



EUROPEAN COMMISSION

Brussels, 24.3.2009  
C(2009) 2150 final

**Subject: State aid No N 111/2009 – United Kingdom  
Working Capital Guarantee Scheme**

Sir,

## **1. PROCEDURE**

(1) By letter of 25 February 2009, the UK authorities notified their intention to implement a guarantee scheme to support the provision of working capital loans to UK businesses ("WCS"). The Commission requested further information by letter dated 11 March 2009, which the UK submitted on 13 and 18 March 2009. Before the notification, the UK authorities submitted an informal letter on 23 January 2009 and met the Commission services on 30 January 2009.

## **2. DESCRIPTION**

### ***2.1. Aim of the scheme***

(2) According to the UK authorities, there is currently a severe credit crunch in the UK. The purpose of the Scheme is to encourage banks to provide new lending to businesses with an annual turnover of up to £500 million operating in the UK market. It will do this by offering banks a guarantee (of up to 50%) in respect of portfolios of working capital loans to sound, creditworthy UK companies with an annual turnover of up to £500 million. The guarantee reduces the risk weighted assets of the bank. By virtue of the Government guarantee, banks will therefore obtain capital relief and will be required to redeploy such saved capital to support further lending to UK companies on entirely commercial terms.

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- (3) The UK estimates the total UK working capital loan market for firms with a turnover below £500 million to be in the region of £70 billion
- (4) Under the Scheme, the Department of Business, Enterprise and Regulatory Reform ("BERR") will make available guarantees to participating banks of up to a total of £10 billion commencing in March 2009. Banks will offer (on a voluntary basis) portfolios of loans to BERR; if these portfolios meet the risk standards, BERR will guarantee up to a maximum of 50% of the risk in return for a fee. In total, the Scheme could, therefore, support £20 billion worth of working capital financing for companies operating in the UK market and provide capital relief sufficient to permit additional lending into the market roughly equivalent, on a risk adjusted basis, to the value of the BERR guarantee.
- (5) As and when short term working capital facilities guaranteed under the Scheme fall due for renewal, the bank can extend the facilities for a further 12 months subject to the associated risk on these loans continuing to meet the stipulated risk standards. Where the banks do not do so, alternative facilities may be substituted which do meet these standards. No such extensions or substitutions will be allowed after 31 March 2010 and the final expiry date for BERR liability under the Scheme will be 31 March 2011. As it is not possible to anticipate the timetable for renewals and substitutions, the trajectory of BERR's exposure under the Scheme cannot be anticipated at this stage.
- (6) The guarantee is provided at *pari passu* meaning that if a default occurs on a guaranteed loan, the defaulted debt is shared between the BERR and the bank concerned. BERR will share in the recoveries in proportion to its share of the company's overall defaulted debt owed to that bank.
- (7) The UK Government is making these guarantees available to the participating banks under the condition that the capital which is thereby released will be redeployed to support new loans to business. These new loans will be on strictly commercial terms and not guaranteed by the UK Government. The beneficiaries of these new loans must be firms active in the UK market with an annual turnover of up to £500 million.
- (8) The banks' performance in redeploying the 'released' capital to support additional lending will be subject to monitoring and control arrangements. A participating bank will be obliged to increase its lending compared to a base scenario and has to submit reports containing information on the implementation of its lending commitment on a monthly and annual basis.
- (9) The UK authorities commit themselves to report on the operation of the Scheme every six months.

## **2.2. Pricing and risk management**

- (10) The UK authorities indicate that the guarantees will be priced at a level designed to deliver a strong confidence of break even and depending on the risk profile of the loans to be guaranteed. This risk profile will be measured in terms of the weighted average probability of default ('PD') and the weighted average Loss Given Default ('LGD') of the guaranteed portfolio by reference to the banks' own risk control systems. There will also be upper limits in respect of the PD and LGD for any individual loan within the portfolio. For this reason, BERR reviews the participating banks' risk systems and processes. This includes a review of

the stress tests to which all the major UK banks are currently subject, among other things, at the direction of the Financial Services Authority (FSA).

