D. RULES ESTABLISHED IN RESPONSE TO THE ECONOMIC AND FINANCIAL CRISIS

II

(Information)

INFORMATION FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COMMISSION

Communication from the commission — Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis

(2009/C 83/01)

1. THE FINANCIAL CRISIS, ITS IMPACT ON THE REAL ECONOMY AND THE NEED FOR TEMPORARY MEASURES

1.1. The financial crisis and its impact on the real economy

On 26 November 2008 the Commission adopted the Communication 'A European Economic Recovery Plan' ([1]) ('the Recovery Plan') to drive Europe's recovery from the current financial crisis. The Recovery Plan is based on two mutually reinforcing main elements. Firstly, short-term measures to boost demand, save jobs and help restore confidence and, secondly, 'smart investment' to yield higher growth and sustainable prosperity in the longer term. The Recovery Plan will intensify and accelerate reforms already underway under the Lisbon Strategy.

In this context, the challenge for the Community is avoiding public intervention which would undermine the objective of less and better targeted State aid. Nevertheless, under certain conditions, there is a need for new temporary State aid.

The Recovery Plan also includes further initiatives to apply State aid rules in a way that achieves maximum flexibility for tackling the crisis while maintaining a level playing field and avoiding undue restrictions of competition. This Communication gives details of a number of additional temporary openings for Member States to grant State aid.

First, the financial crisis has a hard impact on the banking sector in the Community. The Council has stressed that, although public intervention has to be decided at national level, this needs to be done within a coordinated framework and on the basis of a number of common Community principles ([2]). The Commission reacted immediately with various measures including the adoption of the Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ([3]) and of a number of decisions authorising rescue aid to financial institutions.

Sufficient and affordable access to finance is a precondition for investment, growth and job creation by the private sector. Member States need to use the leverage they have acquired as a result of providing substantial financial support to the banking sector to ensure that this support does not lead merely to an improvement in the financial situation of the banks without any benefit to the economy at large. Support for the financial sector should therefore be well targeted to guarantee that banks resume their normal lending activities. The Commission will take this into account when reviewing State aid to banks.

([1]) Communication from the Commission to the European Council, COM(2008) 800.
([2]) Conclusions of the ECOFIN Council of 7 October 2008.
([3]) OJ C 270, 25.10.2008, p. 8.

While the situation on financial markets appears to be improving, the full impact of the financial crisis on the real economy is now being felt. A very serious downturn is affecting the wider economy and hitting households, businesses and jobs. In particular, as a consequence of the crisis on financial markets, banks are deleveraging and becoming much more risk-averse than in previous years, leading to a credit squeeze. This financial crisis could trigger credit rationing, a drop in demand and recession.

Such difficulties could affect not only weak companies without solvency buffers, but also healthy companies which will find themselves facing a sudden shortage or even unavailability of credit. This will be particularly true for small and medium-sized undertakings ('SMEs'), which in any event face greater difficulties with access to finance than larger companies. This situation could not only seriously affect the economic situation of many healthy companies and their employees in the short and medium term but also have longer-lasting negative effects since all Community investments in the future – in particular, towards sustainable growth and other objectives of the Lisbon Strategy – could be delayed or even abandoned.

1.2. **The need for close European coordination of national aid measures**

In the current financial situation, Member States could be tempted to go it alone and, in particular, to wage a subsidy race to support their companies. Past experience shows that individual action of this kind cannot be effective and could seriously damage the internal market. When granting support, taking fully into consideration the current specific economic situation, it is crucial to ensure a level playing field for European companies and to avoid Member States engaging in subsidy races which would be unsustainable and detrimental to the Community as a whole. Competition policy is there to ensure this.

1.3. **The need for temporary State aid measures**

While State aid is no miracle cure to the current difficulties, well targeted public support for companies could be a helpful component in the overall effort both to unblock lending to companies and to encourage continued investment in a low-carbon future.

The temporary additional measures provided for in this Communication pursue two objectives: first, in the light of the exceptional and transitory financing problems linked to the banking crisis, to unblock bank lending to companies and thereby guarantee continuity in their access to finance. As borne out by the recently adopted Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 'Think Small First' – A 'Small Business Act' for Europe of 25 June 2008 ([4]), SMEs are particularly important for the whole economy in Europe and improving their financial situation will also have positive effects for large companies, thereby supporting overall economic growth and modernisation in the longer term.

The second objective is to encourage companies to continue investing in the future, in particular in a sustainable growth economy. There could indeed possibly be dramatic consequences if, as a result of the current crisis, the significant progress that has been achieved in the environmental field were to be halted or even reversed. For this reason, it is necessary to provide temporary support to companies for investing in environmental projects (which could, *inter alia*, give a technological edge to Community industry), thereby combining urgent and necessary financial support with long-term benefits for Europe.

This Communication first recalls the manifold opportunities for public support which are already at the disposal of Member States under existing State aid rules, before setting out additional State aid measures that Member States may grant temporarily in order to remedy the difficulties which some companies are currently encountering with access to finance and to promote investment pursuing environmental objectives.

The Commission considers that the proposed aid instruments are the most appropriate ones to achieve those objectives.

([4]) COM(2008) 394 final.

2. GENERAL ECONOMIC POLICY MEASURES

The Recovery Plan was adopted in response to the current economic situation. Given the scale of the crisis, the Community needs a coordinated approach, big enough and bold enough to restore consumer and business confidence.

The strategic aims of the Recovery Plan are to:

— swiftly stimulate demand and boost consumer confidence;

— lessen the human cost of the economic downturn and its impact on the most vulnerable. Many workers and their families are or will be hit by the crisis. Action can be taken to help stem the loss of jobs and then to help people return rapidly to the labour market, rather than face long-term unemployment;

— help Europe to prepare to capitalise when growth returns, so that the European economy is in tune with the demands for competitiveness and sustainability and the needs of the future, as outlined in the Lisbon Strategy. That means supporting innovation, building a knowledge economy and speeding up the shift towards a low-carbon and resource-efficient economy.

To achieve those objectives, Member States already have at their disposal a number of instruments which are not considered State aid. For instance, some companies may be experiencing even more acute difficulties with access to finance than others, thereby delaying or even scuppering the financing necessary for their growth and for seeing through investments envisaged. For this purpose, Member States could adopt a series of general policy measures, applicable to all companies on their territories and, consequently, falling outside the State aid rules, with the aim of temporarily alleviating financing problems in the short and medium term. For example, payment deadlines for social security and similar charges, or even taxes could be extended or measures for employees could be introduced. If such measures are open to all undertakings, in principle they do not constitute State aid.

Member States may also grant financial support directly to consumers, for instance for scrapping old products and/or buying green products. If such aid is granted without discrimination based on the origin of the product, it does not constitute State aid.

Moreover, general Community programmes, like the Competitiveness and Innovation Framework Programme (2007 to 2013) established by Decision No 1639/2006/EC of the European Parliament and of the Council of 24 October 2006 ([5]) and the Seventh Framework Programme of the European Community for research, technological development and demonstration activities (2007-2013) established by Decision No 1982/2006/EC of the European Parliament and of the Council of 18 December 2006 ([6]) may be used to best effect to deliver support to SMEs, but also to large undertakings. This is fully in line with other European initiatives, such as the European Investment Bank's decision to mobilise EUR 30 billion to support European SMEs and its commitment to step up its ability to intervene in infrastructure projects.

3. STATE AID POSSIBLE UNDER EXISTING INSTRUMENTS

Over the last few years, the Commission has significantly modernised the State aid rules in order to encourage Member States to target public support better on sustainable investments, thus contributing to the Lisbon Strategy. In this context, particular emphasis has been given to SMEs, accompanied by more openings for granting State aid. In addition, the State aid rules have been greatly simplified and streamlined by Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation) ([7]) ('the GBER') which now offers Member States a wide panoply of aid measures with minimum administrative burden. In the current economic situation, the following existing State aid instruments are of particular importance:

([5]) OJ L 310, 9.11.2006, p. 15.
([6]) OJ L 412, 30.12.2006, p. 1.
([7]) OJ L 214, 9.8.2008, p. 3.

Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid ([8]) ('the *de minimis* Regulation') specifies that support measures worth up to EUR 200 000 per company over any three-year period do not constitute State aid within the meaning of the Treaty. The same Regulation also states that guarantees of up to EUR 1,5 million do not exceed the *de minimis* threshold and therefore do not constitute aid. Consequently, Member States can grant such guarantees without calculation of the corresponding aid equivalent and without administrative burdens.

The GBER forms a central element of the State aid rules by simplifying the State aid procedure for certain important aid measures and fostering redirection of State aid to priority Community objectives. All previously existing block exemptions, along with new areas (innovation, environment, research and development for large companies and risk capital measures for SMEs), have been brought under a single instrument. In all the cases covered by the GBER, Member States can grant aid without prior notification to the Commission. Therefore, the speed of the process lies fully in the hands of Member States. The GBER is particularly important for SMEs, in that it provides for special rules on investment and employment aid exclusively for SMEs. In addition, all the 26 measures covered are open to SMEs, allowing Member States to accompany SMEs during the different stages in their development, assisting them in areas ranging from access to finance to research and development, innovation, training, employment, environmental measures, etc.

New Community guidelines on State aid for environmental protection ([9]) were adopted as part of the Energy and Climate Change Package at the beginning of 2008. Under those guidelines, Member States may grant State aid, *inter alia*, as follows:

— aid for companies which improve their environmental performance beyond Community standards, or in the absence of Community standards, of up to 70 % of the extra investment costs (up to 80 % in the field of eco-innovation) for small undertakings and of up to 100 % of the extra investment costs if the aid is granted following a genuinely competitive bidding process, even for large companies; aid for early adaptation to future Community standards and aid for environmental studies is also allowed;

— in the field of renewable energies and cogeneration, Member States may grant operating aid to cover all extra production costs;

— in order to attain environmental targets for energy saving and for reductions in greenhouse gas emissions, Member States may grant aid enabling undertakings to achieve energy savings and aid for renewable energy sources and cogeneration of up to 80 % of the extra investment costs for small undertakings and of up to 100 % of the extra investment costs if the aid is granted following a genuinely competitive bidding process.

