

The new Commission guidance on State aid and the financial crisis

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On October 13, 2008, the European Commission released an important Communication regarding the application of its State aid rules to measures taken during the current global financial crisis to support financial institutions. This new guidance is a contribution by the Commission to the efforts taken at the European and world levels to restore confidence in financial markets, which include the Eurogroup statement of October 12 and the coordinated national schemes announced by several European Member States on October 13 to safeguard the financial system. The Commission had already approved (in record time) certain other support schemes triggered by the financial crisis (eight working days for the Northern Rock plan,¹ and 24 hours for Bradford & Bingley's²). Immediately after releasing the Communication, the Commission approved the Irish and British general support schemes on the basis of the principles outlined in the Communication³, which will likely be applied to the other schemes announced by Member States over the last few days.

I. GENERAL PRINCIPLES

The key principle of the Communication is the recognition by the Commission that Article 87(3)(b) of the EC Treaty, which allows State aid to remedy “*a serious disturbance in the economy of a Member State*”, is applicable to the current financial crisis. The Commission had until now been very reluctant to apply this provision of the Treaty. For example, it had refused to apply it to approve aid to Germany's new Länder⁴ or, until recently, to support measures in favor of individual banks affected by the subprime crisis.⁵ Accordingly, support measures usually were (until now) cleared in two situations: where the Commission found that no aid had been granted (because the State intervention was made at market prices), or where the Commission found that the aid fulfilled the

¹ OJ C14-2008, 2 April 2008, United Kingdom Restructuring aid to Northern Rock.

² State aid: Commission approves UK rescue aid package for Bradford & Bingley, IP/08/1437, October 1 2008.

³ State aid: Commission approves revised Irish support scheme for financial institutions, IP/08/1497, October 13 2008; State aid: Commission approves UK support scheme for financial institutions, IP/08/1496, October 13 2008.

⁴ Joined cases T-132/96 and T-143/96, 15 December 1999, *Freistaat Sachsen, Volkswagen AG and Volkswagen Sachsen GmbH v Commission of the European Communities*.

⁵ See for instance OJ 1998 L 221/28, *Crédit Lyonnais* or OJ C14-2008, 2 April 2008, *United Kingdom Restructuring aid to Northern Rock*.

restrictive conditions of the Rescue and Restructuring guidelines.⁶ Article 87(3)(b) gives the Commission a new basis to authorize exceptional State aid that goes well beyond its pre-existing guidelines.

The Communication, however, stresses that the Commission will not apply Article 87(3)(b) without restrictions. The Commission intends to make an individual assessment of each case, particularly taking account of the statements of the national authorities responsible for financial stability in confirming the risk of serious disturbances. Furthermore, the Commission insists on the need for general schemes, *i.e.*, schemes available to several or all financial institutions in a Member State, to be reviewed at least every six months, and terminated as soon as the economic situation permits. The Commission also stresses the distinction between, on the one hand, the situation of institutions that face a liquidity problem, but that would otherwise be fundamentally sound (absent the current exceptional circumstances), and, on the other hand, the situation of financial institutions that are more fundamentally affected, and that might require substantial restructuring measures under the Rescue and Restructuring Guidelines. Exceptionally, the Communication mentions that this application of Article 87(3)(b) might cover certain *ad hoc* interventions for individual institutions. The Commission, however, clearly indicates its preference for aid granted by way of a general scheme.

As a general rule, the Communication indicates that all measures must: (i) comply with the general principle of non-discrimination; (ii) minimize competitive distortions; and (iii) not exceed what is strictly necessary.

