



State Aid and the financial crisis

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Summary



Background

- I. The Guidance Paper of 13 October 2008
- II. The Recapitalisation Paper of 5 December 2008
- III. The Impaired Assets Paper of 25 February 2009

Conclusion

Background



1) History of State aid control in the financial sector : Art. 87(3)(c) - the Rescue and Restructuring Guidelines

- **Bank in difficulty:** unable to stem losses (with own funds / through creditors or shareholders) which almost certainly leads to its exit in short or medium term
- **Rescue aid:** temporary (time for restructuring/liquidation plan - six months) and reversible (in principle loan or guarantee)
- **Restructuring aid:** restore long-term viability
 - restructuring plan appropriate to restore long-term viability
 - avoidance of undue distortions of competition: compensatory measures (divestment of assets, capacity reduction)
 - Aid limited to the minimum: own contribution from beneficiary

Background



2) Article 87(3)(b)

a) Traditional approach

- Restrictive wording: “remedy a serious disturbance of the economy” (as a whole or significant part)
- Restrictive practice: only 2 decisions concerning Greek economy in the Eighties; never for banks
- Crisis of an individual bank ≠ banking crisis

Background



- b) The changed thinking following the current financial crisis
- Seriousness and scale of the crisis
 - also affecting fundamentally sound banks
 - also affecting the stability of the financial system and jeopardising the entire functioning of the financial markets
 - Confidence problem
 - Possible impact on the overall economy
 - Context and measures are not / only partially covered by Article 87(3)(c) and R&R guidelines

Background



- Need to allow different measures / derogations from R&R guidelines
 - Aid schemes
 - Structural emergency interventions
 - Protection of rights of third parties such as creditors
 - Rescue measures potentially going beyond 6 months
 - Measures for banks that are not technically in difficulties
- At the same time: ensure coherence with R&R guidelines (no circumvention via 87(3)(b) in classic rescue/restructuring cases)
- The principle use of Article 87(3)(b) remains exceptional and limited in scope and time

I. The Guidance Paper: overview



- 1) General Principles
- 2) Measures covered:
 - a) Guarantees
 - b) Recapitalisation
 - c) Winding-up
 - d) Liquidity assistance
- 3) Faster procedures

I. The Guidance Paper: 1) Principles



1) General Principles

- Need for review (6 months)
- Distinction: fundamentally sound banks (exogenous liquidity problems due to extreme situation in the financial markets) / banks with endogenous problems (inefficiency, excessive risk taking)
- This distinction is reflected in the type of restructuring that is required
- Measures need to be well-targeted, proportionate and designed in such a way as to minimise negative spill-over effects
- Where applicable, principles of the R&R guidelines *mutatis mutandis*



I. The Guidance Paper: a) Guarantees

2) Measures covered

a) Guarantees

- Eligibility: objective criteria, non-discriminatory (all institutions incorporated in MS concerned, including subsidiaries)
- Material scope:
 - retail deposits (avoid bank run)
 - also wholesale deposits, short and medium-term debt instruments
 - Further types of debt require closer scrutiny (eg mortgage bonds – Swedish scheme)
 - In principle no subordinated debt (tier 2 capital), unless additional safeguards (eg maintain solvency ratio - Irish scheme)

a) Guarantees



- Temporal scope:
 - Review after 6 months
 - Scheme can be authorised for 2 years, with possibility to extend
 - Practice:
 - window to issue the guaranteed debt: up to 2 years if guarantee covers debt with maturity date not later than the expiry of the issuance period under the scheme (Irish scheme);
 - for debts with a longer maturity period (3-5 years), the issuance period should be shorter: 6 months (UK scheme), or the scheme should be renotified after 6/8 months (German, Swedish, Dutch scheme). Otherwise additional safeguards are needed (PT scheme).
 - Most schemes only cover new liabilities (UK, DE, NL), others also cover existing liabilities (Ireland, DK)

a) Guarantees



- Private sector contribution:
 - Remuneration of the guarantee by the beneficiary or the sector
 - Benchmark: ECB Guidance of 20 Oct :
 - maturities of more than 1 year: 50 basis points + CDS spread
 - maturities up to 1 year: flat fee of 50 basis points
 - If guarantee is activated, notification of restructuring plan within 6 months
 - Better fortune clause to complement or temporarily substitute the remuneration

a) Guarantees



- Avoid undue distortions of competition: behavioural constraints
 - Restrictions on commercial conduct (eg advertising with guarantee)
 - Prohibition of conduct irreconcilable with purpose of the guarantee (eg issuance of new stock options for management – DK, Sweden)
 - Limitations to expansion ? (revised in Recapitalisation Paper because of the objective to ensure lending to the real economy)

b) Recapitalisation



- Revised by more detailed Recapitalisation paper December 2008

c) Controlled winding-up



- Either as second step after unsuccessful rescue or in one single action
- Can be part of guarantee scheme: liquidation if guarantee is activated
- Same principles as for guarantee schemes, *mutatis mutandis*
- Specific considerations
 - Need to minimise moral hazard: exclude shareholders and possibly certain types of creditors (eg Roskilde)
 - Limit liquidation phase to period strictly necessary for the orderly winding-up (eg Roskilde). As long as the beneficiary is still operating as a bank, no new activities and banking licence should be withdrawn asap.
 - If bank or parts of it are sold, no aid should go to the buyers (eg Roskilde): sales process should be open and non-discriminatory; the sale should take place on market terms and the bank/government should maximise the sales price

d) Other liquidity assistance



- General measures open to all comparable market players (eg lending to the whole market on equal terms; standing facilities by Central Bank) are not State aid
- Individual ELA is not State aid if (see Northern Rock):
 - Beneficiary is solvent and the assistance is not part of a larger package
 - The facility is fully secured by collateral to which haircuts are applied
 - Penal interest rate
 - Measure is taken at the Central Bank s own initiative and not counter-guaranteed by the State
- A liquidity assistance scheme that constitutes State aid can be found compatible provided: 6 monthly review

I. The Guidance Paper: 3) Procedure



3) Rapid treatment

- Rapid procedure, allowing decision within 24 hours and also during weekends
- Shorter internal consultation procedures
- If needed, a language waiver might help to accelerate the decision

II. The recapitalisation paper



1) Why a new paper ?

- Need for more detailed guidance
- Recapitalisation not primarily to rescue a bank but broader objectives:
 - Restore financial stability and confidence (inter-bank lending; cushion to absorb losses in times of recession; higher capital ratios required by the market)
 - Ensure continued lending to the real economy
 - Rescue of individual bank to avoid systemic effects

II. The recapitalisation paper



2) Competition concerns

- Undue competitive advantage for bank concerned, level-playing field (fair competition between MS)
- Undue competitive advantage for distressed banks, moral hazard (fair competition between banks)
- Undue disadvantage for banks not using public funding (return to normal market functioning)

Need to balance these concerns against the recap objectives: recap must be proportionate, temporary and provide exit incentives.

Importance of risk profile: fundamentally sound / distressed

II. The recapitalisation paper



3) Principles for different types of recapitalisation

1. Recapitalisation at current market rates: no problem if significant private participation (30%) on equal terms
2. Recapitalisation of fundamentally sound banks
 - Remuneration should reflect risk profile, characteristics of the instrument, built-in exit incentives (eg step-up, restrictive dividend policy), appropriate risk-free rate of interest
 - Can be below market level, but total expected return should not be too distant from current market prices
 - ECB recommendation is appropriate method to determine entry level price (corridor between 7% return on preferred shares and 9,3 % on ordinary shares); other methods possible if higher result.
 - Need for review: report after 6 months

II. The recapitalisation paper



3. Rescue recapitalisations of other banks

- Remuneration should reflect higher risk profile
- Comprehensive restructuring plan (cf. R&R guidelines, including compensatory measures) or liquidation plan within six months
- Behavioural safeguards: eg. dividend ban at least during the restructuring period; limitation of management remuneration and bonuses; obligation to have appropriate solvency ratio

III. The impaired assets paper



1) Why a new paper ?