- (11) As regards the upper limits, at the portfolio level the weighted average (annual) PD cannot exceed 2% and the weighted average LGD cannot exceed 50%. For each individual facility which is part of the portfolio, the annual PD cannot exceed 3% and the LGD cannot exceed 60%.
- (12) The UK authorities indicate that the fee payable by the banks in return for the BERR guarantee will be risk-based and set to deliver a high degree of confidence of break-even relative to the agreed risk parameters. The fee charged to a participating bank will cover the estimated 'expected loss' of the loan portfolio guaranteed by BERR set by reference to the PD and LGD attributed to that portfolio, plus:
  - i. a component to cover the risk of 'unexpected loss' up to the break-even confidence, and
  - ii. a further component to cover the cost of setting up and administering the scheme.
- (13) The UK authorities explained that, following consultation of the FSA, they have made an upwards adjustment to the PDs calculated by the banks of the same magnitude of the adjustments required by the FSA for Risk Weighted Assets. The UK authorities then decided to apply an even harsher adjustment, effectively increasing each PD by a multiple of 1.5 times. On the basis of the resulting PDs, the fees are calculated.

### ***2.3. Mitigation factors***

- (14) A number of controls are being put in place to mitigate risk including:
  - i. only good quality assets are being guaranteed,
  - ii. the fees payable by the banks for BERR's guarantee under the WCS will be set at a level sufficient to absorb some deterioration in the expected loss implied by the agreed risk parameters,
  - iii. There will be a cap of £25 million in respect of BERR's exposure to any one company or group.
  - iv. Banks will not be allowed to submit the working capital facilities of a company accessing BERR's other support schemes. This stipulation will remove any risk that a bank could benefit from the two schemes on a specific credit facility. This same principle will be extended likewise to such further schemes as the UK Government may introduce during the current recession.

### ***2.4. Default of loans***

- (15) In the event that a default occurs on a guaranteed loan and the bank calls the BERR guarantee on that loan, BERR will share in any subsequent recoveries from the defaulting debtor in proportion to its share of the company's overall defaulted debt owed to that bank.

### **2.5. Other conditions attached to the measure**

- (16) As regards the eligibility of a loan portfolio for a State guarantee, the UK authorities excluded loans to financial services companies, on the grounds of expected risk and have applied sector-based limits on all other sectors to ensure diversification of guaranteed risk.
- (17) In terms of new lending requirements, there are no restrictions. The only requirement is that new lending should be to UK businesses that are SMEs or mid-sized companies which are firms with a turnover of up to £500 million. UK businesses are defined as businesses engaged in economic activity in the UK (including subsidiaries and branches of overseas entities conducting such economic activities).
- (18) Finally the UK authorities committed not to provide to any one banking group more than £3.33 billion of guarantees (i.e. no more than one third of the £10 billion total amount of the guarantees offered under the scheme).

## **3. COMMENTS OF THE UK AUTHORITIES**

### **3.1. Existence of aid**

- (19) The working capital facilities subject to the 50% guarantee must, in all cases, have already been given by the banks and are not conditional on that guarantee. The UK authorities therefore believe that there is no likelihood of advantage within the meaning of Article 87(1) of the EC Treaty to the companies having received loan capital facilities.
- (20) As to the companies receiving the new lending as a result of the capital relief procured through the guarantees, the UK authorities stress that no State guarantee is being provided in relation to these exposures and it follows that all such companies will only receive finance if the banks consider them to be an acceptable commercial proposition. The UK authorities therefore believe that there is no likelihood of advantage within the meaning of Article 87(1) of the EC Treaty to the companies receiving the new lending.
- (21) As to the participating banks, the UK authorities considers that there may be grounds to argue by analogy with the *Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees*<sup>1</sup> ("Guarantees Notice") that there is no aid to the participating banks given that a risk-based premium will be paid for the guarantee. In line with the Guarantees Notice, losses under the WCS will be sustained proportionately between the lenders and the UK government as described above. In addition, there will be a risk reflective premium paid by the lenders for the guarantee. Whilst the UK authorities accept that it may be difficult to find a true market price, the risk analysis carried out by the experts hired by them (KPMG has been assisting with the development of the scheme) and the resulting premium rate for these guarantees is in line with the spirit of section 3 of the Notice.