In December 2006, the Commission adopted a new Community framework for State aid for research and development and innovation ([10]). That text contains new provisions on innovation, specially targeted at SMEs and also corresponding to better targeting of aid on job and growth creation along the lines set out in the Lisbon Strategy. In particular Member States may grant State aid, *inter alia*, as follows:

— aid for R&D projects, in particular aid for fundamental research, of up to 100 % of the eligible costs and aid for industrial research of up to 80 % for small enterprises;

— aid for young innovative enterprises of up to EUR 1 million and even more in assisted regions, aid for innovation clusters, aid for innovation advisory services and aid for innovation support services;

([8]) OJ L 379, 28.12.2006, p. 5.
([9]) OJ C 82, 1.4.2008, p. 1.
([10]) OJ C 323, 30.12.2006, p. 1.

— aid for the loan of highly qualified personnel, aid for technical feasibility studies, aid for process and organisational innovation in services and aid for industrial property rights costs for SMEs.

Training is another key element for competitiveness. It is critically important to maintain investment in training, even at a time of rising unemployment, in order to develop new skills. Under the GBER, Member States may grant both general and specific training aid to companies totalling up to 80 % of the eligible costs.

In 2008, the Commission adopted a new Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees ([11]), which specifies the conditions under which public guarantees for loans do not constitute State aid. In accordance with that Notice, guarantees are not considered State aid, in particular, when a market price is paid for them. Besides clarifying the conditions which determine whether or not aid in the form of guarantees is present, the Notice also introduces, for the first time, specific safe-harbour premiums for SMEs, allowing easier but safe use of guarantees in order to foster the financing of SMEs.

New Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises ([12]) were adopted by the Commission in July 2006. They are aimed at innovative and fast-growing SMEs – a key focus of the Lisbon Strategy. The Commission put in place a new safe-harbour threshold of EUR 1,5 million per target SME, a 50 % increase. Beneath that ceiling the Commission accepts that, as a rule, alternative means of funding from financial markets are lacking (that is to say, that a market failure exists). In addition, aid for risk capital has been included in the GBER.

In disadvantaged regions, Member States can grant investment aid for setting up a new establishment, extending an existing establishment or diversifying into new products under the Guidelines on national regional aid for 2007-2013 ([13]), which have applied since January 2007.

The Guidelines on national regional aid for 2007-2013 also introduce a new form of aid to provide incentives to support business start-ups and the early-stage development of small enterprises in assisted areas.

Under the existing Community guidelines on State aid for rescuing and restructuring firms in difficulty ([14]), Member States can also grant aid to companies requiring public support. For that purpose, Member States may notify rescue and/or restructuring aid schemes for SMEs.

On the basis of the existing State aid possible, the Commission has already authorised a large number of schemes that Member States may use to respond to the current financial situation.

4. APPLICABILITY OF ARTICLE 87(3)(B)

4.1. General principles

Pursuant to Article 87(3)(b) of the Treaty the Commission may declare compatible with the common market aid 'to remedy a serious disturbance in the economy of a Member State'. In this context, the Court of First Instance of the European Communities has ruled that the disturbance must affect the whole of the economy of the Member State concerned, and not merely that of one of its regions or parts of its territory. This, moreover, is in line with the need to interpret strictly any derogating provision such as Article 87(3)(b) of the Treaty ([15]).

([11]) OJ C 155, 20.6.2008, p. 10.
([12]) OJ C 194, 18.8.2006, p. 2.
([13]) OJ C 54, 4.3.2006, p. 13.
([14]) OJ C 244, 1.10.2004, p. 2.
([15]) Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, paragraph 167.

This strict interpretation has been consistently applied by the Commission ([16]) in its decision-making.

In this context, the Commission considers that, beyond emergency support for the financial system, the current global crisis requires exceptional policy responses.

All Member States will be affected by this crisis, albeit in different ways and to different degrees, and it is likely that unemployment will increase, demand fall and fiscal positions deteriorate.

In the light of the seriousness of the current financial crisis and its impact on the overall economy of the Member States, the Commission considers that certain categories of State aid are justified, for a limited period, to remedy those difficulties and that they may be declared compatible with the common market on the basis of Article 87(3)(b) of the Treaty.

Therefore Member States have to show that the State aid measures notified to the Commission under this framework are necessary, appropriate and proportionate to remedy a serious disturbance in the economy of a Member State and that all the conditions are fully respected.

4.2. **Compatible limited amount of aid**

4.2.1. *Existing framework*

Article 2 of the *de minimis* Regulation, states that:

> 'Aid measures shall be deemed not to meet all the criteria of Article 87(1) of the Treaty and shall therefore be exempt from the notification requirement of Article 88(3) of the Treaty, if they fulfil the conditions laid down in paragraphs 2 to 5 of this Article.
>
> The total *de minimis* aid granted to any one undertaking shall not exceed EUR 200 000 over any period of three fiscal years. The total *de minimis* aid granted to any one undertaking active in the road transport sector shall not exceed EUR 100 000 over any period of three fiscal years. These ceilings shall apply irrespective of the form of the *de minimis* aid or the objective pursued and regardless of whether the aid granted by the Member State is financed entirely or partly by resources of Community origin. The period shall be determined by reference to the fiscal years used by the undertaking in the Member State concerned.'

4.2.2. *New measure*

The financial crisis is affecting not only structurally weak companies but also companies which will find themselves facing a sudden shortage or even unavailability of credit. An improvement in the financial situation of those companies will have positive effects for the whole European economy.

Therefore, in view of the current economic situation, it is considered necessary to temporarily allow the granting of a limited amount of aid that will nevertheless fall within the scope of Article 87(1) of the Treaty, since it exceeds the threshold indicated in the *de minimis* Regulation.

The Commission will consider such State aid compatible with the common market on the basis of Article 87(3)(b) of the Treaty, provided all the following conditions are met:

([16]) Commission Decision 98/490/EC in Case C 47/96 *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28), point 10.1; Commission Decision 2005/345/EC in Case C 28/02 *Bankgesellschaft Berlin* (OJ L 116, 4.5.2005, p. 1), points 153 *et seq.*; and Commission Decision 2008/263/EC in Case C 50/06 *BAWAG* (OJ L 83, 26.3.2008, p. 7), point 166. See Commission Decision in Case NN 70/07 *Northern Rock* (OJ C 43, 16.2.2008, p. 1), Commission Decision in Case NN 25/08 *Rescue aid to WestLB* (OJ C 189, 26.7.2008, p. 3) and Commission Decision of 4 June 2008 in Case C 9/08 *SachsenLB*, not yet published.

(a) the aid does not exceed a cash grant of EUR 500 000 per undertaking; all figures used must be gross, that is, before any deduction of tax or other charge; where aid is awarded in a form other than a grant, the aid amount is the gross grant equivalent of the aid;

(b) the aid is granted in the form of a scheme;

(c) the aid is granted to firms which were not in difficulty [17] on 1 July 2008; it may be granted to firms that were not in difficulty at that date but entered in difficulty thereafter as a result of the global financial and economic crisis;

(d) the aid scheme does not apply to firms active in the fisheries sector;

(e) the aid is not export aid or aid favouring domestic over imported products;

(f) the aid is granted no later than 31 December 2010;

(g) prior to granting the aid, the Member State obtains a declaration from the undertaking concerned, in written or electronic form, about any other *de minimis* aid and aid pursuant to this measure received during the current fiscal year and checks that the aid will not raise the total amount of aid received by the undertaking during the period from 1 January 2008 to 31 December 2010, to a level above the ceiling of EUR 500 000;

(h) the aid scheme does not apply to undertakings active in the primary production of agricultural products [18]; it may apply to undertakings active in the processing and marketing of agricultural products [19] unless the amount of the aid is fixed on the basis of the price or quantity of such products purchased from primary producers or put on the market by the undertakings concerned, or the aid is conditional on being partly or entirely passed on to primary producers.

4.3. **Aid in the form of guarantees**

4.3.1. *Existing framework*

The Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees is intended to give Member States detailed guidance about the principles on which the Commission intends to base its interpretation of Articles 87 and 88 and application thereof to State guarantees. In particular, the Notice specifies the conditions under which State aid can be considered not to be present. It does not provide compatibility criteria for assessment of guarantees.

4.3.2. *New measure*

In order further to encourage access to finance and to reduce the current high risk aversion on the part of banks, subsidised loan guarantees for a limited period can be an appropriate and well targeted solution to give firms easier access to finance.

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[17] For the purposes of this Communication 'firm in difficulty' means:
— for large companies, a firm in difficulty as defined in point 2.1 of the Community guidelines on State aid for rescuing and restructuring firms in difficulty
— for SMEs, a firm in difficulty as defined in Article 1(7) of the GBER.

[18] As defined in Article 2(2) of Commission Regulation (EC) No 1857/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to State aid to small and medium-sized enterprises active in the production of agricultural products and amending Regulation (EC) No 70/2001 (OJ L 358, 16.12.2006, p. 3).

[19] As defined in Article 2(3) and 2(4) of Regulation (EC) No 1857/2006.

The Commission will consider such State aid compatible with the common market on the basis of Article 87(3)(b) of the Treaty, provided all the following conditions are met:

(a) for SMEs, Member States grant a reduction of up to 25 % of the annual premium to be paid for new guarantees granted in accordance with the safe-harbour provisions as set out in the Annex ([20]);

(b) for large companies, Member States also grant a reduction of up to 15 % of the annual premium for new guarantees calculated on the basis of the same safe-harbour provisions set out in the Annex;

(c) when the aid element in guarantee schemes is calculated through methodologies already accepted by the Commission following their notification under a regulation adopted by the Commission in the field of State aid ([21]), Member States may also grant a similar reduction of up to 25 % of the annual premium to be paid for new guarantees for SMEs and up to 15 % for large companies;

(d) the maximum loan does not exceed the total annual wage bill of the beneficiary (including social charges as well as the cost of personnel working on the company site but formally in the payroll of subcontractors) for 2008. In the case of companies created on or after 1 January 2008, the maximum loan must not exceed the estimated annual wage bill for the first two years in operation;

(e) guarantees are granted until 31 December 2010 at the latest;

(f) the guarantee does not exceed 90 % of the loan for the duration of the loan;

(g) the guarantee may relate to both investment and working capital loans;

(h) the reduction of the guarantee premium is applied during a maximum period of 2 years following the granting of the guarantee. If the duration of the underlying loan exceeds 2 years, Member States may apply for an additional maximum period of 8 years the safe-harbour premiums set out in the Annex without reduction;

(i) the aid is granted to firms which were not in difficulty ([22]) on 1 July 2008; it may be granted to firms that were not in difficulty at that date but entered in difficulty thereafter as a result of the global financial and economic crisis.

