New EU Commission Banking Communication

On July 10, 2013, the European Commission ("the Commission") published an important new communication regarding State aid control in the banking sector entitled *Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis* (the "Communication"). This Communication is the seventh so-called "crisis communication" published by the Commission since the beginning of the financial crisis in October 2008. It provides detailed guidance on the criteria for the compatibility of State aid granted to banks with the requirements of the internal market, pursuant to Article 107(3) (b) of the Treaty on the Functioning of the European Union. While as a matter of principle State shareholding in banks is not always considered as State aid, support measures granted by EU Member States to their banks in the crisis (in particular capital injections) have typically been considered as State aid.

The Communication updates and replaces the Commission's first crisis communication adopted in October 2008 and modifies some of the Commission's following crisis communications on recapitalization, bank restructuring and the treatment of impaired assets. It will be applicable to all cases for which State aid will be notified from August 1st, 2013 concerning credit institutions (as defined under Directive 2006/48/EC) and, *mutatis mutandis*, insurance companies.

The Communication addresses three main objectives: (i) to adapt the Commission's decisional practice to the gradual establishment of the Banking Union in the EU, and in particular the phasing-in of a Single Resolution Mechanism ("SRM") and a Single Supervisory Mechanism ("SSM"); (ii) to identify lessons learned from the recent bank rescues in Spain and Cyprus; and (iii) to codify these lessons as well as the Commission's best practices responding to these and other bank failures over the past six years.

This memorandum discusses the key elements of the Communication and underlines the main changes it establishes in regard to recapitalisation and impaired asset measures (Section I), guarantees and liquidity support outside the provision of central bank liquidity (Section II), and specific considerations for the provision of liquidation aid (Section III).

I. RECAPITALISATION AND IMPAIRED ASSET MEASURES

A. Capital raising measures, pre-notification and notification of the aid

The Communication places new emphasis on the way capital shortfalls are addressed by banks internally in order to prevent as much as possible the intervention of the State. In particular, the Communication states that "*as soon as a capital shortfall that is likely to result in a request for State aid has been identified, all measures to minimise the cost of remedying that shortfall for the Member State should be implemented*".[1] Additionally, the Communication encourages pre-notification contacts between the Member State and the Commission before the aid is notified to the Commission for approval. Crucially, the Communication confirms that as a matter of principle the Commission will now authorise structural aid (i.e. recapitalisation or impaired asset measures) only after it has agreed on a restructuring plan with the Member State.

This new measure represents a significant change in the Commission's practice since the beginning of the financial crisis. Until now, banks could be granted structural State aid well before they obtained a formal positive decision from the Commission on their restructuring plan – such structural aid was typically approved on a temporary basis until the plan was agreed, and the negotiation of the restructuring plan could in some instances take months or even years. The new rule imposed in the Communication was already applied in the case of the Spanish banks and the Commission is now extending its application to all banks. By way of exception to this rule, the Commission will still be able to temporarily authorize structural aid in exceptional cases, provided that (i) the competent supervisory authority confirms the existence of a capital shortfall that cannot be averted with private capital, would force the supervisor to withdraw the banking licence and would threaten financial stability and (ii) the Member State submits a restructuring plan within two months of the temporary authorization.

Additionally, the Communication sets out new requirements for the substance of banks' pre-notification of their need for restructuring aid and impaired assets measures. Banks that seek to benefit from such aid will first have to implement all possible alternative internal capital raising measures, such as rights issues, voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive, securitisation of portfolios in order to generate capital from non-core activities, etc.

Moreover, the Communication creates strong incentives for bank management to undertake timely restructuring. Under the new rules, "*if recourse to State aid could have reasonably been averted through appropriate and timely management action, any entity relying on State aid for its restructuring or orderly winding down should normally replace the Chief Executive Officer of the bank, as well as other board members if appropriate*".[2]

The Communication also requires banks seeking State aid to restrict remuneration of board members and senior management to predetermined levels. The total remuneration of those

[1] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis, paragraph 32.

[2] *Ibid*., paragraph 38.

individuals may not exceed 15 times the national average salary in the Member State where the beneficiary banks is incorporated or 10 times the average salary of employees of the beneficiary bank.

B. Burden sharing

With regard to burden sharing measures, the Commission considers that State support can create moral hazard and undermine market discipline. The Communication therefore requires to ensure that banks losses are first absorbed by equity, hybrid capital and subordinated debt holders in order to reduce the capital shortfall to the maximum extent possible. This can for instance result in the conversion of subordinated debt into Common Equity Tier 1 or a write-down of the instruments' principal. However, the Commission will not require contributions from *senior* debt holders as a mandatory component of burden-sharing.