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<sup>1</sup> OJ C 155, 20.6.2008, p. 10.

### 3.2. *Compatibility of aid*

- (22) If the Commission concludes that the guarantees constitute aid to the participating banks, the UK authorities contend that the aid can be approved under Article 87(3)(b) of the EC Treaty as “aid ... to remedy a serious disturbance in the economy of a Member State” (namely the United Kingdom). Indeed, it complies with the terms of the Communication from the Commission of 13 October 2008 on *the Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*<sup>2</sup> (“the Banking Communication”) and/or with the Communication of 5 December 2008 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*<sup>3</sup> (“the Recapitalisation Communication”).
- (23) The UK authorities underline that the measure is well-targeted to combat the intensification of the credit crunch, which is a serious disturbance in the UK economy. The aid is proportionate and limited to the minimum to achieve the required objective. Finally, there are no unnecessary distortions of competition and there is no discrimination in terms offered. Any negative spillovers to the markets of other Member States have been minimised.

## 4. ASSESSMENT

### 4.1. *Presence of aid pursuant Article 87 (1) EC*

#### 4.1.1. **Aid to the companies receiving the working capital facilities which are guaranteed**

- (24) The Commission explained in the Guarantees Notice how it will assess whether State interventions in the form of guarantees constitute aid or not.
- (25) Section 2.2 of the Guarantees Notice indicates that “*Typically, with the benefit of the State guarantee, the borrower can obtain lower rates and/or offer less security. In some cases, the borrower would not, without a State guarantee, find a financial institution prepared to lend on any terms.*” The Commission observes that the UK government will grant guarantees on existing loans without the terms of these loans being adjusted. Consequently, when the State guarantee is granted, the borrower will not benefit from any of the advantages described in the Guarantee Notice, i.e. no lower rates, no diminution of the securities offered to the bank and no receipt of a loan it would not have obtained on the market. It is also recalled that it is the bank which will apply for a guarantee and which will decide which existing loans to put in the portfolio. The bank has no interest to offer lower interest rates to the firms of which the loans are guaranteed, since it is the bank which has discretionarily decided whether or not to include that loan in the portfolio. In other words, the bank has no interest to transfer an advantage to the borrower.
- (26) As indicated above, as and when short-term working capital facilities guaranteed under the Scheme fall due for renewal, the bank can extend the facilities for a further 12 months. It

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<sup>2</sup> OJ C 270, 25.10.2008, p. 8.

<sup>3</sup> OJ C 10, 15.1.2009, p. 2.

therefore has to be verified whether there could be aid granted at the moment of the 12 months extension.

- (27) In this respect, the Commission first observes that the extension is subject to the associated risk on these loans continuing to meet the stipulated risk standards. If the loans do not meet these risk standards, their extension cannot be covered by a guarantee under the Scheme. It is thus ensured that only good quality assets will continue to be guaranteed. It is also recalled that the guarantee fee is set according to the risk of the guaranteed loans, such that if the risks have increased, the fee will follow. In addition, the bank will continue to support at least 50% of the risks of the loan. Finally, the Commission observes that the bank will have the choice either to prolong the maturing working capital facility or to substitute it by another one. The Commission recalls, as explained above, the bank will have no incentive to transfer any advantage to the borrowers, i.e. it will have no incentive to offer a 12 month extension at an interest rate below market price.
- (28) The Commission concludes that there is no advantage - and therefore no aid - to the borrowers of which the working capital facility will be guaranteed by the State.