4.4. **Aid in the form of subsidised interest rate**

4.4.1. *Existing framework*

The Commission Communication on the revision of the method for setting the reference and discount rates ([23]) establishes a method for calculation of the reference rate, based on the one-year inter-bank offered rate (IBOR) increased by margins ranging from 60 to 1 000 base points, depending on the creditworthiness of the company and the level of collateral offered. The method for calculation of the reference and discount rates may be amended by the Commission, in order to reflect the prevailing market conditions. If Member States apply the calculation method of the reference and discount rates established in the Commission communication in force at the moment of the grant of the loan and comply with the conditions set out in that communication, the interest rate does, in principle, not contain State aid.

([20]) The premiums in the Annex refines the safe-harbour provisions of the 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, 20.6.2008) by taking account of different levels of collateralisation. They may also be used as benchmark to calculate the compatible aid element for guarantee measures falling under point 4.2 of this framework.
The calculation of the safe-harbour premiums is based on the margins provided by the Commission Communication on the revision of the method for setting the reference and discount rates (OJ C 14, 19.1.2008, p. 6), taking account of an additional reduction of 20 basis points (see footnote 11 of the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees). For each rating category, however, the safe-harbour premium as set out in the 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, 20.6.2008) remained the upper premium limit for each rating category. As to the definition of the different levels of collateralisation see footnote 2, page 3 of the Commission Communication on the revision of the method for setting the reference and discount rates (OJ C 14, 19.1.2008, p. 6).

([21]) Such as the GBER or Regulation (EC) No 1628/2006 or Regulation (EC) No 1857/2006, provided that the approved methodology explicitly addresses the type of guarantees and the type of underlying transactions at stake.

([22]) See footnote 17.

([23]) OJ C 14, 19.1.2008, p. 6.

4.4.2. *New measure*

Companies may have difficulties in finding finance in the current market circumstances. Therefore the Commission will accept that public or private loans are granted at an interest rate which is at least equal to the central bank overnight rate plus a premium equal to the difference between the average one year interbank rate and the average of the central bank overnight rate over the period from 1 January 2007 to 30 June 2008, plus the credit risk premium corresponding to the risk profile of the recipient, as stipulated by the Commission Communication on the revision of the method for setting the reference and discount rates.

The aid element contained in the difference between this interest rate and the reference rate defined by the Commission Communication on the revision of the method for setting the reference and discount rates will be considered, on a temporary basis, to be compatible with the Treaty on the basis of Article 87(3)(b), provided the following conditions are met:

(a) this method applies to all contracts concluded on 31 December 2010 at the latest; it may cover loans of any duration; the reduced interest rates may be applied for interest payments before 31 December 2012 ([24]); an interest rate at least equal to the rate defined in the reference and discount rate Communication must apply to loans after that date;

(b) the aid is granted to firms which were not in difficulty on 1 July 2008 ([25]); it may be granted to firms that were not in difficulty at that date but entered in difficulty thereafter as a result of the global financial and economic crisis.

4.5. **Aid for the production of green products**

4.5.1. *Existing framework*

The Commission Communication on the revision of the method for setting the reference and discount rates ([26]) establishes a method for calculation of the reference rate, based on the one-year inter-bank offered rate (IBOR) increased by margins ranging from 60 to 1 000 base points, depending on the creditworthiness of the company and the level of collateral offered. The method for calculation of the reference and discount rates may be amended by the Commission in order to reflect the prevailing market conditions. If Member States apply the calculation method of the reference and discount rates established in the Commission communication in force at the moment of the grant of the loan and comply with the conditions set out in that communication, the interest rate does, in principle, not contain State aid.

4.5.2. *New measure*

Because of the current financial crisis, companies are also finding it more difficult to gain access to finance for production of more environmentally friendly products. Aid in the form of guarantees may not be sufficient to finance costly projects aiming at increasing environmental protection by adapting earlier to future standards not yet in force or by going beyond such standards.

The Commission considers that environmental goals should remain a priority despite the financial crisis. Production of more environmentally friendly, including energy-efficient, products, is in the Community's interest and it is important that the financial crisis should not impede that objective.

Therefore, additional measures in the form of subsidised loans could encourage production of 'green products'. However, subsidised loans may cause serious distortions of competition and should be strictly limited to specific situations and targeted investment.

([24]) Member States who want to use this facility have to publish the daily overnight rates online and have to make them available to the Commission.
([25]) See footnote 17.
([26]) OJ C 14, 19.1.2008, p. 6.

The Commission considers that, for a limited period, Member States should be given the possibility of granting aid in the form of an interest-rate reduction.

On the basis of Article 87(3)(b) of the Treaty, the Commission will consider compatible with the common market any interest-rate subsidy for investment loans that meets all the following conditions:

(a) the aid relates to investment loans for financing projects consisting of production of new products which significantly improve environmental protection;

(b) the aid is necessary for launching a new project; in the case of existing projects, aid may be granted if it becomes necessary, due to the new economic situation, in order to pursue the project;

(c) the aid is granted only for projects consisting of production of products involving early adaptation to or going beyond future Community product standards ([27]) which increase the level of environmental protection and are not yet in force;

(d) for products involving early adaptation to or going beyond future Community environmental standards, the investment starts on 31 December 2010 at the latest with the objective of putting the product on the market at least two years before the standard enters into force;

(e) loans may cover the costs of investment in tangible and intangible assets ([28]) with the exception of loans for investments which account for production capacities of more than 3 % on product markets ([29]) where the average annual growth rate, over the last five years before the start of the investment, of the apparent consumption on the EEA market, measured in value data, remained below the average annual growth rate of the European Economic Area's GDP over the same five year reference period;

(f) the loans are granted on 31 December 2010 at the latest;

(g) for calculation of the aid, the starting point should be the individual rate of the beneficiary as calculated on the basis of the methodology contained in point 4.4.2 of this Communication. On the basis of that methodology, the company may benefit from an interest-rate reduction of:

— 25 % for large companies;

— 50 % for SMEs;

(h) the subsidised interest rate applies during a maximum period of 2 years following the granting of loan;

(i) the reduction in the interest rate may be applied to loans granted by the State or public finance institutions and to loans granted by private financial institutions. Non-discrimination between public and private entities should be ensured;

(j) the aid is granted to firms which were not in difficulty ([30]) on 1 July 2008; it may be granted to firms that were not in difficulty at that date but entered in difficulty thereafter as a result of the global financial and economic crisis;

(k) Member States ensure that the aid is not directly or indirectly transferred to financial entities.

([27]) Future Community product standard means a mandatory Community standard setting environmental levels to be attained for products sold in the Community which has been adopted but is not yet in force.
([28]) As defined in point 70 of the Community guidelines on State aid for environmental protection.
([29]) As defined in point 69 of the Guidelines on national regional aid for 2007-2013.
([30]) See footnote 17.

4.6. **Risk capital measures**

4.6.1. *Existing framework*

The Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises set out the conditions under which State aid supporting risk capital investment may be considered compatible with the common market in accordance with Article 87(3) of the Treaty.

Based on the experience gained from applying the guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, the Commission considers that there is no general risk capital market failure in the Community. It does, however, accept that there are market gaps for some types of investment at certain stages of enterprises' development which are the result of imperfect matching of supply of and demand for risk capital and can generally be described as an equity gap.

Point 4.3 of the guidelines states that for tranches of finance not exceeding EUR 1,5 million per target SME over each period of twelve months, under certain conditions market failure is presumed and does not need to be demonstrated by Member States.

Point 5.1(a) of the same guidelines states that *'The Commission is aware of the constant fluctuation of the risk capital market and of the equity gap over time, as well as of the different degree by which enterprises are affected by the market failure depending on their size, on their stage of business development, and on their economic sector. Therefore, the Commission is prepared to consider declaring risk capital measures providing for investment tranches exceeding the threshold of EUR 1,5 million per enterprise per year compatible with the common market, provided the necessary evidence of the market failure is submitted'*.

4.6.2. *Temporary adaptation of the existing rules*

The turmoil on the financial market has had a negative effect on the risk capital market for early growth SMEs by tightening the availability of risk capital. Due to the currently greatly increased risk perception associated with risk capital linked with uncertainties resulting from possibly lower yield expectations, investors are currently tending to invest in safer assets the risks of which are easier to assess as compared to those associated with risk capital investments. Furthermore the illiquid nature of risk capital investments has proven to be a further disincentive for investors. There is evidence that the resulting restricted liquidity under current market circumstances has widened the equity gap for SMEs. It is therefore considered appropriate to temporarily raise the safe-harbour threshold for risk capital investments to meet the increased equity gap and to temporarily lower the percentage of minimum private investor participation to 30 % also in the case of measures targeting SMEs in non assisted areas.

Accordingly, on the basis of Article 87(3)(b) of the Treaty, certain limits set out in the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises are temporarily adapted until 31 December 2010 as follows:

(a) for the purposes of point 4.3.1:, the maximum permitted tranches of finance are increased to EUR 2,5 million, from EUR 1,5 million per target SME over each period of twelve months;

(b) for the purposes of point 4.3.4, the minimum amount of funding to be provided by private investors is 30 % both in and outside assisted areas;

(c) other conditions laid down in the guidelines remain applicable;

(d) this temporary adaptation of the guidelines does not apply to risk capital measures covered by the GBER.

