

## DG COMPETITION STAFF WORKING DOCUMENT

### THE APPLICATION OF STATE AID RULES TO GOVERNMENT GUARANTEE SCHEMES COVERING BANK DEBT TO BE ISSUED AFTER 30 JUNE 2010

30 APRIL 2010

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#### I. INTRODUCTION

Swiftly after the onslaught of the global financial crisis in the autumn of 2008, the Commission issued a Communication (the 'Banking Communication')<sup>1</sup> which provided detailed guidance on the criteria for the compatibility of government guarantees covering the liabilities of banks, granted either under a national scheme or on an *ad hoc basis*, with the requirements of Article 107 (3) (b) TFEU. The Banking Communication highlighted the danger of distortive effects of guarantees on competition between banks and specified the temporary nature of the admissibility of such aid measures. Moreover, the Communication stated that such guarantees could only be justified as an emergency response to the unprecedented stress in financial markets and only as long as these exceptional circumstances prevail. The authorisation was made conditional upon compliance with a number of specific requirements including: a) a limited temporal scope of schemes, implying the need to obtain a new Commission approval every six months on the basis of a review of a scheme's continued justification and the potential for adjustments to the developments in financial market functioning, and b) an adequate remuneration of the government by the beneficiary institutions coming as close as possible to what could be considered a market price.

The Banking Communication, as well as the subsequent guidance documents<sup>2</sup>, established a distinction between fundamentally sound banks whose difficulties stem exclusively from exceptionally adverse general market conditions and other banks for which the crisis revealed and exacerbated structural weaknesses in their business model, setting out that the latter would have to undergo a further-reaching restructuring.

On the basis of these criteria which were refined over time<sup>3</sup> and complemented by a pricing formula for guarantee fees recommended by the European Central Bank<sup>4</sup>, the Commission has approved and extended guarantee schemes in 19 Member States and taken a number of decisions on guarantees that were notified individually outside a scheme. The availability of guarantees on bank liabilities has proven to be an appropriate and effective tool to improve

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<sup>1</sup> 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, OJ C 270, 25.10.2008, p. 8 ("the Banking Communication")

<sup>2</sup> Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: Limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.01.2009, p. 2 ("the Recapitalisation Communication"); Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, OJ 72, 26.03.2009 ("the Impaired Assets Communication"); Commission Communication on the return to viability and the assessment of restructuring in the financial sector in the current crisis under State aid rules, OJ C 195, 19.08.2009, p. 9 ("the Restructuring Communication").

<sup>3</sup> Consolidated practice is summarized in the staff working document of 7 August 2009 "DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis ("Review paper") published on [http://ec.europa.eu/competition/state\\_aid/legislation/review\\_of\\_schemes\\_en.pdf](http://ec.europa.eu/competition/state_aid/legislation/review_of_schemes_en.pdf). No material changes have taken place since then.

<sup>4</sup> Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt of 20 October 2008, available at [http://www.ecb.int/pub/pdf/other/recommendations\\_on\\_guaranteesen.pdf](http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf).

access to funding for banks<sup>5</sup> and to restore market confidence in a systemic crisis situation and has played a significant role in preventing a collapse of the financial system.

As a result of policy intervention the severe shortage of bank funding that had occurred in autumn 2008 could be overcome relatively quickly. Although market conditions on EU wholesale financial markets have not yet fully normalised, spreads on wholesale bond markets have considerably dropped<sup>6</sup> and access to funding is no longer a systematic and generalized problem.

In the second half of 2009, this improvement in conjunction with indicators of stabilisation and first signs of recovery in financial markets and in Member States' economies at large triggered a discussion on the development of a strategy for a gradual disengagement from the temporary exceptional State support measures for banks. The objective of gradual disengagement would be to promote a return to normal market functioning and facilitate a consolidation of public finances, while safeguarding financial stability in what is still a precarious situation in view of the remaining fragility of the recovery process as illustrated by the current turbulences in relation to sovereign bond markets.

The ECOFIN Council of 2 December 2009 concluded<sup>7</sup> on the necessity to design a strategy for a phasing out of support measures which should be transparent and duly coordinated among Member States to avoid negative spill-over effects but take into account the specific circumstances varying across Member States. 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 incentivising the exit of sound banks and inducing other banks to address their weaknesses.

## **II. MARKET DEVELOPMENTS AND USE OF GOVERNMENT GUARANTEES**

In line with these conclusions and in close cooperation with the European Central Bank, the Commission has carried out a thorough review of the patterns and trends in the use of government guarantees on the one hand and of the economic benefits of their use in comparison with unsecured market funding on the other.

The results of this review are summarized in the Annex to this document. Evidence shows that the use of guarantees has considerably declined since the peak in the first half of 2009 in terms of both numbers of issues of guaranteed bank debt and volume of issuances. The data collected further demonstrates that the number of banks resorting to government guarantees is shrinking and that this group is now essentially made up of banks that are

- either already undergoing restructuring following a Commission decision or where a restructuring commitment has been made pending a final decision on its exact form or shape; or

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<sup>5</sup> The overall liquidity needs of banks were addressed through government guarantees together with the monetary action of central banks to lower interest rates and provide banks with exceptional amounts of liquidity.

<sup>6</sup> In view of the previous under-pricing of risk, the permanence of conditions for access to inter-bank funding (without State support) at a spread higher on average than the pre-crisis levels, should not necessarily be seen as a sign of lack of normalization.

<sup>7</sup> These conclusions were endorsed by the European Council of 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.

- that are under no such obligation, but have a relatively low rating of A or below or no rating.

More solid and unquestionably sound institutions are no longer significant issuers of guaranteed debt.

The review further comprises an analysis of the relative cost of debt issuance for banks with and without government guarantee. This analysis yields the result<sup>8</sup> that, taking into account the guarantee fees according to the present pricing formula, the cost of funding with guarantees is considerably reduced relative to the cost of funding via unsecured debt in particular for banks with a lower estimated creditworthiness.

In general, these findings indicate that a certain exit process has already begun at the level of individual banks. Sound institutions have largely withdrawn from the use of guarantees in order to benefit from more favourable conditions for unsecured market funding and to avoid the conditions attached to State assistance. An exit process can also be observed at the level of Member States. Out of 19 Member States that have introduced guarantee schemes<sup>9</sup>, 15 still have a scheme in place; 12 are currently approved until 30 June 2010 and the others will expire or come up for extension before that date. Four Member States have already discontinued their schemes altogether<sup>10</sup> and one has carried out the most recent extension until June 2010 only in combination with a significant increase in the guarantee fee.

As a consequence of the general improvement in market conditions, the risks for financial stability at large have subsided, and the distortions of competition between those banks that issue guaranteed bonds but are not currently under restructuring obligations<sup>11</sup> and those that issue strictly under market conditions has become greater.