II. GUARANTEES COVERING THE LIABILITIES OF FINANCIAL INSTITUTIONS

Over the last few weeks, governments have used guarantees extensively to support financial institutions in difficulty.⁷ While initially focused on retail deposits, these guarantees have been extended to various kinds of liabilities, including interbank loans. Under the current Commission Notice on Guarantees (“the Guarantees Guidelines”),⁸ State guarantees will be deemed to constitute State aid unless they meet strict criteria. For instance, the extent of the guarantee must be properly defined; the guarantee must not cover more than 80% of each liability covered; the beneficiary must pay a premium covering the risks and the overall costs of the guarantee. It is likely that some guarantees schemes developed during the financial crisis would not have met these criteria. The Communication explains that the Commission may authorize such guarantees schemes on the basis of Article 87(3)(b).

⁶ See OJ 2004 L244/02, Communication of the Commission – rescue or restructuring guidelines.

⁷ For instance, guarantees represent €400Bn out of the €470Bn of the German scheme announced on October 13 and €320Bn out of the €360Bn of the French scheme announced the same day. On October 13, the Dutch government also announced a €200Bn guarantee on inter-bank loans.

⁸ Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C-155, 20 June 2008, p. 10–22).

Regarding the material scope of the guarantees, they may cover liabilities extending beyond retail deposits. In particular, the Commission recognizes that the drying-up of interbank lending may justify guaranteeing certain types of wholesale deposits and even those short- and medium-term debt instruments that are not already adequately protected by existing investor arrangements or by other means. However, such guarantees should not, in principle, include subordinated debt (tier-2 capital) or allow for indiscriminate coverage of all liabilities. If such debt were nevertheless to be covered, specific restrictions might be necessary.

The conditions of eligibility must be objective and non-discriminatory. In particular, the Commission makes clear that there should be no discrimination on the grounds of nationality: all institutions that are incorporated in the Member State (including subsidiaries) and that have significant activities in the Member State should be covered by its guarantee scheme.

The duration and scope of schemes extending beyond retail deposit guarantees must be limited to the minimum necessary. The Commission's approval can (in principle) last for up to two years, but this may be extended further if necessary. The necessity of the scheme must be reviewed by the Member State every six months, under the Commission's control. Additional safeguards (such as quantitative limits, shorter issuance periods or deterrent pricing conditions) will be required for guarantees covering debt of a maturity date later than the expiry of the issuance period under the scheme.

The Communication reaffirms the principle that there must be as much private sector contribution to the scheme as possible in order to ensure that the Member State aid is kept to a minimum. This may be ensured by an adequate remuneration of the guarantee by the beneficiary, a claw-back/better fortune clause, or a rule ensuring that, in case the guarantee is activated, the private sector covers a substantial portion of the outstanding liabilities incurred by the beneficiary.

The scheme should also contain behavioral constraints in order to avoid undue distortion of competition, such as restrictions on commercial conduct, limitations to the size of the balance sheet of the beneficiaries, or the prohibition of the issuance of new stock options or share repurchases.

If the guarantee scheme must be invoked for the benefit of individual financial institutions, payment should be followed within six months by a restructuring or liquidation plan to be assessed by the Commission based on its experience gathered in the application of State aid rules to financial institutions.

III. RECAPITALISATION OF FINANCIAL INSTITUTIONS

Recapitalizations are a second aid mechanism permitted under the new guidelines. Member States may use it to support financial institutions that may be fundamentally sound but that are experiencing distress because of the extreme conditions in financial markets.

The main innovation of the Communication on this issue is that it allows recapitalization to be launched as an emergency measure. By contrast, under the current Rescue and Restructuring guidelines, the Commission allowed such capital interventions only after a Restructuring plan was presented and assessed by the Commission. Rescue aid, which was meant only to cover emergencies, could include only loans lasting not more than six months.

The Communication applies the same conditions to these recapitalization measures as those for general guarantees schemes, regarding the objective and non-discriminatory criteria for eligibility (such as solvency requirements or the evaluation of the need for support by the financial supervisory authorities), the duration of the scheme (up to 2 years), the limitation of the aid to what is strictly necessary (for instance, through the maintenance of enhanced minimum solvency requirements or the limitation of the size of the balance sheet), safeguards against possible abuses (including behavioral constraints), and the requirement for a restructuring plan to be presented to and assessed by the Commission within six months.