#### **4.1.2. Aid to the companies receiving the new lending as a result of the capital relief procured through the guarantees**

- (29) The Commission observes that the loans which will be granted by the banks as a result of the capital relief procured through the State guarantees will not be guaranteed. It follows that all such companies will only receive finance if the banks consider them to be an acceptable commercial proposition. The banks will have no interest in charging below market price since they will entirely support the exposure related to these loans. In other words, the state guarantees will result in an increase of the total amount of loans offered to UK firms but these loans will be offered on entirely commercial terms. In particular, it would not be possible to identify the firms which have received a loan as a consequence of the State guarantees related capital relief and those which would have received a loan from a bank even in the absence of State guarantees<sup>4</sup>.
- (30) It is recalled that the State does not require the new lending to be provided to a specific sector or to specific firms.
- (31) In the light of the above considerations and given the limited size of the measure relative to the importance of the funding gap and relative to total lending to UK firms with a turnover below £ 500 million, the Commission considers that there is no advantage – and therefore no aid - to the companies receiving the new lending as a result of the capital relief procured through the guarantees.

#### **4.1.3. Aid to the participating banks**

- (32) The Guarantees Notice indicates that *"if a State guarantee is given ex post in respect of a loan or other financial obligation already entered into without the terms of this loan or financial obligation being adjusted (...) then there may also be aid to the lender, in so far as*

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<sup>4</sup> The increase in total volume of lending can be observed and monitored.

*the security of the loans is increased.*" Since in the notified scheme, the guarantee is given ex post, the possibility of aid to the lenders should be investigated.

- (33) Section 3.4. "*Guarantee schemes*" of the Guarantees Notice defines the condition under which the presence of aid in guarantee schemes can be ruled out.
- (34) The fourth condition is that "*the terms of the scheme are based on a realistic assessment of the risk so that the premiums paid by the beneficiaries make it, in all probability, self-financing.*"
- (35) Section 2.2 "Pricing and risk management" of the present decision has described how the risk of the loan portfolio will be measured and how the fee will be determined. The Commission observes that the risk of each loan (PD and LGD) will be based on the risk assessment performed by the lending bank. In prior decisions on guarantee schemes, the Commission already accepted the use of the risk assessment made by the lending bank<sup>5</sup>. The Commission notes in the case at stake that the UK authorities will validate with the support of a consultant each participating bank's risk measurement tools and processes for risk assessment.
- (36) As regards the determination of the guarantee premium, the UK authorities indicate that it will be based on the expected losses calculated on the basis of the PD and LGD of the guaranteed portfolio, plus a component to cover the risk of "unexpected loss".
- (37) In normal market conditions, the notified method for determining the guarantee premium seems to make the scheme, in all probability, self-financing, as requested by the Guarantees Notice. However, the Commission observes that the two-year scheme will be implemented at a time of an exceptionally deep financial and economic crisis<sup>6</sup>, which triggers company failures and associated losses. In addition, it has proven very difficult to foresee the evolution of the economy during the recent past. The depth of the recession and notably its sharp acceleration in the last quarter of 2008 has surprised most of the forecasters.
- (38) The UK intends to include in the guarantee premium a component to cover the risk of "unexpected loss". The UK authorities indicate that they have a high degree of confidence that the scheme will break even but they consider that other outcomes are possible as well but that these outcomes have a much lower likelihood. On the basis of the information provided, the Commission notes that in such a volatile recessionary environment, it is not possible to conclude that *in all probability* the premiums paid by the banks under the Scheme at stake will make the notified scheme self-financing.
- (39) The Commission concludes that the guarantee scheme, since it can not be ascertained that the premiums charged will make it *in all probability* self-financing, can not be deemed to be market conform and provides an advantage to the participating banks.
- (40) In order to determine whether the measure constitutes an aid, it needs to be verified whether the other conditions laid down in Article 87 (1) EC Treaty are fulfilled. The

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<sup>5</sup> See paragraph 9 of the Commission decision on the German method to establish the aid element in guarantees (State aid case N 197/2007 published in OJ C 248, 23.10.2007, p.3)

<sup>6</sup> According to the forecasts released by the Commission on 19 January 2009, UK GDP is expected to contract by 2.8% in 2009 and to grow by 0.2% in 2010.