This situation calls for a review of the conditions under which guarantee schemes are approved by the Commission with a view to a) increasing guarantee fees in order to bring the funding costs of beneficiary banks closer to market conditions and thereby reduce distortions of competition and b) requiring banks that continue to heavily rely on government guarantees but are not under restructuring obligations to demonstrate their long-term viability to the Commission. The combined effect of these adjustments, which are set out in more detail below, would be to incentivise the banks concerned to scale down or terminate their use of government guarantees and/or to require banks that cannot convincingly establish their long-term viability to undertake the necessary restructuring to address their structural weaknesses.

A process of gradual disengagement from the use of government guarantee schemes has to take account of several factors: (a) the diversity of circumstances in individual Member States that have a bearing on the possible speed of the phasing-out process and on the extent to which conditions can be presently tightened; (b) the fragility in the recovery of Member States' economies in general and the stabilisation of financial markets in particular; (c) the remaining uncertainty about the extent of further required write-downs of banks assets; (d) the ongoing withdrawal of exceptional liquidity support measures by some central banks amid e

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<sup>8</sup> Set out in more detail in the Annex.

<sup>9</sup> 8 Member States have never had a guarantee scheme.

<sup>10</sup> One of these Member States has reserved the possibility to reactivate the scheme and enable guarantees for debt issued until 31 December 2010 in the case of exceptional circumstances amounting to a serious disturbance in banks' access to financing.

<sup>11</sup> For the purposes of this document, this includes all banks for which Member States are obliged to present a restructuring plan as a consequence of aid granted during the financial crisis on the basis of Article 107 (3) (b) TFEU irrespective of whether the restructuring plan has already been submitted and whether the Commission has already adopted a final decision.

refinancing needs which are considerable for a number of banks in the near future; and (e) the possibility of setbacks or of renewed stress in financial markets.

Against this background, the specific features of the amendments to the requirements for the compatibility of guarantee schemes with Article 107 (3) (b) TFEU need to be sufficiently flexible to permit access to guarantee schemes to the extent necessary to maintain progress in reinforcing financial stability in the wake of the crisis .

### **III. RENEWAL OF GOVERNMENT GUARANTEE SCHEMES: UPDATED CONDITIONS FOR COMPATIBILITY**

The conditions in relation to the pricing of government guarantees and to the requirement of a viability review set out in this document<sup>12</sup> – which will apply to guarantees granted within and outside the framework of guarantee schemes<sup>13</sup> as from 1 July 2010 - have been designed to allow for such flexibility.

A moderate increase in guarantee fees represents a minimum which every Member State still making use of government guarantees should be able to implement without jeopardizing financial stability even in the event of a downturn in market conditions provided that higher stress levels do not reach the same degree of seriousness as in the most acute crisis period<sup>14</sup>. A viability review of individual banks that still heavily rely on guarantees is by its very nature a flexible exercise duly having regard to the overall situation of financial markets at the time it is carried out.

The determination of new minimum criteria for the conformity of guarantee schemes with the State aid rules implies that Member States can – and should whenever circumstances permit<sup>15</sup> – advance further in the phasing-out process by measures ranging from a more substantial increase of guarantee fees or the introduction of new behavioural safeguards to a cap on the amounts available per bank<sup>16</sup> or to the administrative closure of automatic access to the use of a scheme as already put into practice by several Member States<sup>17</sup>.

The principles and criteria for the compatibility of government guarantees under State aid rules as set out in the Banking Communication and further refined and consolidated in decisional practice<sup>18</sup> remain fully applicable. They are complemented by the requirements set

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<sup>12</sup> These requirements have been shared and discussed with the European Central Bank.

<sup>13</sup> The reflections in this document underlying the requirements for a further extension of guarantee schemes will also be reflected in the treatment of individual notifications of government guarantees outside a scheme and will in principle require a guarantee fee along the same lines as well as trigger a thorough viability review where it would have to be required under the terms of a scheme.

<sup>14</sup> A severe new shock of a comparable qualitative dimension to the financial markets across the EU or in one or more Member States undoing the stabilisation that has occurred over the past year would require a reassessment of the situation and the appropriate remedies. A sovereign crisis of such a dimension as to critically jeopardize financial stability would be an example of such exceptional circumstances.

<sup>15</sup> In carrying out its compatibility assessment the Commission will continue to place particular importance on the confirmation of a serious disturbance in the economy by the Member State's authorities responsible for financial stability. In addition, a notification should explain why State assistance specifically through guarantees of bank debt is appropriate and necessary to address the persistent disturbance.

<sup>16</sup> Possibly below the threshold triggering a viability review by the Commission (see below under III 2).

<sup>17</sup> A Member State, which refrains from notifying an extension of a guarantee scheme and de facto puts the scheme into disuse, is not prevented from leaving the national framework legislation in force and re-activating the scheme through a new notification at a later stage if required by a material change in market conditions.

<sup>18</sup> As recalled in the Commission staff working document on the review of schemes; see footnote 3.

out below, in case a Member State seeks authorization of an extension of the government guarantee scheme beyond June 2010.

## 1. PRICING CONDITIONS

Access to the government guarantees is currently subject to a fee, which is determined following the ECB recommendations. In the case of a bond with maturity over one year, the fee comprises a flat charge of 50 basis points augmented by each bank's median five-year senior debt CDS spread observed in the period 1 January 2007 to 31 August 2008.<sup>19</sup>

The credit risk element in the current pricing model is based upon data that predates the most acute phase of the crisis which followed the bankruptcy of Lehman Brothers in September 2008. CDS spread differentials across banks have are currently significantly higher than pre-Lehman and are likely to remain so. Up to now, this has been considered necessary to facilitate banks' access to external funding and thereby safeguard financial stability. However, financial-market developments in the 20 months since 31 August 2008, including changes in the banks' credit status, are not taken into account. Thus, while access to market financing has generally improved, banks which have been downgraded are still benefiting from their pre-Lehman credit rating and perceived creditworthiness. This increases the likelihood of competition distortions. Evidence shows that banks with low rating benefit disproportionately more from guarantees than banks with higher rating because they would normally pay a higher market price due to their low rating.

In order to address these distortions, the pricing of government support should be brought closer to current market conditions, better reflecting individual banks' current creditworthiness. De facto, this requires that the guarantee fee payable by beneficiary institutions would be increased.

A coordinated approach among Member States should promote a gradual phasing out of guarantee schemes while retaining a certain degree of flexibility to take account of the different situations of Member States and their banks. To this end, the Commission considers it appropriate to introduce a minimum increase in the fee for guarantees that should be differentiated according to the beneficiary bank's creditworthiness. The differentiation based on creditworthiness strengthens the price signal for weaker banks allows to better align the price of guarantees with the risk profile of the beneficiary institution thus lowering distortions of competition between institutions and contributing to the protection of a level playing field across banks in the single market.