(e) Member States may adapt approved schemes to reflect the temporary adaptation of the guidelines.

4.7. **Cumulation**

The aid ceilings fixed under this Communication will be applied regardless of whether the support for the aided project is financed entirely from State resources or partly financed by the Community.

The temporary aid measures foreseen by this Communication may not be cumulated with aid falling within the scope of the *de minimis* Regulation for the same eligible costs. If the undertaking has already received *de minimis* aid prior to the entry into force of this temporary framework the sum of the aid received under the measures covered by point 4.2 of this Communication and the *de minimis* aid received must not exceed EUR 500 000 between 1 January 2008 and 31 December 2010. The amount of *de minimis* aid received from 1 January 2008 must be deducted from the amount of compatible aid granted for the same purpose under points 4.3, 4.4, 4.5 or 4.6.

The temporary aid measures may be cumulated with other compatible aid or with other forms of Community financing provided that the maximum aid intensities indicated in the relevant guidelines or block exemptions Regulations are respected.

5. **SIMPLIFICATION MEASURES**

5.1. **Short-term export credit insurance**

The Communication from the Commission to Member States pursuant to Article 93(1) of the EC Treaty applying Articles 92 and 93 of the Treaty to short-term export-credit insurance [31] stipulates that marketable risks cannot be covered by export-credit insurance with the support of Member States. Marketable risks are commercial and political risks on public and non-public debtors established in countries listed in the Annex to that Communication, with a maximum risk period of less than two years. Risks concerning debtors established in the Member States and eight further members of the Organisation for Economic Co-operation and Development are considered marketable.

The Commission considers that, as a consequence of the current financial crisis, a lack of insurance or reinsurance capacity does not exist in every Member State, but it cannot be excluded that, in certain countries cover for marketable risks could be temporarily unavailable.

Point 4.4 of the Communication states that: *'In such circumstances, those temporarily non-marketable risks may be taken on to the account of a public or publicly supported export-credit insurer for non-marketable risks insured for the account of or with the guarantee of the State. The insurer should, as far as possible, align its premium rates for such risks with the rates charged elsewhere by private export-credit insurers for the type of risk in question.*

Any Member State intending to use that escape clause should immediately notify the Commission of its draft decision. That notification should contain a market report demonstrating the unavailability of cover for the risks in the private insurance market by producing evidence thereof from two large, well-known international private export-credit insurers as well as a national credit insurer, thus justifying the use of the escape clause. It should, moreover, contain a description of the conditions which the public or publicly supported export-credit insurer intends to apply in respect of such risks.

Within two months of the receipt of such notification, the Commission will examine whether the use of the escape clause is in conformity with the above conditions and compatible with the Treaty.

If the Commission finds that the conditions for the use of the escape clause are fulfilled, its decision on compatibility is limited to two years from the date of the decision, provided that the market conditions justifying the use of the escape clause do not change during that period.

Furthermore, the Commission may, in consultation with the other Member States, revise the conditions for the use of the escape clause; it may also decide to discontinue it or replace it with another appropriate system.'

[31] OJ C 281, 17.9.1997, p. 4.

Those provisions, applicable to large companies and SMEs, are an appropriate instrument in the current economic situation if Member States consider that cover is unavailable on the private insurance market for certain marketable credit risks and/or for certain buyers of risk protection.

In this context, in order to speed up the procedure for Member States, the Commission considers that, until 31 December 2010, Member States may demonstrate the lack of market by providing sufficient evidence of the unavailability of cover for the risk in the private insurance market. Use of the escape clause will in any case be considered justified if:

— a large well-known international private export credits insurer and a national credit insurer produce evidence of the unavailability of such cover or

— at least four well-established exporters in the Member State produce evidence of refusal of cover from insurers for specific operations.

The Commission, in close cooperation with the Member States concerned, will ensure swift adoption of decisions concerning the application of the escape clause.

5.2. **Simplification of procedures**

State aid measures referred to in this Communication must be notified to the Commission. Beyond the substantive measures set out in this Communication, the Commission is committed to ensuring the swift authorisation of aid measures that address the current crisis in accordance with this Communication provided close cooperation and full information is provided by the Member States concerned.

This commitment will complement the on-going process, whereby the Commission is currently drafting a number of improvements to its general State aid procedures, particularly to allow quicker and more effective decision-making in close cooperation with Member States. This general simplification package should, in particular, enshrine joint commitments by the Commission and Member States to more streamlined and predictable procedures at each step of a State aid investigation and allow faster approval of straightforward cases.

6. **MONITORING AND REPORTING**

Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty ([32]) and Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty ([33]) require Member States to submit annual reports to the Commission.

By 31 July 2009, Member States must provide the Commission with a list of schemes put in place on the basis of this Communication.

Member States must ensure that detailed records regarding the granting of aid provided for by this Communication are maintained. Such records, which must contain all information necessary to establish that the necessary conditions have been observed, must be maintained for 10 years and be provided to the Commission upon request. In particular, Member States must have obtained information demonstrating that the aid beneficiaries under the measures provided for in points 4.2, 4.3, 4.4 and 4.5 were not companies in difficulty on 1 July 2008.

In addition, a report on the measures put in place on the basis of this Communication should be provided to the Commission by Member States by 31 October 2009. In particular, the report should provide elements indicating the need for the Commission to maintain the measures provided for by this Communication after 31 December 2009, as well as detailed information on the environmental benefits of the subsidised loans. Member States must provide this information for any subsequent year during which this Communication is applied, before 31 October of each year.

([32]) OJ L 83, 27.3.1999, p. 1.
([33]) OJ L 140, 30.4.2004, p. 1.

The Commission may request additional information regarding the aid granted, to check whether the conditions laid down in the Commission decision approving the aid measure have been met.

7. FINAL PROVISIONS

The Commission applies this Communication from 17 December 2008, the date on which it agreed in principle its content, having regard to the financial and economic context which required immediate action. This Communication is justified by the current exceptional and transitory financing problems related to the banking crisis and will not be applied after 31 December 2010. After consulting Member States, the Commission may review it before that date on the basis of important competition policy or economic considerations. Where this would be helpful, the Commission may also provide further clarifications of its approach to particular issues.

The Commission applies the provisions of this Communication to all notified risk capital measures on which it must take a decision after 17 December 2008, even if the measures were notified prior to that date.

In accordance with the Commission notice on the determination of the applicable rules for the assessment of unlawful State aid ([34]), the Commission applies the following in respect of non-notified aid:

(a) this Communication, if the aid was granted after 17 December 2008;

(b) the guidelines applicable when the aid was granted in all other cases.

The Commission, in close cooperation with the Member States concerned, ensures swift adoption of decisions upon complete notification of measures covered by this Communication. Member States should inform the Commission of their intentions and notify plans to introduce such measures as early and comprehensively as possible.

The Commission wishes to recall that any procedural improvement depends entirely on submission of clear and complete notifications.

([34]) OJ C 119, 22.5.2002, p. 22.

ANNEX

Safe-harbours Temporary Framework in basis points (*)

Rating category (Standard & Poor's)	Collateralisation		
	High	Normal	Low
AAA	40	40	40
AA+ AA AA-	40	40	40
A+ A A-	40	55	55
BBB+ BBB BBB-	55	80	80
BB+ BB	80	200	200
BB- B+	200	380	380
B B-	200	380	630
CCC and below	380	630	980

(*) For companies which do not have a credit history or a rating based on a balance sheet approach (such as certain special purpose companies or start-up companies), Member States may grant a reduction up to 15 % (25 % for SMEs) on the specific safe-harbour premium set at 3,8 % in the 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, 20.6.2008). However, the premium can never be lower than the premium which would be applicable to the parent company or companies.

II

(Information)

INFORMATION FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COMMISSION

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

(2008/C 270/02)

1. INTRODUCTION

1. The global financial crisis has intensified markedly and has now impacted heavily on the EU banking sector. Over and above specific problems related in particular to the US mortgage market and mortgage-backed assets or linked to losses stemming from excessively risky strategies of individual banks, there has been a general erosion of confidence in the past weeks within the banking sector. The pervasive uncertainty about the credit risk of individual financial institutions has dried up the market of interbank lending and has consequently made access to liquidity progressively more difficult for financial institutions across the board.

2. The current situation threatens the existence of individual financial institutions with problems that are a result of their particular business model or business practices whose weaknesses are exposed and exacerbated by the crisis in the financial markets. If such institutions are to be returned to long-term viability rather than liquidated, a far reaching restructuring of their operations will be required. Under the prevailing circumstances, the crisis equally affects financial institutions that are fundamentally sound and whose difficulties stem exclusively from the general market conditions which have severely restricted access to liquidity. Long-term viability of these institutions may require less substantial restructuring. In any case however, measures taken by a Member State to support (certain) institutions operating within its national financial market may favour these institutions to the detriment of others operating within that Member State or in other Member States.

3. The ECOFIN Council on 7 October 2008 adopted Conclusions committing to take all necessary measures to enhance the soundness and stability of the banking system in order to restore confidence and the proper functioning of the financial sector. The recapitalisation of vulnerable systemically relevant financial institutions was recognized as one means, among others, of appropriately protecting the depositors' interests and the stability of the system. It was further agreed that public intervention has to be decided on at national level but within a coordinated framework and on the basis of a number of EU common principles ([1]). On the same occasion the Commission offered to shortly issue guidance as to the broad framework within which the State aid compatibility of recapitalisation and guarantee schemes, and cases of application of such schemes, could be rapidly assessed.

4. Given the scale of the crisis, now also endangering fundamentally sound banks, the high degree of integration and interdependence of European financial markets, and the drastic repercussions of the potential failure of a systemically relevant financial institution further exacerbating the crisis, the Commission recognises that Member States may consider it necessary to adopt appropriate measures to safeguard the stability of the financial system. Due to the particular nature of the current problems in the financial

([1]) The ECOFIN Council conclusions enumerate the following principles:
— interventions should be timely and the support should in principle be temporary,
— Member States will be watchful regarding the interests of taxpayers,
— existing shareholders should bear the due consequences of the intervention,
— Member States should be in a position to bring about a change of management,
— the management should not retain undue benefits — governments may have *inter alia* the power to intervene in remuneration,
— legitimate interest of competitors must be protected, in particular through the State aid rules,
— negative spill-over effects should be avoided.

sector such measures may have to extend beyond the stabilisation of individual financial institutions and include general schemes.

