CLEARY GOTTLIEB Alert Memo

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Commission Releases New Communication On Bank Restructuring In The Financial Crisis

On July 23, the European Commission released an important Communication on the assessment under State aid rules of restructuring measures and the return to viability of financial institutions in the current crisis (the Restructuring Communication).[1] This fourth communication is part of the Commission's effort to adapt State aid rules to support granted by the Member States to financial institutions with a view to safeguarding the stability of the sector, and restoring the normal functioning of wholesale credit markets and the supply of credit to the real economy.

Since October 2008, the Commission had adopted three earlier communications dealing with State aid to the banking industry on the basis of Article 87(3)(b) of the EC Treaty which provides that the Commission may allow State aid *"to remedy a serious disturbance in the economy of a Member State"*. These communications (the Banking Communication, the Recapitalization Communication and the Impaired Assets Communication)[2] provide guidance on the design and implementation of State aid in favor of banks in the financial crisis. Under these guidelines, the Commission will require from EU Member States a "viability" plan for fundamentally sound banks, or a more in-depth "restructuring" plan for banks in difficulties whenever State aid is granted to an individual financial institution on a lasting basis such as capital increase or toxic assets relief (with the exception of certain guarantees). This plan (i) should confirm the prospects for the relevant bank's long-term viability without further reliance on State support (see I. below); (ii) should be accompanied by adequate "burden sharing" *i.e.* contributions from the recipient of the aid or its private shareholders (see II. below); as well as (iii) measures to minimize distortions of competition (see III. below).

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1 *See* http://ec.europa.eu/competition/state_aid/legislation/restructuring_paper_en.pdf

2 *See* 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 2008 C 270/8 (the Banking Communication); Communication from the Commission - T*he recapitalization of financial intuitions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition,* OJ 2009 C10/2 (the Recapitalization Communication); Communication from the Commission on the *Treatment of Impaired assets in the Community Banking Sector*, OJ 2009, (the Impaired Assets Communication). *See* also Cleary Gottlieb alert memorandum of December 10, 2008 - *Commission guidance on State aid in the financial crisis*.

Although the Commission has already taken a few individual decisions on restructuring plans for banks[3], it is in the process of examining many more restructuring or viability plans within the next few months.[4] The Restructuring Communication is designed to provide guidance on the Commission's assessment. Although it applies the principles laid down in the existing Rescue and Restructuring Guidelines[5], the Restructuring Communication provides additional flexibility for restructuring measures taken in the current crisis. Given the exceptional character of the systemic crisis of 2008, this flexibility is however limited and applies only to restructuring aid notified to the Commission before December 31st, 2010.

I. RESTORING LONG TERM VIABILITY

The Restructuring Communication enumerates the main elements that a restructuring plan or a viability review[6] must include for the Commission to assess whether long term viability is ensured. The Communication also provides for an indicative model of a restructuring plan.

The restructuring plan or viability review should be comprehensive, detailed and should demonstrate either why the relevant bank is viable in the long-term for fundamentally sound banks or how it is proposing to restore its long-term viability - *i.e.* cover all its costs and provide an appropriate return on equity, taking into account its risk profile – at the earliest possible date without further State aid for banks in difficulties. The notification should include a comparison of all available options, in particular the break-up of the bank or its absorption by another bank. The distinction between fundamentally sound banks and banks in difficulties is not clear-cut. Thus, even for

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3 See in particular Commission Decision of 12 May, 2009, *West LB*, Case C48/2008, not yet published; Commission decision of 7 May 2009, *Commerzbank*, Case N244/2009, OJ 2009 C 147/4; Commission decision of 4 June, 2008, *Sachsen LB*, Case C9/2008, OJ 2009 L104/34; Commission Decision of 12 May 2009, *Fortis*, Case N/255/2009, not yet published; and Commission decision of 20 May 2009, *Dexia*, Case C9/2009, not yet published.

4 Based on public information, at least seventeen restructuring/viability plans must be submitted to the Commission, in particular for the following institutions: ING, Dexia, Lloyds, RBS, Allied Irish Bank, KBS, Ethias, Hypo Real Estate Holding, Bayern LB, Nord LB, IKB, Bank of Ireland, Anglo Irish Bank, JCS Parex Banka, Aegon, SNS Reaal, Banco Privado Portugués, Canergie Investment Bank, Bradford and Bingley.

5 Communication from the Commission – *Community guidelines on State aid for rescuing and restructuring firms in difficulty,* OJ 2004 C 244/2

6 Unlike other sections of the Communication which apply only to restructuring plans, the section dealing with the restoration of long-term viability applies both to banks in difficulty, which are under the obligation to submit a restructuring plan, and to fundamentally sound banks which are only required to demonstrate viability.

healthy banks, the viability plan could imply modifications to the business model of the bank.

The plan should include a thorough analysis of each business activity of the relevant bank, as well as a stress test that should be to the extent possible based on common parameters agreed to at the EU level (such as a methodology developed by the CEBS)[7].

The State aid received must either be redeemed over time, as anticipated at the time of the granting of the aid, or be remunerated based on market conditions.

Taking account of the exceptional circumstances, the Commission may allow some structural measures to be completed, and the return to viability to be achieved, within a longer time frame than is usually the case *i.e.* five years, instead of three under the 2004 Rescue and Restructuring Guidelines.

Viability can also be attained through the sale of the relevant bank as long as the requirements of viability, own contribution and limitations of distortions of competition are complied with. The sale process must be transparent, objective, unconditional and non-discriminatory. The Commission will verify whether such sale, in particular in case of a negative price, is carried out at arm's length *i.e.* does not involve any State aid to the buyer.

In case long-term viability cannot be restored, an orderly winding-up or auctioning off of the bank should be undertaken. Other options contemplated by the Commission are the acquisition of the "good" assets and liabilities of a bank in difficulties by a healthy bank or the creation of an autonomous "good bank" from a combination of the "good" assets and liabilities of an existing bank.

II. OWN CONTRIBUTION BY THE BENEFICIARY (BURDEN SHARING)

This section only applies to restructuring plans of banks in difficulties. The aid must be limited to the minimum necessary and the burden of the restructuring costs should be shared between the Member State and the private sector (including the beneficiary bank itself and its shareholders). However, in contrast with the previous rule under the 2004 Rescue and Restructuring Guidelines which provided that aid beneficiaries are expected to make a contribution of at least 50% of total restructuring

[7] The Committee of European Banking Supervisors (CEBS) gives advice to the Commission on banking policy issues and promotes cooperation and convergence of supervisory practices across the EU.

costs,[8] the Restructuring Communication no longer applies an *ex-ante* burden sharing formula. The Commission will therefore assess the contribution on a case-by-case basis.

The Communication however lays down certain rules regarding burden sharing:

- New investments or acquisition of shares in other firms cannot in principle be financed by State aid;

- Special emphasis is laid on sales of assets by the beneficiary bank. The Commission is likely to take favorably into account the fact that the bank sells assets on its home market rather than in other geographical areas;

- Discretionary offset of losses by the beneficiary bank in order to guarantee the payment of dividends and coupons on outstanding subordinated debts is in principle prohibited. A possible exception is the payment of coupons on newly issued hybrid capital instruments with greater seniority over existing subordinated debt; and

- Bank's purchase of own shares is generally prohibited during the restructuring phase.

III. LIMITING DISTORTIONS OF COMETITION AND ENSURING A COMPETITIVE BANKING SECTOR

This section only applies to the restructuring plans of banks in difficulties.

A. MAIN PRINCIPLES APPLIED

According to the Commission, restructuring aid to banks may create three types of distortions: (i) it may harm the position of fundamentally sound banks that did not receive any aid; (ii) since State aid is granted on a national basis, it may foster the relevant bank's retrenchment behind national borders and (iii) it may increase moral hazard.

To avoid these distortions, the Commission will require pro-competitive measures, the nature and scope of which will depend on two criteria: (i) the amount of the aid and degree of burden sharing (whether in absolute terms or in proportion of the bank's risk-weighted assets) and (ii) the characteristics of the market in which the beneficiary bank will continue to operate.

Importantly, the Communication also recognizes two additional important goals that might limit possible pro-competitive measures, namely: (i) preserving the Single

8 The threshold is lowered at 25% for small enterprises and at 40% for medium-sized enterprises.

Market (which may lead the Commission to not require certain cross-border divestitures in order to avoid a bank retrenching behind its national borders)[9] and (ii) allowing Member States to impose on beneficiary banks lending targets to the real economy. This means that caps on issuance of new loans which were imposed in the past by the Commission in restructuring cases may no longer be seen as appropriate.

B. TYPES OF MEASURES IMPOSED

A key component of restructuring plans and of negotiations with the Commission will be structural measures such as divestitures of subsidiaries/branches or portfolios of customers or business units. The Commission may impose a binding timetable of up to five years for such measures. Balance sheet reductions due to assets write-offs will however not be counted as structural measures. The Commission may also impose a limit on the bank's expansion in some business or geographical areas.

The Commission might also impose behavioral commitments, such as:

- A prohibition of State-funded acquisitions of competing business (exceptions may be granted in the context of a consolidation strengthening financial stability and competition);
- An imposition of a claw-back mechanism of the aid upon the recipient's return to viability;
- A prohibition to provide credit on non-commercial terms that cannot be matched by competitors;
- A prohibition on advertising the existence of State support as a competitive advantage; or
- A prohibition to propose higher than average interest rates on the market for retail deposits.

These restrictions should remain in place for a period between three years and the entire duration of the restructuring period (*i.e.* up to five years).

IV. MONITORING AND PROCEDURAL RULES

The Restructuring Communication sets up a monitoring mechanism based on the submission of detailed regular reports, the first of which has to be submitted no later than 6 months after the approval of the restructuring plan.

9 For instance, in *Commerzbank*, the Commission refrained from ordering the sale of certain assets of the German bank in Central Europe in order to maintain the integrity of the Single Market.

If Member States notify the Commission of an aid accompanied by a restructuring plan that meets all the conditions contained in the Communication, the Commission reserves the possibility to declare such aid compatible under article 87(3)(b) without opening a formal investigation procedure (*i.e.* within two months of the notification).

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Cleary Gottlieb was or is involved in many of the current financial events including Barclay's acquisition of Lehman's assets, BNP Paribas' acquisition of Fortis, Dexia's recapitalization, Bank of America's acquisition of Merrill Lynch, Morgan Stanley's reorganization and the Frannie Mae and Freddie Mac reorganization. Cleary Gottlieb is also advising the Federal Reserve Bank of New York on a number of matters.

For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at http://www.cgsh.com/financial_crisis_resource_center/eu_resources/.

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