The approval of the extension of a guarantee scheme<sup>20</sup> beyond 30 June 2010 would therefore require the fee for a government guarantee<sup>21</sup> to be higher than under the pricing formula recommended by the ECB in October 2008 at least

- by 20 basis points for banks with a rating of A+ or A<sup>22</sup>,
- by 30 basis points for banks rated A<sup>-23</sup>, and

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<sup>19</sup> See [http://www.ecb.int/pub/pdf/other/recommendations\\_on\\_guaranteesen.pdf](http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf).

<sup>20</sup> Individual notifications of government guarantees outside a scheme will generally require a guarantee fee along the same lines. Where the beneficiary is under restructuring obligations and a lower fee may be justified depending on the specific circumstances this deviation will have to be taken into account in the overall assessment of the restructuring and the measures necessary to minimize distortions of competition.

<sup>21</sup> This includes guarantees covering liabilities of 1 year or less.

<sup>22</sup> Or A1 and A2 depending on the rating system employed.

<sup>23</sup> Or A3 depending on the rating system employed.

- by 40 basis points for banks rated below A-. Banks without rating will be considered to belong to the category of banks with a BBB rating<sup>24</sup>.

Member States would have the possibility to go beyond these minimum requirements in defining the top-ups for the guarantee fee. As a further element of flexibility allowing Member States to adjust the conditions to the specific circumstances prevailing in their financial sectors, the Commission would accept a different model for the calculation of a fee increase provided that it can be unequivocally demonstrated that this formula leads at least to the minimum rise set out above for the banks concerned<sup>25</sup>.

## **2. VIABILITY REVIEW OF BANKS STILL DEPENDENT ON GOVERNMENT DEBT GUARANTEES**

The various Commission Communications providing guidance on the compatibility of crisis-related support measures with State aid rules set out a clear relationship between i) the size of aid and ii) the sound or distressed situation of the aid beneficiary on the one hand, and the extent of a need for restructuring on the other. Capital injections and asset relief measures always entail the requirement to present either a fully-fledged restructuring plan or at least a viability review that sheds light on a beneficiary's business model and risk profile with a view to appreciating the prospect for long-term viability without State support. A viability review is an appropriate instrument in particular to review the bank's situation in view of market developments and to assess if and to what extent restructuring efforts are necessary to return to viability without State support. Against that background, the Restructuring Communication spells out as a general principle that where a financial institution has received State aid, Member States should submit a viability plan or, for distressed banks, a more fundamental restructuring plan in order to confirm or re-establish individual banks' long-term viability without reliance on State support<sup>26</sup>.

As far as government guarantee schemes for bank liabilities are concerned, the mere use of guarantees has so far not automatically triggered the obligation to submit a viability review or a restructuring plan. Under the terms of the Banking Communication and the decisional practice of the Commission, a restructuring or liquidation plan has to be notified only if the guarantee is called upon because the bank defaults on a covered liability<sup>27</sup>, a situation that is tantamount to technical insolvency. While no conditions or thresholds were specified that would necessitate a viability review as a consequence of benefitting from government guarantees<sup>28</sup>, the Banking Communication does stipulate that guarantees must be limited to the minimum necessary to confront the relevant aspects of the current financial crisis and targeted, to the extent possible, to the specific source of difficulties in the access to financing. It highlights that the limitation of the amount of the guarantee available, possibly in relation to the balance sheet size of the beneficiary bank – triggering the necessity of an individual

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<sup>24</sup> In the case of divergent assessments by different rating agencies the relevant rating for the calculation of the fee increase should be the higher rating. The material time for the rating in the determination of the guarantee fee is the day on which the guarantee is granted in relation to a specific bond issuance by the beneficiary.

<sup>25</sup> E.g. an update of the CDS reference period stipulated in the ECB recommendations of October 2008 that demonstrably leads to an increase of at least 20 bp for banks rated A+ and A, 30 bp for banks rated A- and 40 bp for banks rated below A-

<sup>26</sup> Restructuring Communication, point 4.

<sup>27</sup> Banking Communication, point 30

<sup>28</sup> A viability review would thus currently be required from a bank using government guarantees only if this bank also receives a capital injection or benefits from relief measures in relation to its impaired assets.

notification where that ceiling amount has to be exceeded – may be an element safeguarding the proportionality of a guarantee scheme in that respect<sup>29</sup>.

At the current juncture in the evolution of market conditions, access to liquidity on the market no longer represents a serious obstacle for banks across the board as in the more acute crisis period. Accordingly, it seems justified to introduce a differentiation in the conditions attached to the use of State guarantees based on the extent to which banks rely on them. While limited usage could be allowed without prompting further scrutiny, a larger usage both in absolute terms and in relation to the bank's total amount of liabilities should trigger the requirement of a viability review as a prerequisite for the conformity of the further extension of guarantee schemes with Article 107 (3) (b) TFEU. A persistent failure to obtain a considerable proportion of the funding needed without government guarantees may indicate a lack of confidence in the viability of a bank's business model. It should be avoided that a bank retains a heavy reliance on guarantee schemes, which were designed to tackle unprecedented difficulties in access to financing, even when these exceptional circumstances have subsided, thereby possibly allowing that bank to postpone necessary structural adjustments.

Therefore, the Commission considers it appropriate that guarantee schemes to be prolonged beyond 30 June 2010 should include a threshold concerning the ratio of total guaranteed liabilities outstanding over total liabilities of a bank and the absolute amount of guaranteed liabilities which, if exceeded, triggers the requirement of a viability review. For any bank that requests government guarantees under a scheme covering new or renewed debt to be issued as from 1 July 2010 which takes or keeps the total amount of outstanding guaranteed liabilities beyond this threshold in relation to both of its elements (absolute and relative size)<sup>30</sup> the Member State concerned would be required to submit a review demonstrating the bank's long-term viability to the Commission within 3 months of the granting of guarantees.

This mechanism does not apply to banks that are already in restructuring or are obliged to present a restructuring plan or that are already subject to a pending viability review at the material time. In those scenarios the award of additional State aid will have to be taken into account within the framework of the ongoing restructuring/viability review process<sup>31</sup>.

The threshold is set at a ratio of 5% of outstanding guaranteed liabilities over total liabilities and at a total amount of guaranteed debt of €500 million. The determination of this trigger

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<sup>29</sup> Banking Communication, point 20 and FN 2. Where Member States have introduced such a cap, such as in Spain (where maximum amounts that can be guaranteed were allocated to each beneficiary in direct proportion to its market share, see Commission decision of 23 December 2008 - *Guarantee scheme for credit institutions in Spain*, State aid NN 54/B/2008) or in Austria (cap in relation to the size of the beneficiary with an absolute ceiling, see Commission decision of 9 December 2008 - *Maßnahmen nach dem Finanzmarktstabilitäts- and Interbankmarktstärkungsgesetz für Kreditinstitute und Versicherungsunternehmen in Österreich*, State aid N 557/2008) this was taken into account in the Commission's assessment of compatibility with State aid rules.