5. While the exceptional circumstances prevailing at the moment have to be duly taken into account when applying the State aid rules to measures addressing the crisis in the financial markets the Commission has to ensure that such measures do not generate unnecessary distortions of competitions between financial institutions operating in the market or negative spillover effects on other Member States. It is the purpose of this Communication to provide guidance on the criteria relevant for the compatibility with the Treaty of general schemes as well as individual cases of application of such schemes and *ad hoc* cases of systemic relevance. In applying these criteria to measures taken by Member States, the Commission will proceed with the swiftness that is necessary to ensure legal certainty and to restore confidence in financial markets.

2. **GENERAL PRINCIPLES**

6. State aid to individual undertakings in difficulties is normally assessed under Article 87(3)(c) of the Treaty and the Community Guidelines on State aid for rescuing and restructuring firms in difficulty ([1]) (hereinafter 'R&R guidelines') which articulate the Commission's understanding of Article 87(3)(c) of the Treaty for this type of aid. The R&R guidelines are of general application, while foreseeing certain specific criteria for the financial sector.

7. In addition, under Article 87(3)(b) of the Treaty the Commission may allow State aid 'to remedy a serious disturbance in the economy of a Member State'.

8. The Commission reaffirms that, in line with the case law and its decision making practice ([2]), Article 87(3)(b) of the Treaty necessitates a restrictive interpretation of what can be considered a serious disturbance of a Member State's economy.

9. In the light of the level of seriousness that the current crisis in the financial markets has reached and of its possible impact on the overall economy of Member States, the Commission considers that Article 87(3)(b) is, in the present circumstances, available as a legal basis for aid measures undertaken to address this systemic crisis. This applies, in particular, to aid that is granted by way of a general scheme available to several or all financial institutions in a Member State. Should the Member State's authorities responsible for financial stability declare to the Commission that there is a risk of such a serious disturbance, this shall be of particular relevance for the Commission's assessment.

10. *Ad hoc* interventions by Member States are not excluded in circumstances fulfilling the criteria of Article 87(3)(b). In the case of both schemes and *ad hoc* interventions, while the assessment of the aid should follow the general principles laid down in the R&R guidelines adopted pursuant to Article 87(3)(c) of the Treaty, the current circumstances may allow the approval of exceptional measures such as structural emergency interventions, protection of rights of third parties such as creditors, and rescue measures potentially going beyond 6 months.

11. It needs to be emphasised, however, that the above considerations imply that the use of Article 87(3)(b) cannot be envisaged as a matter of principle in crisis situations in other individual sectors in the absence of a comparable risk that they have an immediate impact on the economy of a Member State as a whole. As regards the financial sector, invoking this provision is possible only in genuinely exceptional circumstances where the entire functioning of financial markets is jeopardised.

12. Where there is a serious disturbance of a Member State's economy along the lines set out above, recourse to Article 87(3)(b) is possible not on an open-ended basis but only as long as the crisis situation justifies its application.

13. This entails the need for all general schemes set up on this basis, e.g. in the form of a guarantee or recapitalization scheme, to be reviewed on a regular basis and terminated as soon as the economic situation of the Member State in question so permits. While acknowledging that it is currently impossible to predict the duration of the current extraordinary problems in the financial markets and that it may be indispensable in order to restore confidence to signal that a measure will be extended as long as the crisis continues, the Commission considers it a necessary element for the compatibility of any general scheme that the Member State carries out a review at least every six months and reports back to the Commission on the result of such review.

14. Furthermore, the Commission considers that the treatment of illiquid but otherwise fundamentally sound financial institutions in the absence of the current exceptional circumstances should be distinguished from the treatment of financial institutions characterized by endogenous problems. In the first case, viability problems are

([1]) OJ C 244, 1.10.2004, p. 2.

([2]) Cf. in principle case Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, paragraph 167. Confirmed in Commission Decision 98/490/EC in Case C 47/96 *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28), point 10.1, Commission Decision 2005/345/EC in Case C 28/02 *Bankgesellschaft Berlin* (OJ L 116, 4.5.2005, p. 1), points 153 *et seq.* and Commission Decision 2008/263/EC in Case C 50/06 *BAWAG* (OJ L 83, 26.3.2008, p. 7), point 166. See Commission Decision in Case NN 70/07 *Northern Rock* (OJ C 43, 16.2.2008, p. 1), Commission Decision in Case NN 25/08 *Rescue aid to WestLB* (OJ C 189, 26.7.2008, p. 3), Commission Decision of 4 June 2008 in Case C 9/08 *SachsenLB*, not yet published.

inherently exogenous and have to do with the present extreme situation in the financial market rather than with inefficiency or excessive risk-taking. As a result distortions of competition resulting from schemes supporting the viability of such institutions will normally be more limited and require less substantial restructuring. By contrast, other financial institutions, likely to be particularly affected by losses stemming for instance from inefficiencies, poor asset-liability management or risky strategies, would fit with the normal framework of rescue aid, and in particular need a far-reaching restructuring, as well as compensatory measures to limit distortions of competition ([1]). In all cases, however, in the absence of appropriate safeguards, distortions of competition may be substantial from the implementation of guarantee and recapitalization schemes, as they could unduly favour the beneficiaries to the detriment of their competitors or may aggravate the liquidity problems for financial institutions located in other Member States.

15. Moreover, in line with the general principles underlying the State aid rules of the Treaty, which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimized as far as possible, and taking due account of the current circumstances, all general support measures have to be:

— well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,

— proportionate to the challenge faced, not going beyond what is required to attain this effect, and

— designed in such a way as to minimize negative spill-over effects on competitors, other sectors and other Member States.

16. The observance of these criteria in compliance with the State aid rules and the fundamental freedoms enshrined in the Treaty, including the principle of non-discrimination, is necessary for the preservation of the proper functioning of the internal market. In its assessment, the Commission will take into account the following criteria to decide upon the compatibility of the State aid measures enumerated below.

3. GUARANTEES COVERING THE LIABILITIES OF FINANCIAL INSTITUTIONS

17. The principles set out above translate into the following considerations as regards guarantee schemes protecting liabilities established by way of a declaration, legislation or contractual regime, it being understood that these considerations are of a general nature and need to be adapted to the particular circumstances of every individual case.

([1]) It being understood that the exact nature and timing of the restructuring to be carried out may be affected by the present turmoil in the financial markets.

Eligibility for a guarantee scheme

18. A significant distortion of competition may arise if some market players are excluded from the benefit of the guarantee. The eligibility criteria of financial institutions for coverage by such a guarantee must be objective, taking due account of their role in the relevant banking system and the overall economy, and non-discriminatory so as to avoid undue distortive effects on neighbouring markets and the internal market as a whole. In application of the principle of non discrimination on the grounds of nationality, all institutions incorporated in the Member State concerned, including subsidiaries, and with significant activities in that Member State should be covered by the scheme.

Material scope of a guarantee — types of liabilities covered

19. In the present exceptional circumstances, it may be necessary to reassure depositors with financial institutions that they will not suffer losses, so as to limit the possibility of bank runs and undue negative spillover effects on healthy banks. In principle, therefore, in the context of a systemic crisis, general guarantees protecting retail deposits (and debt held by retail clients) can be a legitimate component of the public policy response.

20. As regards guarantees going beyond retail deposits, the selection of the types of debt and liabilities covered must be targeted, to the extent practicable, to the specific source of difficulties and restricted to what can be considered necessary to confront the relevant aspects of the current financial crisis, as they could otherwise delay the necessary adjustment process and generate harmful moral hazard ([2]).

21. In the application of this principle, the drying-up of interbank lending due to an erosion of confidence between financial institutions may also justify guaranteeing certain types of wholesale deposits and even short and medium-term debt instruments, to the extent such liabilities are not already adequately protected by existing investor arrangements or other means ([3]).

22. The extension of the coverage of any guarantee to further types of debt beyond this relatively broad scope would require a closer scrutiny as to its justification.

23. Such guarantees should not, in principle, include subordinated debt (tier 2 capital) or an indiscriminate coverage of all liabilities, as it would merely tend to safeguard the interests of shareholders and other risk capital investors. If such debt is covered, thereby allowing expansion of capital and thus of lending activity, specific restrictions may be necessary.

([2]) The limitation of the amount of the guarantee available, possibly in relation to the balance sheet size of the beneficiary may also be an element safeguarding the proportionality of the scheme in this respect.

([3]) Such as, for example, covered bonds and debt and deposits with collateral in government bonds or covered bonds.

Temporal scope of the guarantee scheme

24. The duration and scope of any guarantee scheme going beyond retail deposit guarantee schemes must be limited to the minimum necessary. In line with the general principles set out above, taking into account the currently unpredictable duration of the fundamental shortcomings in the functioning of financial markets, the Commission considers it a necessary element for the compatibility of any general scheme for the Member State to carry out a review every six months, covering the justification for the continued application of the scheme and the potential for adjustments to deal with evolution in the situation of financial markets. The results of this review will have to be submitted to the Commission. Provided that such regular review is ensured, the approval of the scheme may cover a period longer than six months and up to two years in principle. It may be further extended, upon Commission approval, as long as the crisis in the financial markets so requires. Should the scheme permit guarantees to continue to cover the relevant debt until a maturity date later than the expiry of the issuance period under the scheme, additional safeguards would be necessary in order to prevent excessive distortion of competition. Such safeguards may include a shorter issuance period than that allowed in principle under the present communication, deterrent pricing conditions and appropriate quantitative limits on the debt covered.

Aid limited to the minimum — private sector contribution

25. In application of the general State aid principle that the amount and intensity of the aid must be limited to the strict minimum, Member States have to take appropriate steps to ensure a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee and, where the need arises, the cost of State intervention if the guarantee has to be drawn upon.

