 August 2013.

90. Notifications registered by the Commission prior to 1 August 2013 will be examined in the light of the criteria in force at the time of notification.

91. The Commission will examine the compatibility with the internal market of any aid granted without its authorisation and therefore in breach of Article 108(3) of the Treaty on the basis of this Communication if some or all of that aid is granted after the publication of the Communication in the Official Journal of the European Union.

92. In all other cases it will conduct the examination on the basis of the Crisis Communications in force at the time at which the aid is granted.

93. The Commission will review this Communication as deemed appropriate, in particular so as to cater for changes in market conditions or in the regulatory environment which may affect the rules it sets out.

94. The 2008 Banking Communication is withdrawn with effect from 31 July 2013.

95. Point 47 and Annex 5 of the Impaired Assets Communication are withdrawn.

96. The Restructuring Communication is adapted as follows:

In point 4 the first sentence is replaced by the following: ‘Where a financial institution has received State aid, the Member State should submit a restructuring plan in order to confirm or re-establish individual banks’ long-term viability without reliance on State support.’

(24) See e.g. N 407/10, Danish winding-up scheme for banks (OJ C 312, 17.11.2010, p. 7).
Footnote 4 relating to point 4 is withdrawn.

Point 7 third indent is replaced by the following: ‘The Commission will apply the basic principle of appropriate burden-sharing between Member States and the beneficiary banks with the overall situation of the financial sector in mind.’

Point 8 is withdrawn.

In footnote 1 relating to point 21 the first sentence is replaced by the following: ‘See Section 6 of the 2013 Banking Communication.’

Point 25 is replaced by the following: ‘Any derogation from an adequate burden-sharing ex ante which may have been exceptionally granted before a restructuring plan is approved for reasons of financial stability must be compensated by a further contribution at a later stage of the restructuring, for example in the form of claw-back clauses and/or by farther-reaching restructuring including additional measures to limit distortions of competition.’