Furthermore, Member States should receive rights whose values correspond to this contribution in the recapitalization. The issue price of new shares must be fixed using a market-oriented valuation. Instruments such as preferred shares with adequate remuneration or claw-back mechanisms will be looked upon favorably.

Member States must report on the use of the scheme every six months and individual plans for beneficiary undertakings must be reported upon within six months of the date of the intervention. The Commission will assess these reports according to the principles of the Rescue and Restructuring guidelines.

IV. CONTROLLED WINDING-UP OF FINANCIAL INSTITUTIONS

Member States may initiate a controlled winding-up of the institutions that have benefited from a recapitalization, a guarantee scheme or other aid. In this context, the Communication provides that the assessment of such scheme and individual liquidation measures should follow the same lines, *mutatis mutandis*, as those of guarantees schemes.

In addition, shareholders (and possibly certain types of creditors) should be excluded from receiving the benefits of any aid in the context of a controlled winding-up procedure.

The liquidation phase should be limited to a period strictly necessary for the orderly winding-up. The beneficiary should not be allowed to pursue new activities and its banking license should be withdrawn as soon as possible.

In order to ensure that no aid is granted to the buyers, the Commission reaffirms that it will take into account the following criteria: (i) the sales process should be open and non-discriminatory; (ii) the sale should take place on the market's terms; (iii) the sales price should be maximized; and (iv) any aid granted to support the economic activity to be sold will be examined under the principles of the Rescue and Restructuring Guidelines.

V. PROVISION OF OTHER FORMS OF LIQUIDITY ASSISTANCE

Member States often accompany guarantee or recapitalization schemes with liquidity support, including support from Central Banks. The Commission reasserts that general, non-selective measures open to all comparable market players in the market (for instance open market operations or standing facilities) are not covered by State aid rules.⁹

Dedicated support to a specific financial institution may also not fall under the State aid rules when the following (non-exhaustive) conditions are met: (i) the financial institution is solvent at the moment of the provision of liquidity; (ii) the facility is fully secured by collateral to which haircuts have been applied; (iii) the Central Bank charges a punitive interest rate to the beneficiary; and (iv) the measure was taken on the central bank's own initiative.

The Communication adds that a scheme involving liquidity support from public sources that does not fulfill these criteria may still be considered as compatible aid, provided that it fulfills the principles of the Rescue and Restructuring Guidelines and is reviewed every six months. Again, the approval of the scheme may cover a period of up to two years, with the possibility of further extension.

VI. RAPID TREATMENT OF STATE AID AND INVESTIGATIONS

The Communication stresses the importance of the Member States informing the Commission of their intentions and of notifying the Commission of plans to introduce such measures as early and comprehensively as possible (and in any event before the measure is implemented). The Communication reasserts the Commission's readiness to take a decision on notified measures within 24 hours if necessary.

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For additional information, please do not hesitate to contact Stephan Barthelmess, Brian Byrne, Christopher Cook, Maurits Dolmans, Francisco-Enrique González-Díaz,

⁹ See for instance *Northern Rock*, OJ C 43, 16 February 2008, p.1.

Nicholas Levy, Laurent Legein, Jan Meyers, James Modrall, Till Müller-Ibold, Robbert Snelders, Romano Subiotto, John Temple Lang, Dirk Vandermeersch, or Antoine Winckler of the Firm's Brussels office (+32 2 287 2000); Mario Siragusa or Giuseppe Scassellati-Sforzolini in Rome (+39 06 69 52 21); Dirk Schroeder or Romina Polley in Cologne (+49 221 800 400); François Brunet in Paris (+33 1 40 74 68 00); Shaun Goodman in London (+44 20 7614 2200)

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS

12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW

Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

COLOGNE

Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME

Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN

Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING

Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax