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Alert Memo

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EU Bank State Aid Framework and Recapitalization

On December 1, 2011, the European Commission adopted a communication (the "Communication")[1] extending and updating the temporary State aid crisis rules for banks adopted in 2008-2009. On December 8, the President of the Economic and Financial Affairs Council ("ECOFIN") and the Chairperson of the European Banking Authority ("EBA") issued a joint statement (the "Joint Statement")[2] and the EBA published a formal recommendation (the "EBA Recommendation")[3] on EU bank recapitalisations.

This Alert Memo describes the Communication and discusses some of its implications in light of the Joint Statement and the EBA Recommendation, as well as the conclusions of the October 26, 2011, European Council and the parallel summit of the 17 Heads of State or Government of the Eurozone (the "Euro Summit").[4]

I. THE COMMUNICATION

The Communication extends into 2012 the temporary framework adopted in October 2008 to relax some of the State aid rules applied to banks under Article 107(3)(b) TFEU,[5]

1 Commission Communication of December 1, 2011, on the application of State aid rules to support measures in favor of banks in the context of the financial crisis from January 1, 2012. http://ec.europa.eu/competition/state_aid/legislation/en.pdf

2 http://pl2011.eu/sites/default/files/users/shared/spotkania_i_wydarzenia/201120122008-pl.pdf

3 http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20Recommendation%20FINAL.pdf

4 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf

5 Commission Communication of October 13, 2008 on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global crisis, OJ 2008 C 270/8 ("Banking Communication"); Commission Communication of December 8, 2008, on the Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition, OJ 2009 C 10/2 ("Recapitalisation Communication"); Commission Communication of February 25, 2009, on the Treatment of Impaired Assets in the Community Banking Sector, OJ 2009 C 72/1 ("Impaired Assets Communication"); Commission Communication of July 23, 2009, on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ 2009 C 195/9 ("Bank Restructuring Communication"); Commission communication of December 1, 2010, on the application, from January 1, 2011, of State aid rules to support measures in favor of banks in the context of the financial crisis, OJ 2009 329/7 ("Exit Communication").

with amendments as of January 1, 2012 to take into account the current sovereign debt crisis and developments in banks' risk profile since the start of the crisis. No fixed deadline is set for an end to the temporary framework, but the Commission will take steps towards more permanent rules under Article 107(3)(c) TFEU "as soon as market conditions permit."

A. CAPITAL INJECTIONS

The Communication clarifies the rules on pricing of capital injections in the form of shares bearing a variable remuneration (*i.e.*, ordinary shares), which the Commission expects will be more commonly used in the near future.

To give reasonable assurance of an adequate remuneration to the State, the issue price should be "at a sufficient discount to the share price (after adjustment for the 'dilution effect') immediately prior to the announcement of the capital injection". The size of the discount will depend in particular on the size of the capital injection in relation to the issuer's existing Core Tier 1 capital. The higher the capital shortage in relation to existing capital, the greater the risk to the State, and thus, the higher the discount must be. The size of the discount may also depend on whether the shares carry voting rights.

The Communication provides that hybrid instruments should contain an "alternative coupon satisfaction mechanism" allowing coupons that cannot be paid out in cash to be paid in the form of newly issued shares. This approach is consistent with proposals discussed by the Financial Stability Board and the Commission to encourage the use of "bail-in" features in bank debt instruments, such as contingent convertible bonds, commonly referred to as "cocos."

The Commission will continue to require a restructuring plan within at most six months of the authorization of rescue aid in the form of recapitalization or impaired asset measures.

B. GUARANTEES

The Communication introduces a new formula for the remuneration of State guarantees covering debt with a maturity of between one and five years (or seven years in the case of covered bonds) issued on or after January 1, 2012, and granted on a national basis. This formula, which should overall be more favorable for banks, consists of a basic fee of 40 basis points and an additional risk-based fee equal to:

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

The new formula reflects the fact that increases in CDS spreads in recent years are partially due to influences that are not specific to individual banks and is intended to ensure that the remuneration on State guarantees reflects the intrinsic risk of individual banks rather than the risk related to the Member State concerned or the market as a whole. For State guarantees covering debt of less than one year, the current formula (a basic fee of 50 basis points plus a risk-based fee of 20 to 40 basis points depending on the bank's rating) continues to apply.

C. VIABILITY

The Commission will continue to require Member States to submit restructuring plans for banks that receive structural aid (*e.g.*, capital injections or impaired asset measures). The Commission will however apply a more lenient and "proportionate" approach when assessing banks' long-term viability in light of the sovereign debt crisis. The Commission will thus take account of (i) whether a bank's capital shortage is essentially linked to a crisis of confidence on sovereign debt, (ii) whether the public capital injection is limited to the amount necessary to offset losses stemming from marking to market sovereign bonds of the EEA member states held by banks that are otherwise viable, and (iii) whether the bank took excessive risk in acquiring sovereign debt.

II. THE EU BANK RECAPITALIZATION PROGRAM

The Communication is particularly significant in light of the Joint Statement and EBA Recommendation of December 8, 2011, which implement the conclusions of October's Euro Summit.

Both the EBA Recommendation and the conclusions reached at the Euro Summit (the "Consensus") set a target ratio of 9 % of the highest quality (or "Core Tier 1") capital, significantly higher than required by the Commission's proposed amendments to the Capital

Requirements Directive ("CRD IV"), which will implement the Basel III requirements in the EU,[6] after removing prudential filters on sovereign debt based on values as of September 30, 2011. This capital ratio will have to be attained by June 30, 2012, and plans should be submitted to national supervisors by January 20, 2012.

The EBA Recommendation is intended to build an exceptional and temporary buffer, allowing banks to face further losses (*e.g.*, on sovereign exposures). However, the buffer for sovereign exposures will not be revised as a result of market value fluctuations after September 30, 2011, and EU banks may not sell sovereign bonds as part of their plan to create the capital buffer. Moreover, no new standards are set for Greek banks, which are subject to stricter benchmarks under the capital package agreed as part of the EU/IMF program for assistance to Greece.

To achieve the 9% target, the EBA Recommendation suggests increasing retained earnings and reducing bonus payments, as well as issuance of new common equity and suitably strong contingent capital. The EBA Recommendation provides a common term sheet for cocos that could be included in the capital buffer.[7] Existing convertible capital instruments will not be eligible unless they are converted into Core Tier 1 instruments by October 2012. Banks should incorporate the requirements for trading book and securitization treatment in Basel 2.5 and the 0.80 floors for credit and operational risk from Basel I.

The EBA Recommendation and the Consensus provide that banks should "first" use private sources of funding to create the capital buffer. The Consensus further indicates that national governments should provide support where necessary. In particular, the Consensus indicates that guarantees of bank liabilities would be required to provide support for banks to access long-term funding while limiting deleveraging actions. If this support is not available, in the case of Eurozone countries, recapitalization should be funded via a loan from the ESFS.

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6 CRD IV increases the required levels of common equity tier 1 capital ("CET 1", otherwise known as "Core Tier 1" capital), which consists of ordinary shares or other instruments with the same loss-absorbing nature. It also increases the required level of Additional Tier 1 instruments, which are instruments that are risk-absorbing on an ongoing basis. As of January 1 2013, CET 1 must comprise at least 3.5% of risk-weighted assets, rising to 4.5% as of January 1, 2015. CET 1 and Additional Tier 1 instruments (together comprising 'Tier 1 capital') must comprise 6% of all risk-weighted assets as of January 1, 2015.

7 The EBA Recommendation states that existing convertible capital instruments will not be eligible unless they are converted to Core Tier 1 capital by the end of October 2012.

National supervisory authorities may, after consultation with the EBA, agree to partial achievement of the capital ratio target through the sales of certain assets where this does not lead to a reduced flow of lending, but simply to a transfer of contracts or business units to a third party. Such transfers are not to be considered as deleveraging of the financial system, as the assets are transferred to third parties rather than reduced.

One tool to reach the target capital ratio could be for banks to convert outstanding hybrid instruments. This approach will not be available to many banks already subject to State aid restructuring plans, however, since most such plans contain a dividend or coupon/call ban that prohibit banks from calling hybrid instruments.[8] Banks subject to a restructuring plan or an ongoing State aid procedure may require Commission approval for any such transactions. The Commission is likely to examine whether such transactions are made below par, with a reasonable premium in line with market practices, in order to ensure some form of burden sharing by hybrid bondholders.

The Joint Statement and EBA Recommendation confirm that once the deployment of the increased EFSF capacity becomes effective in addressing the sovereign debt crisis by lifting sovereign bond valuations from the distressed prices of today, the EBA will reassess both the size and ongoing need for capital buffers against banks' sovereign exposures.

III. CONCLUSION

EU institutions and regulators have set EU banks a formidable challenge. Instead of increasing Core Tier 1 to 4.5%, with a 2.5% capital buffer, by 2015, they will be required to raise Core Tier 1 capital to 9% by June 2012. To reach this goal, EU banks will not be allowed to sell sovereign bonds (even though ESMA recently recommended that EU banks consider whether such bonds should be treated as impaired[9]) or risk-weighted assets, except in limited circumstances. Banks subject to existing State aid restructuring plans will likely also not be able to convert existing hybrid instruments into Core Tier 1 capital.

As a result, by June 2012 EU banks will be required to issue large amounts of new common equity and cocos complying with the EBA's standard terms. It is not clear how much new capital will be needed, but the Boston Consulting Group recently estimated that

8 Out of 14 available definitive restructuring decisions adopted by the Commission, nine contain a dividend ban.

9 http://www.esma.europa.eu/system/files/2011_397.pdf

EU banks would need to raise EUR 221 billion in new capital only to meet the more modest Basel III targets.[10]

EU banks that are unable to raise sufficient new capital may need to seek substantial amounts of new State aid in 2012. Although the Communication has extended the crisis regime for bank State aid, past experience indicates that the process of reviewing and approving such aid will nonetheless be arduous, and that the measures required by banks' restructuring plans agreed with the Commission will lead to further drastic changes in the EU banking sector.

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10 http://www.bcg.com/documents/file93568.pdf

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