Commission observes that the measure is financed by State resources since the State will support the risk associated with the guarantees. The advantage is selective since limited to the participating banks. By favouring these banks, the measures distort competition. Several banks operating on the UK market are subsidiaries of foreign banks and most of the potential participating banks have international activities. Consequently, the measure affects trade between Member States.

- (41) The Commission concludes that the measure contains aid in favour of the participating banks.

## **4.2. *Compatibility of the aid***

### **4.2.1. *Applicability of Article 87(3) (b)***

- (42) The intensification of the credit crunch in the wholesale lending market that has led to the partial nationalisation of some UK banks and the provision of emergency liquidity has also led to widespread credit tightening across all sectors of the economy. The systemic difficulties in the UK banking sector, characterised by deleveraging and de-risking, has led to a lower amount of finance being supplied by banks and at much higher cost. The effects of the credit shock are becoming more acute as increasingly risk-averse banks fear the recession will be prolonged and deep-seated. The deterioration in credit conditions has been amplified by retrenchment by credit insurers evidenced by the cancellation of export/domestic credit limits and a reduction of cover.
- (43) Trading conditions for firms have also deteriorated exemplified by rising overdue payments from buyers and with key buyers demanding longer repayment periods (120 days as opposed to 30/60days in normal trading conditions). Such conditions imply increased demand for working capital and other forms of finance.
- (44) The past year has witnessed a reduction in credit supply manifested by a withdrawal of bank lines of credit, reduction in overdraft facilities and other credit support. Further compounding the problem of credit availability in the UK has been the reduction in lending from foreign banks (especially Irish and Icelandic), the reduction in lending from participants who have now exited the market and reduced activities in corporate bond markets and securitisation markets. All these effects exert significant demand pressure on the main UK lending banks, at a time when their commercial rationale is to degear their balance sheets.
- (45) Foreign banks and other smaller UK lenders operating in the UK market accounted for £152 billion of business lending (out of a total £497bn) at the end of 2008. This figure was reduced by £7 billion during 2008 and BERR estimates that it will reduce by a further £25 billion during 2009. Taking account also of the contraction of the corporate bond market and securitisations, BERR concludes that there is a corporate funding gap in the UK of some £42 billion.
- (46) The Commission notes that the amount of the guarantees provided will not necessarily translate 1 to 1 into new lending as the regulatory capital required for a loan depends on the individual risk of the loans provided.
- (47) The Commission acknowledges that the current global crisis in the financial sector – banks which were active on the UK market have been severely hit – has led to a credit crunch

with constitutes a serious disturbance of the UK economy. In these exceptional circumstances, the notified measure, since it intends to contribute to solving the serious disturbance, can be assessed under Article 87 (3) (b).

#### 4.2.2. Compatibility on the basis of Article 87 (3) (b)

- (48) In order to deal with measures taken in the context of the current global financial and economic crisis, the Commission has until now adopted four Communications. Three concern aid to the banking sector: the Banking Communication, the Recapitalisation Communication, the Communication from the Commission on the *Treatment of Impaired Assets in the Community Banking Sector*<sup>7</sup> ("the Impaired Assets Communication"). One concerns aid to the real economy, namely the Communication from the Commission on the *Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis*<sup>8</sup> ("the Temporary Framework").
- (49) The Temporary Framework authorises a series of aid measures to support access to finance in the current financial and economic crisis. It includes a part on aid in the form of state guarantees. However, this concerns new guarantees at reduced rate for new financing provided to firms, allowing therefore the firms concerned to finance themselves at a lower cost. The measure notified by the UK consist in State guarantees on *existing* loans and, as shown earlier in this decision, it has neither the aim nor the effect of allowing firms to finance themselves at lower costs. The measure contains no aid to the borrowers but aid to the banks. In addition, there is no provision in the notified scheme limiting the guaranteed amount to the labour costs of the borrowers.
- (50) Although the objective of the scheme is similar to the objective of the Temporary Framework, it can therefore not be assessed under the Temporary Framework. Nevertheless, the Commission notes that the scheme does not contradict the Temporary Framework. The Commission therefore comes to the conclusion that the Scheme has to be assessed under one of the Commission communications on aid to the financial institutions.
- (51) The Impaired Assets Communication explains how the Commission will assess State guarantees on (and State purchase of) certain assets of banks. The notified measure consists in State guarantees on the certain assets of banks. However, the Impaired Assets Communication concerns bank assets which are impaired and of which the value is very volatile, due to their riskiness, their long duration or their complexity (which leads to uncertainty regarding the value of the instrument). The volatility of their value is a destabilizing factor for the banks since it means they could suffer additional large losses endangering their solvability and viability. The effect of guaranteeing or purchasing these assets is to end this uncertainty and "*therefore help to revive confidence in the sector*"<sup>9</sup>.