The Commission authorises an exception to these stringent burden sharing requirements where their implementation would endanger financial stability or lead to disproportionate results. This is for instance the case when the aid to be received is minimal compared to the bank's risk weighted assets and the bank's capital shortfall has been reduced significantly through some of the capital raising measures.

C. Prevention of outflow of funds prior to a restructuring decision

The Communication also underlines that a beneficiary bank should adopt all necessary measures in order to prevent the outflow of funds prior to a restructuring decision. Therefore, from the time capital needs are known or should have been known to the bank, and even before the restructuring plan is agreed and the aid is granted, the bank may not pay dividends on shares or coupons of hybrid capital instruments, repurchase its own shares, call hybrid capital instruments, perform capital management transactions, engage in aggressive commercial practices, acquire a share in undertakings or advertise by referring to State support. If a bank fails to comply with these provisions in the pre-restructuring period, the Commission will add an amount equivalent to the outflow of funds to the aid amount for the purposes of establishing the required measures to limit distortions of competitions in the restructuring plan. In other terms, the less ambitious the pre-restructuring measures will be, the more the Commission will require painful compensation measures at the restructuring stage. This new rule could result in a significantly toughening of the Commission's practice, since it requires the bank to undertake preventative measures even before it has received any State aid. Its implementation may raise practical issues in cases where the existence of a capital shortfall is clear, but the need for State intervention is not yet established.

D. Softening of procedural requirements for smaller banks

The Communication softens procedural requirements for small banks (banks with a total balance-sheet of not more than EUR 100 million and with a balance-sheet of less than 1.5% of the total assets held by banks in the domestic market concerned). The Commission will authorise schemes for recapitalisation and restructuring of small banks (without requiring individual authorization for each bank) where such schemes have a clear remit and are limited to a six-month period. This provision recognizes that aid to small banks typically affects competition less than aid to large banks.

II. GUARANTEES AND LIQUIDITY SUPPORT

Guarantees and liquidity support account for close to two-thirds of the amount of State support to banks since the beginning of the crisis. In contrast with structural measures such as recapitalizations, the Communication confirms that guarantee and liquidity interventions do not require the prior approval of a restructuring plan. Guarantee or liquidity schemes (which are open to all banks and do not require individual approval for each bank) may be authorized for a period of 6 months, and may only be open to banks that do not have any capital shortfall. Other guarantees or liquidity interventions must be subject to prior individual approval by the Commission.

The Communication provides a general description of the requirements that must be satisfied before a guarantee or liquidity support will be authorised. For instance, guarantees may now only be granted for new issues of credit institutions' senior debt and for maturities from 3 months to 5 years (7 years for covered bonds). The remuneration of the State for the guarantee must be at equal to the level determined in the 2011 Prolongation Communication. A restructuring plan must be submitted within two months when the guarantee amounts exceed both 5% of the bank's liabilities and € 500 million.

The Communication also codifies the Commission's decisional practice on liquidity provision by central banks in the conduct of their monetary policy tasks and on deposit guarantee funds, which are generally not considered as State aid

III. LIQUIDATION AID

With regard to so-called orderly liquidation, the Communication codifies the Commission's case practice and highlights that Member States should encourage the exit of non-viable players, which should occur in an orderly manner in order to preserve overall financial stability. As a general principle, no new third party business may be undertaken in a liquidation process, except for "existing business" that reduces the liquidation costs, such as the restructuring or change of terms of existing loans, provided such change improves the corresponding asset's net present value.

In terms of burden sharing, particular care should be exercised to avoid any aid to the shareholders and subordinated debt holders, whose claims may not be transferred to any continuing economic activity.

The Commission notes that the sale of a credit institution may entail State aid to the buyer, unless the sale is organised via an open and unconditional competitive tender and the assets are sold to the highest bidder. The Communication also contemplates the possibility that the sale may entail aid to the economic activity that is being sold, in which case the Commission might impose additional pro-competitive measures and verify the entity's viability after the sale (taking into consideration the strength of the purchaser). The Communication however remains silent on the circumstances in which the Commission could exclude the existence of aid to the sold entity – it might thus be prudent for banks in resolution (and their purchasers) to verify with the Commission whether aid is involved in such sales, in order to have legal certainty on the sold entity's future business and avoid that the Commission imposes restrictive measures (or orders recovery of alleged aid) after the sale is closed.

Finally, the Banking Communication contemplates the possibility of authorizing orderly liquidation schemes for smaller banks (with total assets of less than € 3 bn), subject to the submission by the Member State concerned of annual monitoring reports.

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If you have any questions with respect to the issues addressed herein, please contact any of your regular contacts listed at http://www.cgsh.com/.

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