<sup>30</sup> The assessment will be carried out when a Member State receives the application for an approval of guarantees for the issuance of new or renewed debt as from 1 July 2010 and will include the amount of debt to be covered by the requested guarantees as well as all existing outstanding guaranteed liabilities in relation to total liabilities/balance sheet at the material time. Outstanding liabilities that exceed the threshold due to issuances before 1 July 2010 do not trigger a viability review unless the bank resorts to the issuance of new debt keeping the guaranteed liabilities above the threshold.

<sup>31</sup> For example, where a bank is already undergoing a viability review because of a recapitalization and the threshold for guarantees is exceeded, the review has to be extended to address the reasons why the bank continues to rely on state guarantees, to include a liquidity stress test, and to analyze if and to what extent further use of State guarantee is foreseen.

threshold is based on a comparative analysis which illustrates that the vast majority of banks that use guarantees and are presently not under restructuring obligations (and even a significant proportion of banks that are subject to such obligations) stay well below this level. For the small but not negligible group of banks exceeding this limit, it is warranted to scrutinize whether the considerable reliance on guarantees for funding indicates a more structural weakness of their business models. The trigger function provides an incentive for sound banks to initiate a swift process of return to funding predominantly or exclusively on undistorted market terms. For all banks undergoing a thorough viability review either their long-term viability will be confirmed or doubts in that respect will indicate the need to confront the necessity of a farther-reaching restructuring.

In relation to the content to be provided in a viability review exercise, reference can be made to the Restructuring Communication which sets out that the principles concerning the analysis of a bank's situation with a view to the restoration of long-term viability in a restructuring plan apply by analogy to cases where the aid beneficiary is not under a formal obligation to present a restructuring plan but is nonetheless required to demonstrate long-term viability. In particular the bank will have to demonstrate the solidity of its funding capacity and, where necessary, to undergo a liquidity stress test<sup>32</sup>. A viability review should also take account of any factors specific to the beneficiary financial institutions<sup>33</sup> or to the Member State concerned<sup>34</sup> and the situation of its financial markets that have an impact on the viability assessment and on the indicative value of the ratio of guaranteed liabilities over total liabilities. As a general rule, the more significant the reliance on government guarantees is and the more it is combined with the use of other forms of State assistance and/or a low creditworthiness<sup>35</sup> the stronger the indication of a need to undergo changes in the business model in order to ensure long-term viability.

The mechanism triggering the requirement of a viability review conveys the signal that banks have to prepare for a return to normal market mechanisms without State support as the financial sector gradually emerges from crisis conditions and represents an incentive for individual institutions to scale down the reliance on government guarantees or to refrain from their use altogether. At the same time, it affords sufficient flexibility to duly take account of potentially diverse circumstances affecting the situation of different banks or national financial markets and also caters for the possibility of an overall deterioration in relation to financial stability which cannot be excluded at this stage given the residual fragility in the recovery of financial markets.

#### **IV. TEMPORAL SCOPE, GENERAL OUTLOOK**

In line with the ECOFIN Council Conclusions of 2 December 2009 and the European Council Conclusions of 11 December 2009, the requirements set out in this document would initiate the phasing-out of public support for financial institutions starting with government guarantee schemes. The requirements would incentivise the exit of sound banks while confronting other

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<sup>32</sup> Restructuring Communication, point 8 and section 2, also pointing to the related sections in point 40 of the Recapitalisation Communication and Annex V of the Impaired Assets Communication.

<sup>33</sup> Including, for example, a higher ratio of guaranteed debts that is explained by a particular effort to sustain or increase lending to the real economy in the public interest and with the backing of the Member State concerned provided that such conduct is compatible with the common market.

<sup>34</sup> Having due regard to the macro-economic situation of the Member State in general and in particular to those elements such as the sovereign risk that have a direct bearing on the terms of access to funding for banks located in that Member State.

<sup>35</sup> As expressed in the beneficiary's rating or CDS spread.

banks with the need to thoroughly assess their prospects for long-term viability and to address their weaknesses through restructuring where appropriate.

This constitutes the first step towards the exit from guarantee schemes within a coherent framework for a coordinated approach across Member States with the future objective of discontinuing the general access to such schemes when they are not justified any longer by systemic reasons of financial stability of the banking sector. The prerequisites for the compatibility of guarantee schemes with Article 107 (3) (b) TFEU retain the necessary degree of flexibility to accommodate country-specific features and adjust the timing of the eventual termination of schemes to those conditions. Subject to market developments, further steps could be undertaken, at the most appropriate moment.

The new criteria set out in this document apply exclusively to the extension of guarantee schemes for the second half of 2010 and are without prejudice to the possibility of further advancing the exit by adjusting the conditions to a further improvement in market conditions prior to a further round of extensions. In order to gather the necessary factual information to prepare the ground for further progress on exit Member States will be asked to provide the Commission with a concise mid-term review on the operation of their respective guarantee schemes by October 2010.

## ANNEX

### BACKGROUND ON THE BANKS' USE OF STATE GUARANTEES

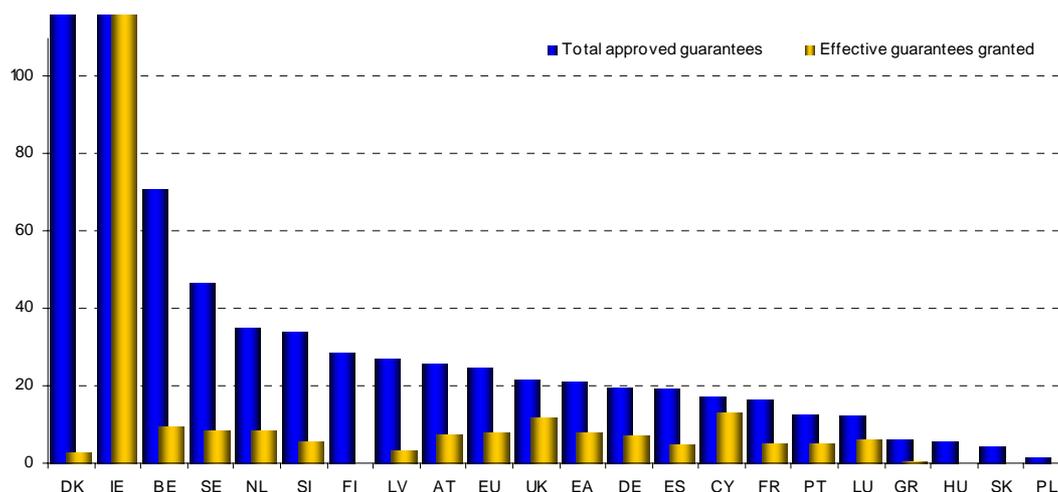
#### 1. Access to government guarantees on bank debt in the Member States

##### 1.1 Overall access to guarantees

During the financial crisis, the State aid framework has played an important role by providing guidance for the design of national interventions within the EU internal market context. In particular and in line with the Banking Communication, the Commission has approved, under Art 107.3(b) TFEU, many government guarantee schemes and individual measures in favour of banks, which were designed to preserve financial stability and avoid serious disturbance to the real economy. In general, schemes and individual guarantees have been approved for 6 months with the possibility of being rolled over and subject to a fee, based on the ECB recommendations of October 2008. For example, in the case of a bond with maturity over one year, the fee comprises a flat charge of 50 bps augmented by each bank's median five-year CDS spread observed over the period January 2007–August 2008.<sup>36</sup>

According to information collected by Commission services from Member States concerned, among the total volume of 2899 billion euros of guarantees approved by the Commission until end of 2009, 916 billion euros have been effectively used by financial institutions. Out of this total amount of State guarantees used, 146 billion euros stem from individual measures and 770 billion euros were granted through guarantee schemes. The figure below, built on State aid decisions and EFC survey on State aid effective amounts as of 31 December 2009, gives an overview by Member States of volumes of guarantees granted in favour of financial institutions, either as individual measures or through guarantee schemes.

**Figure 1: State guarantees approved and effectively used by financial institutions (Oct. 2008 – Dec. 2009) (in % of GDP)**



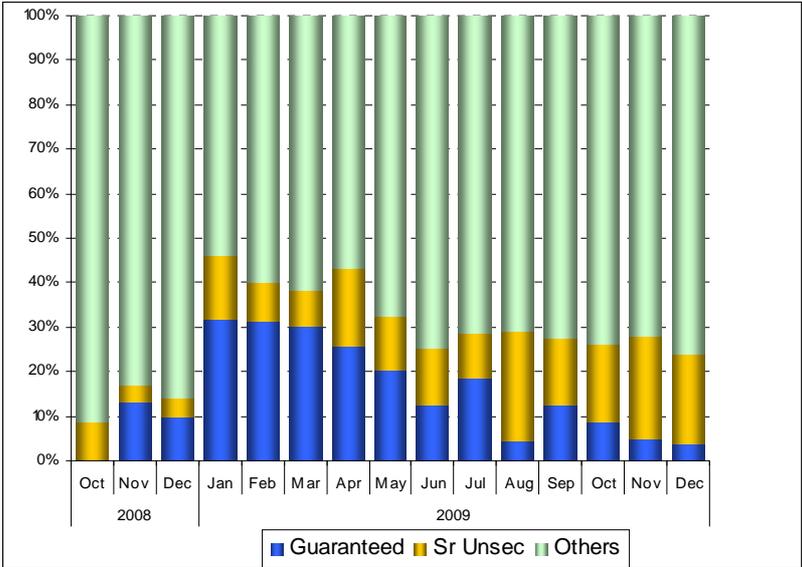
*Note:* Denmark: 237.5% of GDP of approved guarantees. Ireland: 167.5% of approved and effective guarantees granted. These high figures are due to blanket guarantees given to bank liabilities. The rest of MS not included on the graph did not have any amount approved or effective (BG, CZ, EE, IT, LT, MT, RO).

*Source:* Commission services' elaboration on data provided by MS to the EFC Task Force.

<sup>36</sup> For details on the ECB pricing, see [http://www.ecb.int/pub/pdf/other/recommendations\\_on\\_guaranteesen.pdf](http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf).

A mere overview of euro-denominated bond market over the period October 2008 – December 2009 shows that the most important part of guaranteed bonds was issued in the first quarter of 2009, where guaranteed bond issuances reached a monthly average of 30% of total banks funding in euro. The total amount of guaranteed bonds newly issued then decreased progressively until December 2009, to reach about 4% of total banks funding.

**Figure 2: Evolution of guaranteed bonds in the total amount of banks funding (Oct. 2008 – Dec. 2009)**



*Notes: The database includes all euro-denominated bonds with a maturity of at least 1 year and with a minimum amount of €50 million. Senior unsecured bonds are also highlighted as they will be used as a reference for comparison of yields below. Source: Commission services*

**1.2 Access to guarantees via schemes**

15 guarantee schemes on new debt<sup>37</sup> issued by banks are currently in place, of which 12 expire on 30 June 2010. Italy, the UK and France<sup>38</sup> have terminated their guarantee scheme and the Netherlands has increased as of 1 January 2010 the pricing of the guarantees under the scheme to encourage financial institutions to look for alternative ways of funding.

<sup>37</sup> Denmark and Ireland also have a scheme that covers existing liabilities, those schemes are not expected to be renewed at their expiry date.

<sup>38</sup> In total the State guaranteed bonds issued by UK banks amounted to 157 billion euros and the bonds issued by the State guaranteed Société de Financement de l'Economie Française (SFEF) to fund French beneficiary banks amounted to 78.5 billions euros.

**Table 1: List of Member States having a guarantee scheme in place**

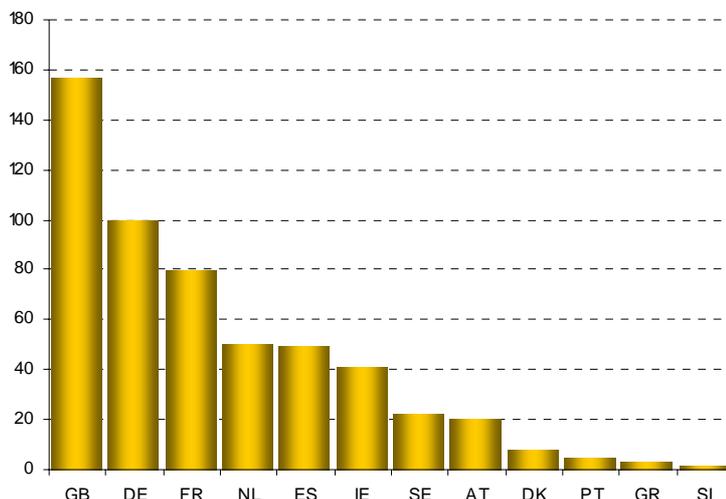
<b>Member States</b>	<b>Date of first authorisation by the Commission</b>	<b>Date of expiry of current Commission authorisation</b>
Cyprus	22/10/2008	31/05/2010
Ireland	20/11/2008	01/06/2010
Slovakia	08/12/2009	08/06/2010
Germany	27/10/2008	30/06/2010
Sweden	29/10/2008	30/06/2010
Austria	09/12/2008	30/06/2010
Finland	13/11/2008	30/06/2010
Netherlands	30/10/2008	30/06/2010
Slovenia	20/03/2009	30/06/2010
Latvia	22/12/2008	30/06/2010
Spain	23/12/2008	30/06/2010
Greece	19/11/2008	30/06/2010
Portugal	29/10/2008	30/06/2010
Denmark	03/02/2009	30/06/2010
Poland	25/09/2009	30/06/2010

*Source: Commission services*

To get a more detailed picture of State guaranteed bonds issued by banks through guarantee schemes, the Commission has put in place a dedicated database comprising 818 guaranteed bonds issued by 112 banks across Member States. In this database, bonds issued through guarantee schemes have been identified according to information provided by the Member States. Out of the 818 guaranteed bonds recorded in the database, 52 benefit from State guarantee in the context of ad hoc measures, for the amount of 32 billion euros, and 766 were issued through schemes, for a total amount of 533 billion euros.

Guaranteed bond issued through schemes are concentrated on a few Member States and have been most significant in the United Kingdom (29% of total amounts of guaranteed bonds issued through schemes), in Germany (19%), France (15%), Netherlands (9%), Spain (9%), and Ireland (8%). Besides, a majority of those bonds (56%) have been issued by banks that are currently under restructuring or under an obligation to submit a restructuring plan in the coming months, according to the Commission banking communications. For these banks, any new debt issuance benefitting from a State guarantee is subject to a dedicated assessment either in the context of the restructuring plan approval or on the basis of an individual notification, after a final Commission decision on the restructuring plan.

**Figure 3: Amounts of guaranteed bonds issued through schemes across MS (Oct. 2008 – Mar. 2010)  
(in billion euros)**



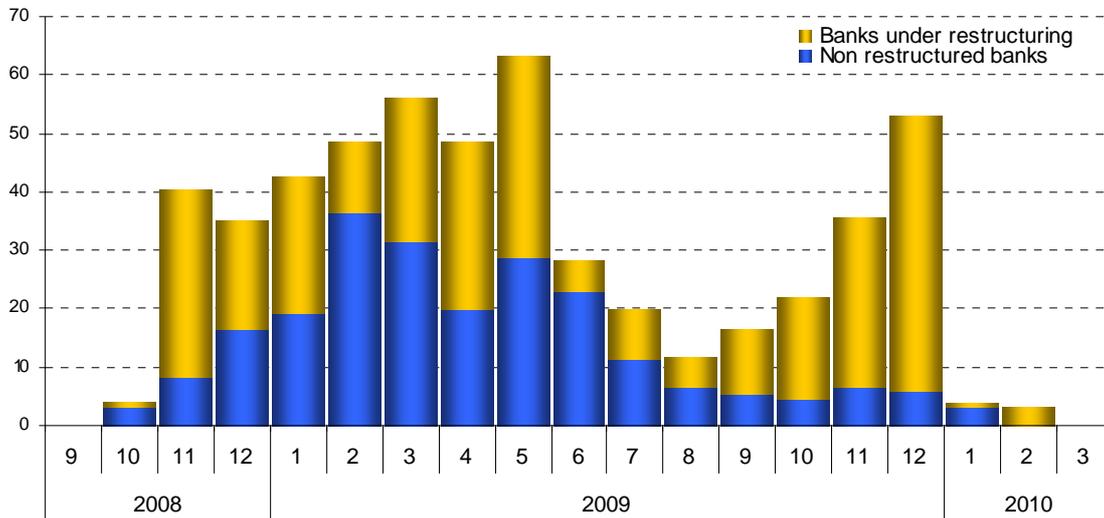
*Source: Commission services (database of guaranteed bonds<sup>39</sup>)*

In recent months banks have had a decreasing recourse to guarantee schemes, both in terms of numbers of issuances and their volumes, in parallel to the stabilisation in financial markets. The issuance of guaranteed bonds has varied over time, and its volume has decreased considerably overall since the peak in Q1&2 of 2009, where it amounted to a monthly average of 51.7 billion euros, although a still important amount of state guaranteed debt was issued before the end of last year, notably by few banks under restructuring obligations according to the Commission banking Communications<sup>40</sup>. The total amount of guaranteed debt issued through schemes has decreased since then and in January and February 2010 was of 3.2 billion euros.

<sup>39</sup> The database was created on the basis of the information extracted from Bloomberg and the verification by Member States.

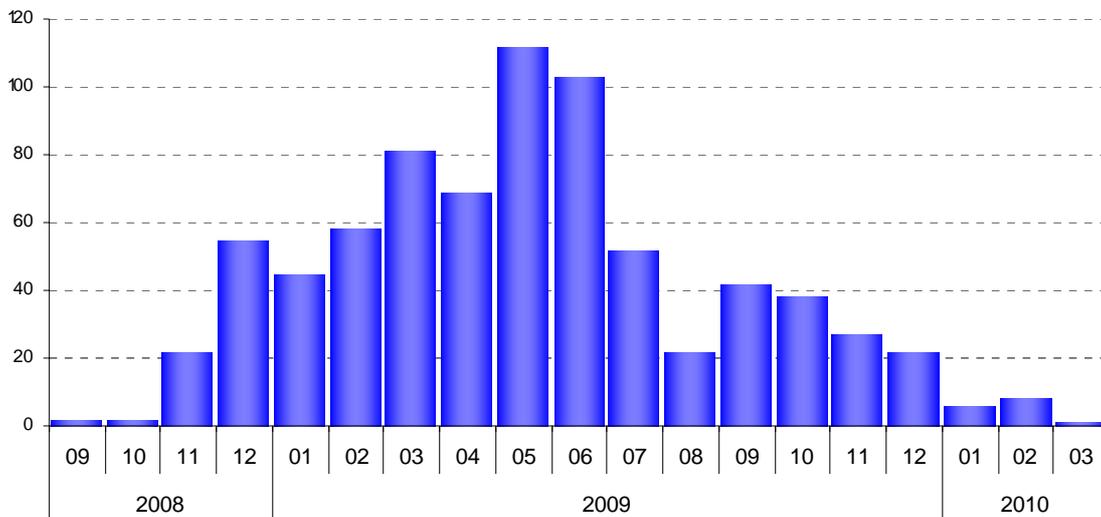
<sup>40</sup> Mainly in Germany and the UK.