26. The exact calculation and composition of such contribution depends on the particular circumstances. The Commission considers that an adequate combination of some or all of the following elements ([1]) would satisfy the requirement of aid being kept to the minimum:

— the guarantee scheme must be based on an adequate remuneration by the beneficiary financial institutions individually and/or the financial sector at large ([2]). Bearing in mind the difficulty of determining a market rate for guarantees of this nature and dimension in the absence of a comparable benchmark, and taking into account the potential difficulties in the current circumstances for beneficiaries to bear the amounts that might properly be charged, the fees charged for the provision of the scheme should come as close as possible to what could be considered a market price. Appropriate pricing mechanisms reflecting the varying degree of risks and the beneficiaries' different credit profiles and needs, will be important contributions to the proportionality of the measure,

— if the guarantee has to be activated, a further significant private sector contribution could consist in the coverage of at least a considerable part of the outstanding liabilities incurred by the beneficiary undertaking (if it continues to exist) or by the sector, the Member State's intervention being limited to amounts exceeding this contribution,

— the Commission recognizes that beneficiaries may not immediately be able to pay an appropriate remuneration in its entirety. Therefore, in order to complement or partially substitute the preceding elements, Member States could consider a clawback/better fortunes clause that would require beneficiaries to pay either an additional remuneration for the provision of the guarantee as such (in case it does not have to be activated) or to reimburse at least a part of any amounts paid by the Member State under the guarantee (in case it needs to be drawn upon) as soon as they are in a position to do so.

Avoidance of undue distortions of competition

27. Given the inherent risks that any guarantee scheme will entail negative effects on non-beneficiary banks, including those in other Member States, the system must include appropriate mechanisms to minimize such distortions and the potential abuse of the preferential situations of beneficiaries brought about by a State guarantee. Such safeguards, which are also important to avoid moral hazard, should include an adequate combination of some or all of the following elements ([3]):

— behavioural constraints ensuring that beneficiary financial institutions do not engage in aggressive expansion against the background of the guarantee to the detriment of competitors not covered by such protection. This can be done, for example by:

— restrictions on commercial conduct, such as advertising invoking the guaranteed status of the beneficiary bank, pricing or on business expansion, e.g. through the introduction of a market share ceiling ([4]),

— limitations to the size of the balance-sheet of the beneficiary institutions in relation to an appropriate benchmark (e.g. gross domestic product or money market growth ([5])),

([1]) This is a non-exhaustive list of tools contributing to the objective of keeping the aid to the minimum.

([2]) E.g. through an association of private banks.

([3]) This is a non-exhaustive list of tools contributing to the objective of avoiding undue distortions of competition.

([4]) The retention of profits in order to ensure adequate recapitalization could also be an element to be considered in this context.

([5]) While safeguarding the availability of credit to the economy notably in case of recession.

— the prohibition of conduct that would be irreconcilable with the purpose of the guarantee such as, for example, share repurchases by beneficiary financial institutions or the issuance of new stock options for management,

— appropriate provisions that enable the Member State concerned to enforce these behavioural constraints including the sanction of removing the guarantee protection from a beneficiary financial institution in case of non-compliance.

Follow-up by adjustment measures

28. The Commission considers that, in order to avoid distortions of competition to the maximum extent possible, a general guarantee scheme needs to be seen as a temporary emergency measure to address the acute symptoms of the current crisis in financial markets. Such measures cannot, by definition, represent a fully-fledged response to the root causes of this crisis linked to structural shortcomings in the functioning of the organization of financial markets or to specific problems of individual financial institutions or to a combination of both.

29. Therefore, a guarantee scheme needs to be accompanied, in due course, by necessary adjustment measures for the sector as a whole and/or by the restructuring or liquidation of individual beneficiaries, in particular for those for which the guarantee has to be drawn upon.

Application of the scheme to individual cases

30. Where the guarantee scheme has to be called upon for the benefit of individual financial institutions it is indispensable that this emergency rescue measure aimed to keep the insolvent institution afloat, which gives rise to an additional distortion of competition over and above that resulting from the general introduction of the scheme, is followed up as soon as the situation of the financial markets so permits, by adequate steps leading to a restructuring or liquidation of the beneficiary. This triggers the requirement of the notification of a restructuring or liquidation plan for recipients of payments under the guarantee which will be separately assessed by the Commission as to its compliance with the State aid rules ([1]).

31. In the assessment of a restructuring plan, the Commission will be guided by the requirements:

— to ensure the restoration of long-term viability of the financial institution in question,

— to ensure that aid is kept to the minimum and that there is substantial private participation to the costs of the restructuring,

— to safeguard that there is no undue distortion of competition and no unjustified benefits deriving from the activation of the guarantee.

32. In this assessment, the Commission can build on the experience gathered in the application of State aid rules to financial institutions in the past, having regard to the particular features of a crisis that has reached a dimension to qualify as a serious disturbance of the economy of Member States.

33. The Commission will also take into account the distinction between aid measures necessitated exclusively by the current bottleneck in access to liquidity in relation to an otherwise fundamentally sound financial institution, as opposed to assistance provided to beneficiaries that are additionally suffering from structural solvency problems linked for instance to their particular business model or investment strategy. In principle, assistance to the latter category of beneficiaries is likely to raise greater concerns.

4. RECAPITALISATION OF FINANCIAL INSTITUTIONS

34. A second systemic measure in response to the ongoing financial crisis would be the establishment of a recapitalisation scheme which would be used to support financial institutions that are fundamentally sound but may experience distress because of extreme conditions in financial markets. The objective would be to provide public funds so as to strengthen the capital base of the financial institutions directly or to facilitate the injection of private capital by other means, so as to prevent negative systemic spillovers.

35. In principle, the above considerations in relation to general guarantee schemes apply, *mutatis mutandis*, also to recapitalisation schemes. This holds true for:

— objective and non-discriminatory criteria for eligibility,

— the temporal scope of the scheme,

— limitation of the aid to the strict necessary,

— the need for safeguards against possible abuses and undue distortions of competition, bearing in mind that the irreversible nature of capital injections entails the need for provisions in the scheme which allow the Member State to monitor and enforce the observance of these safeguards and to take steps avoiding undue distortions of competition, where appropriate, at a later stage ([2]), and

([1]) As a matter of principle, the Commission considers that in the event of payments having to be made to beneficiary financial institution, the payment has to be followed within six months by a restructuring plan or a liquidation plan, as the case may be. In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring/liquidation cases. The Commission may consider that there is no need to submit a plan for the pure liquidation of an institution, or where the size of the institution is negligible.

([2]) According to the principles of the R&R guidelines.

— the requirement for recapitalisation as an emergency measure to support the financial institution through the crisis to be followed up by a restructuring plan for the beneficiary to be separately examined by the Commission, taking into account both the distinction between fundamentally sound financial institutions solely affected by the current restrictions on access to liquidity and beneficiaries that are additionally suffering from more structural solvency problems linked for instance to their particular business model or investment strategy and the impact of that distinction on the extent of the need for restructuring.

36. The particular nature of a recapitalisation measure gives rise to the following considerations.

37. Eligibility should be based on objective criteria, such as the need to ensure a sufficient level of capitalisation with respect to the solvency requirements that do not lead to unjustified discriminatory treatment. Evaluation of the need for support by the financial supervisory authorities would be a positive element.

38. The capital injection must be limited to the minimum necessary and should not allow the beneficiary to engage in aggressive commercial strategies or expansion of its activities or other purposes that would imply undue distortions of competition. In that context the maintenance of enhanced minimum solvency requirement levels, and/or limitation to the total size of the balance sheet of the financial institution will be evaluated positively. The beneficiaries should contribute as much as possible in the light of the current crisis through their own means including private participation ([1]).

39. Capital interventions in financial institutions must be done on terms that minimise the amount of the aid. According to the instrument chosen (e.g. shares, warrants, subordinated capital, …) the Member State concerned should, in principle, receive rights, the value of which corresponds to their contribution to the recapitalisation. The issue price of new shares must be fixed on the basis of a market-oriented valuation. In order to ensure that the public support is only given in return for an appropriate counterpart, instruments such as preferred shares with adequate remuneration, will be regarded positively. Alternatively the introduction of claw-back mechanisms or better fortunes clauses will have to be considered.

40. Similar considerations will apply to other measures and schemes aimed at tackling the problem from the financial institutions' asset side, that would contribute to the strengthening of the institutions' capital requirements. In particular, where a Member State buys or swaps assets this will have to be done at a valuation which reflects their underlying risks, with no undue discrimination as to the sellers.

([1]) The upfront provision of a certain contribution may need to be supplemented by provisions allowing the imposition of additional contributions at a later stage.

41. The approval of the aid scheme does not exempt Member States from submitting a report to the Commission on the use of the scheme every six months and individual plans for the beneficiary undertakings within 6 months from the date of the intervention ([2]).

42. As in the case of guarantee schemes but having regard to the inherently irreversible nature of recapitalisation measures, the Commission will carry out its assessment of such plans in such a way as to ensure the coherence of the overall results of recapitalisation under the scheme with those of a recapitalisation measure taken outside such a scheme according to the principles of the R&R guidelines, taking into consideration the particular features of a systemic crisis in the financial markets.

5. CONTROLLED WINDING-UP OF FINANCIAL INSTITUTIONS

43. In the context of the current financial crisis a Member State may also wish to carry out a controlled winding-up of certain financial institutions in its jurisdiction. Such a controlled liquidation, possibly carried out in conjunction with a contribution of public funds, may be applied in individual cases, either as a second step, after rescue aid to an individual financial institution when it becomes clear that the latter cannot be restructured successfully, or in one single action. Controlled winding-up may also constitute an element of a general guarantee scheme, e.g. where a Member State undertakes to initiate liquidation of the financial institutions for which the guarantee needs to be activated.

44. Again, the assessment of such a scheme and of individual liquidation measures taken under such a scheme follows the same lines, *mutatis mutandis*, as set out above for guarantee schemes.