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<sup>7</sup> Adopted on 25 February 2009, not yet published.

<sup>8</sup> OJ C 16, 22.1.2009, p.1.

<sup>9</sup> First sentence of paragraph (7) of the Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, adopted on 25.02.2009.

- (52) The nature of the assets covered by the notified scheme and its effect are different. The assets covered by the scheme are short term, simple, originated by the bank itself<sup>10</sup>, and classical/not innovative<sup>11</sup>, such that the volatility of their value and of potential losses is limited and therefore does not constitute a destabilizing factor for the bank. The purpose and effect of the measure is therefore not to restore confidence of the investors in the participating banks.
- (53) Only assets which are not impaired at the moment of being guaranteed are eligible under the scheme. There are limitations as to the maximum probability of default of each individual loan<sup>12</sup>, such that it can be concluded that borrowers in difficulty are not eligible for a guarantee. The UK authorities will review risk-assessment methods used by banks before including the bank to the scheme. .
- (54) The Commission also considers that the Scheme provides for safeguards against guaranteed loans becoming impaired assets during the time period that they are covered by the guarantee. Only short-term loans will be covered (renewals maximum for 12 months), which will enable frequent re-assessment of the risk of the loan and eligibility of such an asset under the Scheme. Assets must remain eligible (i.e. comply with the risk standards) at the moment of renewals. The scheme runs for 2 years and thus will probably coincide with the recession.
- (55) Based on the foregoing, the Commission considers that the Impaired Assets Communication is not applicable.
- (56) As regards the application of the Recapitalisation Communication, the Commission notes that no capital is provided to the participating banks under the Scheme. It is not the objective of the measure either to provide public funds to strengthen the capital base of the banks. Contrary to a recapitalisation, the State does not run a risk of failure of the bank but a risk of default of specific assets. The Commission therefore considers that the Recapitalisation Communication is not applicable.
- (57) Nevertheless, as explained above, the guarantees strengthen the regulatory capital of the participating banks. Through the provision of the guarantees, the banks will find less of their capital tied up on existing loans and they will be able to use the relieved capital for further lending. The measure therefore has, in its effect, an element of recapitalisation. The Recapitalisation Communication lays down a minimum remuneration for recapitalisation measures. In order to limit distortions of competition and to ensure the proportionality of the aid, the Commission will therefore assess below whether the Scheme allows the participating banks to free up capital at a price below the one set in the Recapitalisation Communication.
- (58) The Banking Communication contains detailed provisions regarding State guarantees on the debt instruments issued by the banks (i.e. the State guarantees on bank liabilities). The

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<sup>10</sup> Since the loans were granted by the participating banks, they therefore directly knows the borrowers and its characteristics. It is a fundamental difference with structured credits, where the investor has not granted the underlying loans, has therefore no direct contact with the borrowers, and has to rely only on aggregated data provided by the issuer.

<sup>11</sup> In other words, for these instruments, there exists long historical data including periods of recession regarding their default rate and their rate of losses given default.