- MS envisage asset relief as a measure to safeguard financial stability and underpin bank lending
→ uncertainty about valuation and localisation of bad assets is key cause; asset relief is thus needed to restore confidence and avoid repeated recaps
- Need for more detailed guidance and Community approach (level-playing field)
- Ensure that asset relief also ensures in the long term return to viability of the banking sector (eg via restructuring) and sustainability of public finances (prevent repeated need for support, avoid over-indebtedness)

III. The impaired assets paper



2) Criteria:

1. Transparency and disclosure

- based on adequate valuation, certified by independent experts and validated by the supervisory authority

Disclosure leads to identification of the aid amount (difference between transfer value and market price) and losses (difference between book value and transfer value)

- full viability review in parallel with entry into the asset relief program

III. The impaired assets paper



2. Burden sharing State/shareholders/creditors

- Correct remuneration
- If identified losses lead to technical insolvency:
 - put into administration or winding up
 - for systemic banks: guarantee or asset relief for the period necessary to devise a plan for restructuring or winding up
- If burden sharing *ex ante* is not possible: *ex post*
eg clawback clauses; first loss for the bank; additional loss sharing
- The lower the contribution upfront, the higher the need for shareholder contribution later (eg conversion of State losses into shares or additional compensatory measures)

III. The impaired assets paper



3. Aligning incentives for banks to participate
 - Enrolment window of 6 months
 - Ensure that banks who need it participate, eg
 - mandatory participation;
 - warrants or rights for existing shareholders so that they may participate in future private capital-raising at preferential terms
 - **Need for behavioural constraints** (eg ensure credit to real economy; restrictions on dividend policy and caps on excessive remunerations)

III. The impaired assets paper



4. Eligibility of assets

- Balance between too broad and too narrow: not limited to toxic assets only in order to restore confidence
- Community approach to define categories of impaired assets ('baskets') see guidance in annex 3
 - prevent distortions between MS and limit incentives for cross-border banks for arbitrage among asset schemes
- Flexibility to allow also
 - assets affected by specific problems in a MS upon due justification
 - other assets without specific justification for 10-20% max of total assets
- Assets that entered the balance sheet after a specified cut-off date prior to announcement of the scheme (eg end 2008) are not eligible
- Wider eligibility requires more thorough restructuring and more remedies to avoid undue distortions of competition

III. The impaired assets paper



5. Valuation of assets and pricing

- Methodology, to be verified by Commission See annex 4
 - Current market value (can be very different from book value) eg 30
 - Transfer value: benchmark should be the 'real economic value' eg 50
 - Aid: 20
- Adequate remuneration; if transfer price is above real economic value (eg to avoid insolvency) there is a need for more restructuring and conditions such as better fortune clause

6. Management of assets subject to relief

- Ensure clear separation between bank and impaired assets, notably as to their management, staff and clientele

III. The impaired assets paper



7. Restructuring and return to viability

- Viability review should certify the actual and prospective capital adequacy of the bank after assessment of risk factors
- **Extent of necessary restructuring depends on:** criteria in recap paper; proportion of assets concerned; transfer price compared to market price; features of the asset relief; size of State exposure relative to the bank's risk-weighted assets; nature of the problems of the bank; soundness of business model and investment strategy; other guarantees or recap.
- **In-depth restructuring needed if**
 - Asset valuation leads to negative equity/technical insolvency
 - Bank already received State aid to cover or avoid losses or aid exceeds 2% of total risk weighted assets
- **Extent of compensatory measures** (eg downsizing, divestment, behavioural commitments) **depends on eg:** aid amount, volume and risk profile of assets, proportion of losses resulting from the asset, soundness, quality of risk management, solvency ratios in the absence of aid, impact of aid on the market

III. The impaired assets paper



3) Procedure

- Notification
- Approval for 6 months if commitment to present restructuring plan / viability review for each beneficiary within 3 months
- New decision after 6 months: reassessment in light of the adequacy of the restructuring and the remedial measures
- Report every 6 months on the functioning of the asset relief programmes and the development of the restructuring plans