45. The particular nature of a liquidation measure gives rise to the following considerations.

46. In the context of liquidation, particular care has to be taken to minimise moral hazard, notably by excluding shareholders and possibly certain types of creditors from receiving the benefit of any aid in the context of the controlled winding-up procedure.

47. To avoid undue distortions of competition, the liquidation phase should be limited to the period strictly necessary for the orderly winding-up. As long as the beneficiary financial institution continues to operate it should not pursue any new activities, but merely continue the ongoing ones. The banking licence should be withdrawn as soon as possible.

([2]) In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring cases. The Commission may also consider that there is no need to submit a plan relating to a pure liquidation of the institution, or where the size of the residual economic activity is negligible.

48. In ensuring that the aid amount is kept to the minimum necessary in view of the objective pursued, it needs to be taken into account that the protection of financial stability within the current financial turmoil may imply the necessity to reimburse certain creditors of the liquidated bank through aid measures. The choice of criteria for the selection of the types of liabilities for this purpose should follow the same rules as in relation to the liabilities covered by a guarantee scheme.

49. In order to ensure that no aid is granted to the buyers of the financial institution or parts of it or to the entities sold, it is important that certain sales conditions are respected. The following criteria will be taken into account by the Commission when determining the potential existence of aid:

— the sales process should be open and non-discriminatory,

— the sale should take place on market terms,

— the financial institution or the government, depending on the structure chosen, should maximise the sales price for the assets and liabilities involved,

— in case it is necessary to grant an aid to the economic activity to be sold, this will lead to an individual examination according to the principles of the R&R guidelines.

50. Where the application of these criteria leads to the finding of aid to buyers or to sold entities, the compatibility of that aid will have to be assessed separately.

6. **PROVISION OF OTHER FORMS OF LIQUIDITY ASSISTANCE**

51. In dealing with acute liquidity problems of some financial institutions, Member States may wish to accompany guarantees or recapitalisation schemes with complementary forms of liquidity support, with the provisions of public funds (including funds from the central bank). The Commission has already clarified that where a Member State/central bank reacts to a banking crisis not with selective measures in favour of individual banks, but with general measures open to all comparable market players in the market (e.g. lending to the whole market on equal terms), such general measures are often outside the scope of the State aid rules and do not need to be notified to the Commission. The Commission considers for instance that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules. Dedicated support to a specific financial institution may also be found not to constitute aid in specific circumstances. The Commission considers ([1]) that the provision of central banks' funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as:

— the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,

— the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value,

— the central bank charges a penal interest rate to the beneficiary,

— the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

52. The Commission considers that in the current exceptional circumstances a scheme of liquidity support from public sources (including the central bank) where it constitutes aid, can be found compatible, according to the principles of the R&R guidelines. Provided that the regular review of such a liquidity scheme every six months is ensured ([2]), the approval of the scheme may cover a period longer than six months and up to two years, in principle. It may be further extended, upon Commission approval, in the event that the crisis in the financial markets so requires.

7. **RAPID TREATMENT OF STATE AID INVESTIGATIONS**

53. When applying the State aid rules to the measures dealt with in this Communication in a manner that takes account of prevailing financial market conditions, the Commission, in co-operation with the Member States, should ensure both that they achieve their objective and that the related distortions of competition both within and between Member States are kept to a minimum. In order to facilitate this cooperation and to provide both Member States and third parties with the necessary legal certainty on the compliance of the measures undertaken with the Treaty (which is a significant component of restoring confidence to the markets), it is of paramount importance that Member States inform the Commission of their intentions and notify plans to introduce such measures as early and comprehensively as possible and in any event before the measure is implemented. The Commission has taken appropriate steps to ensure the swift adoption of decisions upon complete notification, if necessary within 24 hours and over a weekend.

([1]) See for instance *Northern Rock* (OJ C 43, 16.2.2008, p. 1).

([2]) The principles set out above in point 24 would apply to this review.

Communication from the Commission — The recapitalisation of financial institutions [1] in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition

(Text with EEA relevance)

(2009/C 10/03)

1. INTRODUCTION

(1) The Commission Communication of 13 October 2008 on *The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis* [2] ('the Banking Communication') recognizes that recapitalisation schemes are one of the key measures that Member States can take to preserve the stability and proper functioning of financial markets.

(2) The ECOFIN Council of 7 October 2008 and the Eurogroup meeting of 12 October 2008 addressed recapitalisation in a similar spirit by concluding that '*Governments commit themselves to provide capital when needed in appropriate volume while favouring by all available means the raising of private capital. Financial institutions should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non beneficiaries*', and '*legitimate interest of competitors must be protected, in particular through the State aid rules*'.

(3) So far, the Commission has approved recapitalisation schemes in three Member States, as well as individual recapitalisation measures, in line with the principles laid down in the Banking Communication [3]. Recapitalisation, notably in the form of ordinary and preferred shares, has been authorized, subject in particular to the introduction of market-oriented remuneration rates, appropriate behavioural safeguards and regular review. However, as the nature, scope and conditions of recapitalisation schemes currently being envisaged vary considerably, both Member States and potential beneficiary institutions have called for more detailed guidance as to whether specific forms of recapitalisation would be acceptable under State aid rules. In particular, some Member States envisage the recapitalisation of banks, not primarily to rescue them but rather to ensure lending to the real economy. The ECOFIN Council of 2 December 2008 recognised the need for further guidance for precautionary recapitalisations to sustain credit, and called for its urgent adoption by the Commission. The present Communication provides guidance for new recapitalisation schemes and opens the possibility for adjustment of existing recapitalisation schemes.

Common objectives: Restoring financial stability, ensuring lending to the real economy and dealing with the systemic risk of possible insolvency

(4) In the context of the current situation in the financial markets, the recapitalisation of banks can serve a number of objectives. First, recapitalisations contribute to the restoration of financial stability and help restore the confidence needed for the recovery of inter-bank lending. Moreover, additional capital provides a cushion in recessionary times to absorb losses and limits the risk of banks becoming insolvent. Under current conditions, triggered in particular by the collapse of Lehman Brothers, fundamentally sound banks may require capital injections to respond to a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk and the increased cost of funding.

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[1] For the convenience of the reader, financial institutions are referred to simply as 'banks' in this document.

[2] OJ C 270, 25.10.2008, p. 8.

[3] See Commission Decision of 13 October 2008 in Case N 507/08 *Financial Support Measures to the banking Industry in the UK* (OJ C 290, 13.11.2008, p. 4), Commission Decision of 27 October 2008 in Case N 512/08 *Support measures for financial institutions in Germany* (OJ C 293, 15.11.2008, p. 2) and Commission Decision of 19 November 2008 in Case N 560/08 *Support measures for the credit institutions in Greece*, Commission Decision of 12 November 2008 in Case N 528/08 the Netherlands, *Aid to ING Groep N.V.*, Commission Decision of 25 November 2008 in Case NN 68/08 on *Latvian State support to JSC Parex Banka*.

(5) Second, recapitalisations can have as objective to ensure lending to the real economy. Fundamentally sound banks may prefer to restrict lending in order to avoid risk and maintain higher capital ratios. State capital injection may prevent credit supply restrictions and limit the pass-on of the financial markets' difficulties to other businesses.

(6) Third, State recapitalisation may also be an appropriate response to the problems of financial institutions facing insolvency as a result of their particular business model or investment strategy. A capital injection from public sources providing emergency support to an individual bank may also help to avoid short term systemic effects of its possible insolvency. In the longer term, recapitalisation could support efforts to prepare the return of the bank in question to long term viability or its orderly winding-up.

Possible competition concerns

(7) With these common objectives in mind, the assessment of any recapitalisation scheme or measure must take into account possible distortions of competition at three different levels.

(8) First, recapitalisation by one Member State of its own banks should not give those banks an undue competitive advantage over banks in other Member States. Access to capital at considerably lower rates than competitors from other Member States, in the absence of an appropriate risk-based justification, may have a substantial impact on the competitive position of a bank in the wider single European market. Excessive aid in one Member State could also prompt a subsidy race among Member States and create difficulties for the economies of Member States which have not introduced recapitalisation schemes. A coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalisation, is indispensable to the preservation of a level playing field. Unilateral and uncoordinated action in this area may also undermine efforts to restore financial stability ('Ensuring fair competition between Member States').

(9) Secondly, recapitalisation schemes which are open to all banks within a Member State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles may give an undue advantage to distressed or less-performing banks compared to banks which are fundamentally sound and better-performing. This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of European banks ('Ensuring fair competition between banks').

(10) Thirdly, public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position. A public scheme which crowds out market-based operations will frustrate the return to normal market functioning ('Ensuring a return to normal market functioning').

(11) Any proposed recapitalisation has cumulative competitive effects at each of these three levels. However, a balance must be struck between these competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the one hand, banks must have sufficiently favourable terms of access to capital in order to make the recapitalisation as effective as necessary. On the other hand, the conditions tied to any recapitalisation measure should ensure a level playing field and, in the longer-term, a return to normal market conditions. State interventions should therefore be proportionate and temporary and should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances permit, in order for a competitive and efficient European banking sector to emerge from the crisis. Market-oriented pricing of capital injections would be the best safeguard against unjustified disparities in the level of capitalisation and improper use of such capital. In all cases, Member States should ensure that any recapitalisation of a bank is based on genuine need.

(12) The balance to be achieved between financial stability and competition objectives underlines the importance of the distinction between fundamentally sound, well-performing banks on one hand and distressed, less-performing banks on the other.

(13) In its assessment of recapitalisation measures, whether in the form of schemes or support to individual banks, the Commission will therefore pay particular attention to the risk profile of the beneficiaries ([1]). In principle, banks with a higher risk profile should pay more. In designing recapitalisation schemes open to a set of different banks, Member States should carefully consider the entry criteria and the treatment of banks with different risk profiles and differentiate in their treatment accordingly (see Annex 1). Account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis.