**Figure 4: Amounts of guaranteed bonds issued through schemes (Oct. 2008 - Mar. 2010)**  
(in billion euros)<sup>41</sup>



Source: Commission services (database of guaranteed bonds)

**Figure 5: Number of guaranteed bonds issued through schemes (Oct. 2008 - Mar. 2010)**



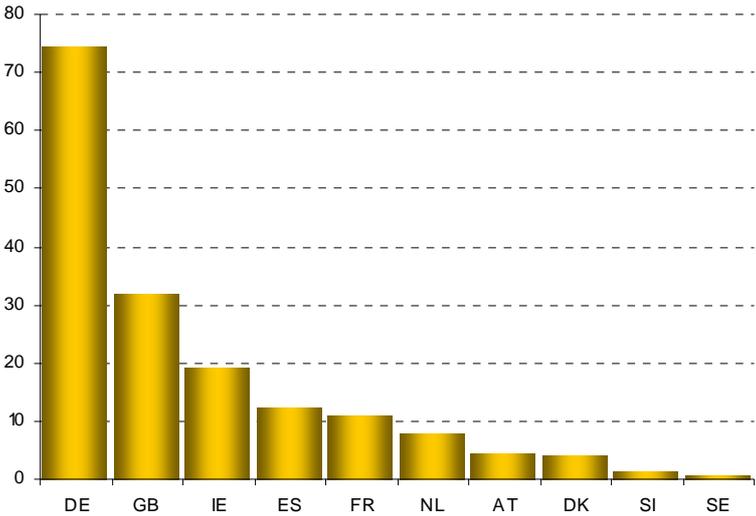
Source: Commission services (database of guaranteed bonds)

Although the decrease in guaranteed bond issuance is general in the EU, it has not followed the same pace in all Member States; guarantee schemes were still importantly used in the second half of 2009 and the first months of 2010 in Germany, United Kingdom, Ireland,

<sup>41</sup> It is worth noting that countries involved and amounts of guaranteed bonds as displayed here differ from those mentioned in figure 1 above since the scope of data is different: data used in this section cover only State guaranteed bonds issued through schemes whereas data mentioned in figure 1 cover all kinds of State guarantees used by banks .

France, Spain, and Netherlands, as shown in figure 4 below. As far as Germany, the United Kingdom, and Ireland are concerned, those bonds were mainly issued by banks that are subject to a restructuring obligation according to the Commission banking communications.

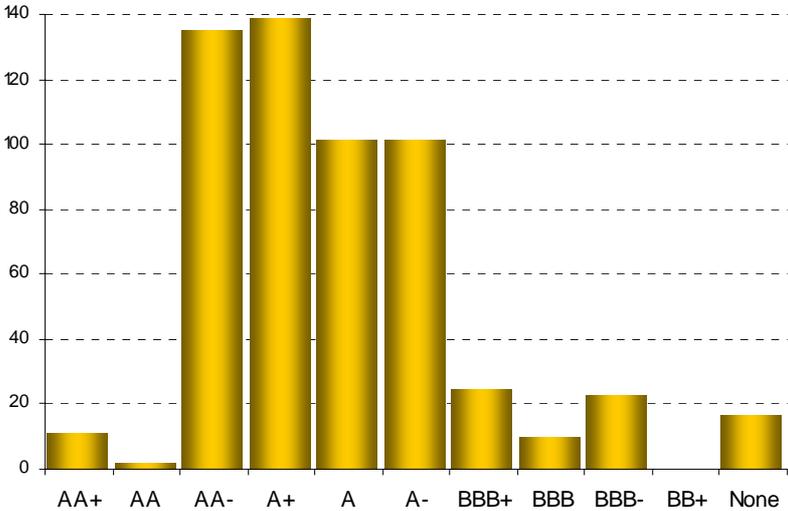
**Figure 6: Amounts of guaranteed bonds recently issued through schemes across MS, (Jul. 2009 - Mar. 2010) (in billion euros)**



Source: Commission services (database of guaranteed bonds)

Among banks that have issued State guaranteed bonds since October 2008 through guarantee schemes, a vast majority were rated A or above (76%).

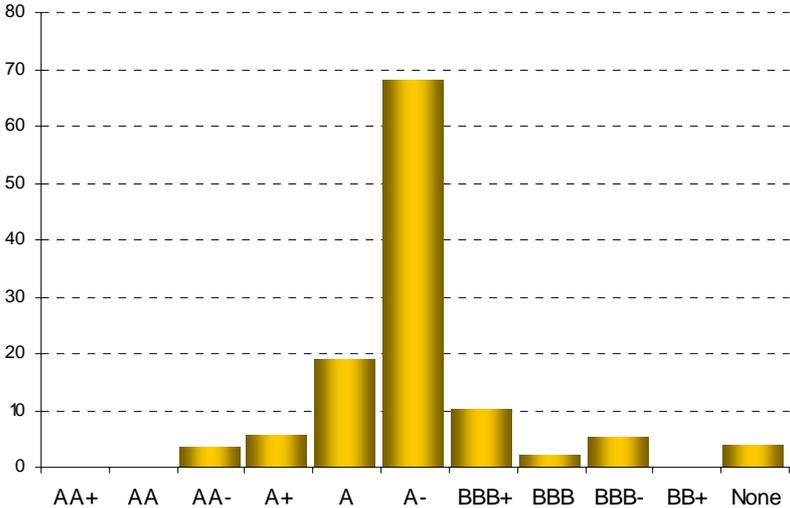
**Figure 7: Amounts of Guaranteed Bonds Issued through Schemes by Issuer's Rating Category (Oct. 2008 – Mar. 2010) (in billion euros)**



Source: Commission services (database of guaranteed bonds)

However, in the recent months, issuance of State-guaranteed debt has shifted towards issuers with a rating A- or below. The latter represent more than 79% of the total amount of State-guaranteed debt issued through guarantee schemes since October 2009.

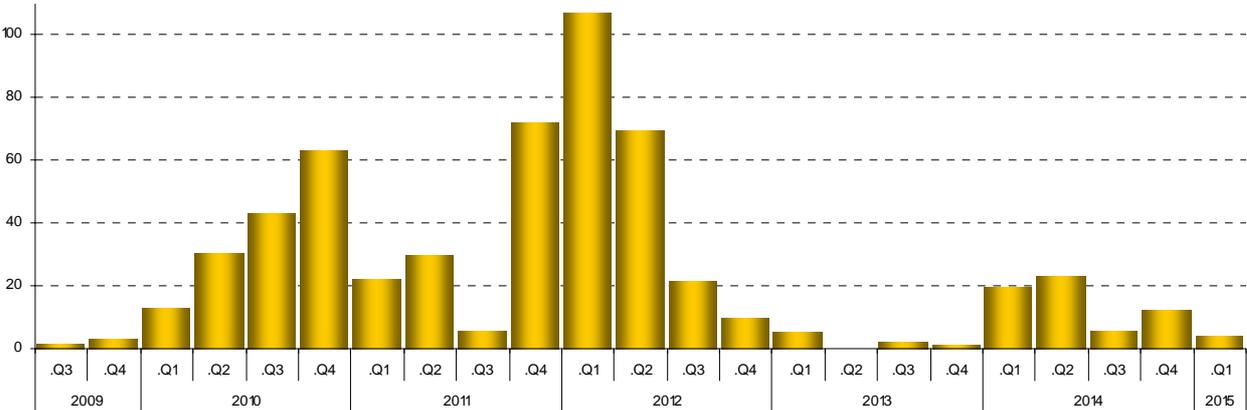
**Figure 8: Amounts of Guaranteed Bonds recently Issued through Schemes by Issuer's Rating Category (Oct. 2009 – Mar. 2010) (in billion euros)**



Source: Commission services (database of guaranteed bonds)

As regards the maturity of guaranteed bonds, it appears that a majority of bonds issued have a maturity of around three years. As a consequence, important amounts of guaranteed bonds issued in the first half of 2009 will mature in the first and second quarter of 2012, as shown in figure 7 below.