<sup>12</sup> Calculated by the bank risk measurement tools at the time of the application for a State guarantee.

measure at stake concerns however guarantees on bank assets, for which no detailed guidance is provided for by the Banking Communication.

(59) The Banking Communication does acknowledge that Article 87(3)(b) EC Treaty may, in the present circumstances, be available as a legal basis for aid measure undertaken to address the current systemic crisis. It lays down conditions which have to be complied with by all the aid measures. Paragraph 15 provides that "*all general support measures have to be:*

- *well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,*
- *proportionate to the challenge faced, not going beyond what is required to attain this effect, and*
- *designed in such a way as to minimize negative spill-over effects on competitors, other sectors and other Member States."*

(60) The Commission will therefore assess the compliance of the notified measure with these principles.

*Well-targeted*

(61) While assessing the gap in UK corporate lending is difficult, relying on numerous assumptions for expected loan demand and the possible responses of capital markets, BERR has undertaken analysis of the potential shortfall in corporate lending and concluded that a figure of up to £42bn can be supported.

(62) The provision of a State guarantee reduces significantly the regulatory capital which banks are required to hold in respect of the part of the facilities guaranteed by BERR. Banks will have to redeploy such saved capital to support further lending to UK companies on entirely commercial terms. Participating banks will enter into agreements with the State defining the increase of volume of lending they have to achieve. As such the BERR guarantee affords capital relief for an amount which would support additional lending roughly equivalent, on a risk-adjusted basis, to the £10bn value of the guarantees under the Scheme (assuming full utilisation). The notified measure is thus targeted at filling a material portion of the estimated £42 billion corporate funding gap in the UK. The aid is therefore well targeted.

*Proportionate to the challenge faced*

(63) As to the duration of the measure, the Commission agrees with the UK that the identified funding gap is temporary and one which will be made good in due course by market forces as the world economy moves out of recession. Meanwhile, and as a matter of urgency, the notified scheme is looking to address that shortfall by providing support into the market with a view to increasing the availability of corporate funding. Any State liabilities under the notified scheme will cease on 31 March 2011. The Commission concludes that the short duration of the aid is proportionate to the challenge faced and does not last longer than what is necessary.

(64) As to the level of the fee, it has been explained earlier that it will be based on risk pricing principles. The pricing formula aims at encouraging take-up of the Scheme while ensuring a high confidence of break-even. Although other financial outturns are possible, with a sizeable

surplus or significant losses depending on how the risks in the portfolio perform during the life of the scheme, the negative outcome has statistically a much lower likelihood. Based on the methodology developed by the UK authorities, it has been confirmed that the probability of default which is used to determine the fee not only reflects the assumptions used by the FSA when setting the capital requirements of UK banks, but also includes an additional upward adjustment. This harsher adjustment translates itself into an add-on fee that the Commission considers equivalent to a remuneration of the capital. According to the simulations made, the Commission is satisfied that the Scheme does not allow banks to obtain capital at a price below the one set in the Recapitalisation Communication. The estimated capital relief could equate to a range of £ 56 - 70 million per £ 1 billion (i.e. max. 7%) of State guarantee. Therefore, taking into account a maximum capital relief of 7% of the amount guaranteed and considering that a remuneration of the capital relief of at least 5% is required to be in line with the Recapitalisation Communication<sup>13</sup> (the 5% is exclusively the risk premium, since there is no funding provided by the State), this translates into a minimum add-on of 0.35%. In all the simulations available, the increase of the fee due to the harsher adjustment of the PD of the guaranteed loans largely exceeds this level. Hence, the Commission is satisfied that a sufficient cost is charged for the relieved capital.

- (65) The Commission notes also that build-in safeguards exist limiting the possibility of unnecessary aid to the participating banks: First, the overall budget is limited and subject to a cap of the portfolio guaranteed per participating bank<sup>14</sup>; Secondly, participating banks will have on a monthly basis to report to the State on the correct redeployment of the freed capital. The UK authorities will report to the Commission every six months.
- (66) The Commission concludes that the measures is proportionate to the challenge faced and does not go beyond what is required to attain this effect.