**Figure 9: Amounts of Guaranteed Bonds Issued by expiration date (Oct. 2008 – Feb. 2010) (in billion euros)**



Source: Commission services (database of guaranteed bonds)

**2. Access to guarantee schemes by individual banks**

Many banks that made significant use of guarantee schemes in the first half of 2009 have been restructured or are under a restructuring process. Such a restructuring has to be approved by the Commission, which allows a thorough monitoring of the usage of State guarantees by those banks. Therefore, the Commission has focused its analysis on banks not subject to a

restructuring obligation but which still benefit from State guarantees for their funding. 89 banks belong to this category.

However, among these 89 banks, 15 are located in Member States where guarantee schemes have already been discontinued (i.e. France and UK), while 74 banks (or 66% of the banks recorded in the database) in 10 Member States have still access to a guarantee scheme.

Among the 74 identified banks using guarantees without being submitted to a restructuring process, 35 have issued guaranteed bonds since July 2009.

### ***2.1. Current large users of government guarantees***

A closer look allows identifying the banks which are the most significant users of guarantees. For that purpose, all banks with outstanding guaranteed debt of at least €500 million and with a ratio of guaranteed debt over total liabilities of at least 5% have been selected. On the basis of public information available on the total liabilities of the 74 banks identified, it appears that 18 banks in 8 Member States are above the 5% threshold<sup>42</sup>.

While some of these large users of State guarantees may be able to return to the market in the future without the State support, others may find themselves in a situation of dependence on the State support for debt market access, and thus may deserve a closer look if they continue to have access to a state guarantee for debt issuance.

### ***2.2 Potential future users of government guarantees***

It is however equally possible that other banks, at present not heavily reliant on State guarantees, may become such in the near future, notably in view of the need to roll-over large amount of debt.

On the basis of a first provisional analysis, among the 74 banks that have used State guarantee schemes without having been subject to a restructuring obligation, some of them will have to cope with important amounts of guaranteed bonds maturing in the course of 2010 and may need to use again guarantee schemes in the near future. 15 banks have guaranteed debt coming due in 2010. Out of these 15 banks, one has announced that it would not use guarantee scheme as of April 2010 and 5 others were already identified as current large users. 9 more banks from two Member States may also have to roll-over guaranteed bonds in the near future, although for amounts generally below 500 millions. Having regard to the present exposure, only 1, out of these 9 banks, appears having a certain probability to hit the (double) threshold identified above.

In one other Member States, 8 banks have just applied for a larger amount of State guarantees. None of them appears to meet the double threshold above, although some may anyway come under the obligation to submit a restructuring plan in view of the receipt of additional aid measures in form of recapitalisation.

## **3. Comparison between guaranteed and non-guaranteed funding**

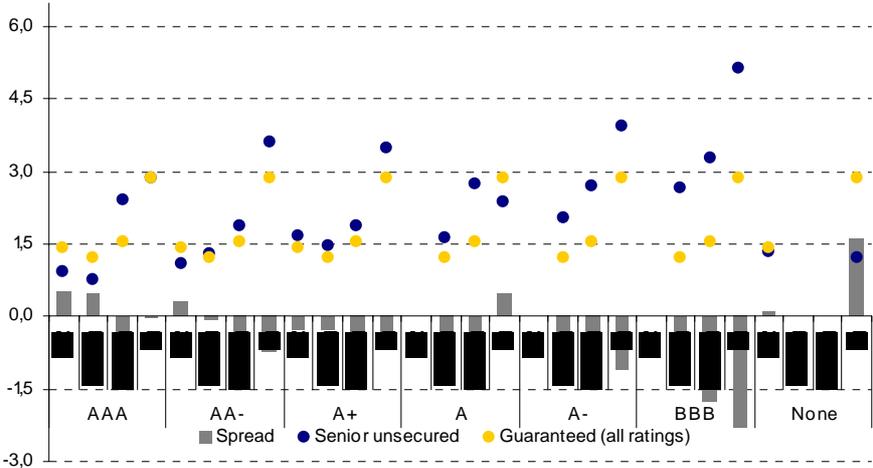
Identifying the price advantage of issuing bonds through guarantee schemes is a complex task since the price of bond issues depends on many factors like the bond maturity, the currency in

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<sup>42</sup> Among these 18 banks, 12 banks have issued State-guaranteed bonds since July 2009.

which the bonds are denominated, the coupon (fixed or floating), the issuer's rating and CDS spread, the issuance volume, the sovereign rating, etc. Ideally, an accurate analysis of price difference between guaranteed and non-guaranteed bonds should compare only very similar bonds, some benefitting from State guarantees and others not. At the same time meaningful results could only be inferred where a sufficient number of observations are pulled together. Therefore a certain number of working assumptions are necessary beforehand. Subject to this caveat, on the basis of information contained in its database of State guaranteed bonds and market information on senior unsecured bonds, the Commission compared the yields of State guaranteed bonds (to which the fee paid to the State would need to be added) and senior unsecured bonds by remaining maturities and issuers' rating categories. The figure below illustrates the result of this comparison<sup>43</sup>:

**Figure 10: Price difference between State guaranteed and senior unsecured bonds (bonds issued between Oct. 2008 and Dec. 2009, yields at 31/12/2009)**



Note: "AA-" includes also "AA" and "BBB" includes "BBB+", "BBB", "BBB-" and "BB+"  
 Source: Commission Services (database of guaranteed bonds), Bloomberg and own calculations

The graph shows that, by and large, for well rated issuers (AAA<sup>44</sup> and AA) and short-term maturity bonds (maturity below one year), it is generally less expensive for banks to raise funding on senior unsecured markets than through State guarantees, even without taking into account the cost of guarantees. For AAA-rated issuers, it is less expensive in all maturity ranges below three years to fund themselves on senior unsecured markets than through State guarantees. For all other rating categories and maturity ranges, the funding via senior unsecured markets is generally more expensive, with spreads widening with maturities and lower ratings<sup>45</sup>. The spread between guaranteed and senior unsecured funding ranks between 10 and 230 basis points according to rating categories and maturity ranges. Therefore, taking into consideration the fee that ranks between 70 and 115 basis points for most banks, the price differences are clearly reduced but they remain significant for banks with lower ratings and for longer maturities.

<sup>43</sup> All currencies have been pulled together under the assumption that the interest rates in the main currencies (EUR, USD and GBP) are very low and at very similar levels.

<sup>44</sup> The only AAA-rated issuer of State-guaranteed bonds in the database is the Société de Financement de l'Economie Française (SFEF) issuing bonds used to fund French beneficiary banks, which are themselves either unrated or rated between BBB and AA+.

<sup>45</sup> With the exception of 5-year bonds with A rating.