*Minimisation of negative spill-over effects on competitors and other Member States*

- (67) First, the Commission observes that the strictly limited duration of the scheme, the limited capital relief it provides, and the level of the fees charged by the State are factors strongly limiting potential negative spill-overs on competitors and other Member States. The risk reflective level of the fee notably entails that banks submitting loans portfolios with a higher risk profile will have to pay a higher premium.
- (68) Second, as to the risk of discrimination between banks, the Commission observes that the Scheme is open to all major banks which are established in the UK with exposure to the business sector in the UK. The UK authorities have also signalled their readiness to consider propositions from small banks. Even if smaller banks might be excluded because they might not have a substantial portfolio of eligible loans, the Commission observes that the Scheme is a short term scheme – all state liabilities expire in two years – which is implemented in the context of an exceptional banking crisis which is causing a serious disturbance to the UK economy. The detailed review process of the internal risk management tools of each participating bank as well as that underlying the determination by BERR of a risk-based price

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<sup>13</sup> As regards pricing, the Recapitalisation Communication makes reference to the Recommendations of the Governing Council of the European Central Bank (ECB) of 20 November 2008. This recommendation sets the required risk premium for ordinary capital at 5%.

<sup>14</sup> See paragraph (18) above.

is resource intensive and, for this objective reason, the Scheme is targeted primarily at the major banks which are established in the UK and with lending activity in the UK business corporate sector in order to deliver the maximum impact in the shortest possible time. In these exceptional circumstances and considering that the measure is short lived and limited in size, the Commission finds that potential discrimination does not exceed what is necessary to quickly achieve the objective of the scheme and can be authorised.

- (69) Third, as to the risk of distortion between Member States, the Commission recalls that the capital relief must result in extra lending to companies operating in the UK. In addition, there is little risk that the Scheme will inhibit the expansion of banks from other EU Member States into the UK corporate lending market. Evidence shows there is a withdrawal of foreign banks which is the most significant single factor in creating the funding gap which the WCS is looking to fill. However, given the limited size of the Scheme and the much larger size of the funding gap there is still commercial potential for foreign banks if they wish to come back to the UK market.
- (70) In view of the foregoing elements, the Commission concludes that the measure is designed in such a way as to minimize spill-over effects on competitors and other Member States.

#### **4.2.3. Conclusion on the compatibility on the basis of Article 87 (3) (b)**

- (71) The Commission concludes that the measure is compatible on the basis of Article 87(3) (b). As the foregoing reasoning demonstrates, this conclusion hinges on the assumption that the participating banks will entirely redeploy the capital relieved for new lending. The Commission therefore stresses the importance of the commitment of the UK authorities to strictly monitor that the new lending to the economy. If the monitoring reports, which the UK authorities committed to submit every six months, do not demonstrate that this new lending is happening, the Commission could therefore consider that the aid has been misused.
- (72) The Commission also recalls that in conformity with the principles of the community guidelines on state aid for rescuing and restructuring firms in difficulty<sup>15</sup>, if some of the participating banks have to submit a restructuring plan to the Commission because they benefited of other aid measures, the aid received under the present scheme will be taken into account when assessing the restructuring aid and the restructuring plan.

## **5. CONCLUSION**

The Commission has accordingly decided to consider the aid to be compatible with the EC Treaty.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the

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<sup>15</sup> OJ C 244 of 1.10.2004, p.2, See in particular paragraph 68.

Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: [http://ec.europa.eu/community\\_law/state\\_aids/index.htm](http://ec.europa.eu/community_law/state_aids/index.htm)

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

European Commission  
Directorate-General for Competition.  
State Aid Registry  
Rue de la Loi/Wetstraat, 200  
B-1049 Brussels  
Fax No: +32-2-296 12 42

Yours faithfully,

For the Commission

Neelie KROES  
Member of the Commission