(14) In addition to indicators such as compliance with regulatory solvency requirements and prospective capital adequacy as certified by the national supervisory authorities, pre-crisis CDS spreads and ratings should, for example, be a good basis for differentiation of remuneration rates for different banks. Current spreads may also reflect inherent risks which will weaken the competitive situation of some banks as they come out of the general crisis conditions. Pre-crisis and current spreads should in any event reflect the burden, if any, of toxic assets and/or the weakness of the bank's business model due to factors such as overdependence on short-term financing or abnormal leverage.

(15) It may be necessary, in duly justified cases, to accept lower remuneration in the short term for distressed banks, on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures. Financially sound banks may be entitled to relatively low rates of entry to any recapitalisation, and correspondingly significantly reduced conditions on public support in the longer term, provided that they accept terms on the redemption or conversion of the instruments so as to retain the temporary nature of the State's involvement, and its objective of restoring financial stability/lending to the economy, and the need to avoid abuse of the funds for wider strategic purposes.

Recommendations of the Governing Council of the European Central Bank (ECB)

(16) In the Recommendations of its Governing Council of 20 November 2008, the European Central Bank proposed a methodology for benchmarking the pricing of State recapitalisation measures for fundamentally sound institutions in the Euro area. The guiding considerations underlying these Recommendations fully reflect the principles set out in this introduction. In line with its specific tasks and responsibilities, the ECB places particular emphasis on the effectiveness of recapitalisation measures with a view to strengthening financial stability and fostering the undisturbed flow of credit to the real economy. At the same time, it underlines the need for market-oriented pricing, including the specific risk of the individual beneficiary banks and the need to preserve a level playing field between competing banks.

(17) The Commission welcomes the ECB Recommendations which propose a pricing scheme for capital injections based on a corridor for rates of return for beneficiary banks which, notwithstanding variations in their risk profile, are fundamentally sound financial institutions. This document aims to extend guidance to conditions other than remuneration rates and to the terms under which banks which are not fundamentally sound may have access to public capital.

(18) In addition, while acknowledging that the current exceptional market rates do not constitute a reasonable benchmark for determining the correct level of remuneration of capital, the Commission is of the view that recapitalisation measures by Member States should take into account the underestimation of risk in the pre-crisis period. Without this, public remuneration rates could give undue competitive advantages to beneficiaries and eventually lead to the crowding out of private recapitalisation.

([1]) See Annex 1 for more details.

2. PRINCIPLES GOVERNING DIFFERENT TYPES OF RECAPITALISATION

(19) Closeness of pricing to market prices is the best guarantee to limit competition distortions ([1]). It follows that the design of recapitalisation should be determined in a way that takes the market situation of each institution into account, including its current risk profile and level of solvency, and maintains a level playing field by not providing too large a subsidy in comparison to current market alternatives. In addition, pricing conditions should provide an incentive for the bank to redeem the State as soon as the crisis is over.

(20) These principles translate into the assessment of the following elements of the overall design of recapitalisation measures: objective of recapitalisation, soundness of the beneficiary bank, remuneration, exit incentives, in particular with a view to the replacement of State capital by private investors ([2]), to ensure the temporary nature of the State's presence in banks' capital, safeguards against abuse of aid and competition distortions, and the review of the effects of the recapitalisation scheme and the beneficiaries' situation through regular reports or restructuring plans where appropriate.

2.1. *Recapitalisations at current market rates*

(21) Where State capital injections are on equal terms with significant participation (30 % or more) of private investors, the Commission will accept the remuneration set in the deal ([3]). In view of the limited competition concerns raised by such an operation, unless the terms of the deal are such as to significantly alter the incentives of private investors, in principle there does not appear to be any need for *ex ante* competition safeguards or exit incentives.

2.2. *Temporary recapitalisations of fundamentally sound banks in order to foster financial stability and lending to the real economy*

(22) In evaluating the treatment of banks in this category, the Commission will place considerable weight on the distinction between fundamentally sound and other banks which has been discussed in paragraphs 12 to 15.

(23) An overall remuneration needs to adequately factor in the following elements:

(a) current risk profile of each beneficiary ([4]);

(b) characteristics of the instrument chosen, including its level of subordination; risk and all modalities of payment ([5]);

(c) built-in incentives for exit (such as step-up and redemption clauses);

(d) appropriate benchmark risk-free rate of interest.

(24) The *remuneration* for State recapitalisations cannot be as high as current market levels (about 15 %) ([6]) since these may not necessarily reflect what could be considered as normal market conditions ([7]). Consequently, the Commission is prepared to accept the *price* for recapitalisations of fundamentally

([1]) See point 39 of the Banking Communication.
([2]) All the references to exit incentives or incentives to redeem the State in this document have to be understood as aiming at the replacement of State capital by private capital to the extent necessary and appropriate in the context of a return to normal market conditions.
([3]) See for example Commission Decision of 27 October 2008 in Case N 512/08 *Support measures for financial institutions in Germany*, point 54.
([4]) See Annex 1 for more details.
([5]) For example, a number of parameters increase or decrease the value of preferred shares, depending on their exact definition, such as: convertibility into ordinary shares or other instruments, cumulative or non-cumulative dividends, fixed or adjustable dividend rate, liquidation preference before ordinary shares, participation or not in earnings above dividend rate paid to ordinary shares, put option, redemption clauses, voting rights. The Commission will use the general classification of capital instrument among the different regulatory categories as a benchmark (e.g. core/non core, Tier 1/Tier 2).
([6]) For example JP Morgan, Europe Credit Research, 27 October 2008; Merrill Lynch data on euro denominated Tier 1 debt from at least investment grade rated financial institutions, publicly issued in the Eurobond market or in the domestic market of Member States' having adopted the euro. Data are provided by ECOWIN (ml: et10yld).
([7]) Current levels of remuneration may also reflect present relatively high demand for Tier 1 capital, as banks move away from what is now perceived as the undercapitalised business model of the past, combined with relatively small supply and high market volatility.

sound banks at rates below current market rates, in order to facilitate banks to avail themselves of such instruments and to thereby favour the restoration of financial stability and ensuring lending to the real economy.

(25) At the same time, the total expected return on recapitalisation to the State should not be too distant from current market prices because (i) it should avoid the pre-crisis under-pricing of risk, (ii) it needs to reflect the uncertainty about the timing and level of a new price equilibrium, (iii) it needs to provide incentives for exiting the scheme and (iv) it needs to minimise the risk of competition distortions between Member States, as well as between those banks which raise capital on the market today without any State aid. A remuneration rate not too distant from current market prices is essential to avoid crowding out recapitalisation via the private sector and facilitating the return to normal market conditions.

Entry level price for recapitalisations

(26) The Commission considers that an adequate method to determine the price of recapitalisations is provided by the Eurosystem recommendations of 20 November 2008. The remunerations calculated using this methodology represent in the view of the Eurosystem an appropriate basis (entry level) for the required nominal rate of return for the recapitalisation of fundamentally sound banks. This price may be adjusted upwards to account for the need to encourage the redemption of State capital ([1]). The Commission considers that such adjustments will also serve the objective of protecting undistorted competition.

(27) The Eurosystem recommendations consider that the required rate of return by the government on recapitalisation instruments for *fundamentally sound banks* — preferred shares and other hybrid instruments — could be determined on the basis of a 'price corridor' defined by: (i) the required rate of return on subordinated debt representing a *lower bound*, and (ii) the required rate of return on ordinary shares representing an *upper bound*. This methodology involves the calculation of a price corridor on the basis of different components, which should also reflect the specific features of individual institutions (or sets of similar institutions) and of Member States. The application of the methodology by using average (mean or median) values of the relevant parameters (government bond yields, CDS spreads, equity risk premia) determines a corridor with an average required rate of return of 7 % on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9,3 % on ordinary shares relating to Euro area banks. As such, this average price corridor represents an indicative range.

(28) The Commission will accept a minimum remuneration based on the above methodology for fundamentally sound banks ([2]). This remuneration is differentiated at the level of an individual bank on the basis of different parameters:

(a) the type of capital chosen ([3]): the lower the subordination, the lower the required remuneration in the price corridor;

(b) appropriate benchmark risk-free interest rate;

(c) the individual risk profile at national level of all eligible financial institutions, (including both financially sound and distressed banks).

(29) Member States may choose a pricing formula that in addition includes step-up or payback clauses. Such features should be appropriately chosen so that, while encouraging an early end to the State's capital support of banks, they should not result in an excessive increase in the cost of capital.

(30) The Commission will also accept alternative pricing methodologies, provided they lead to remunerations that are higher than the above methodology.

([1]) See points 5 to 7 of the ECB Governing Council recommendations on the pricing of recapitalisations of 20 November 2008.
([2]) Specific situation of Member States outside the Eurosystem may have to be taken into account.
([3]) Such as ordinary shares, non-core Tier 1 capital, or Tier 2 capital.

Incentives for State capital redemption

(31) Recapitalisation measures need to contain appropriate incentives for State capital to be redeemed when the market so allows ([1]). The simplest way to provide an incentive for banks to look for alternative capital is for Member States to require an adequately high remuneration for the State recapitalisation. For that reason, the Commission considers it useful that an add-on be generally added to the entry price determined ([2]) to incentivise exit. A pricing structure including increase over time and step-up clauses will reinforce this mechanism to incentivise exit.

(32) If a Member State prefers not increasing the nominal rate of remuneration, it may consider increasing the global remuneration through call options or other redemption clauses, or mechanisms that encourage private capital raising, for instance by linking the payment of dividends to an obligatory remuneration of the State which increases over time.

(33) Member States may also consider using a restrictive dividend policy to ensure the temporary character of State intervention. A restrictive dividend policy would be coherent with the objective of safeguarding lending to the real economy and strengthening the capital basis of beneficiary banks. At the same time, it would be important to allow for dividend payment where this represents an incentive to provide new private equity to fundamentally sound banks ([3]).

(34) The Commission will assess proposed exit mechanisms on a case-by-case basis. In general, the higher the size of the recapitalization and the higher the risk profile of the beneficiary bank, the more necessary it becomes to set out a clear exit mechanism. The combination of the level and type of remuneration and, where and to the extent appropriate, a restrictive dividend policy, needs to represent, in its entirety, a sufficient exit incentive for the beneficiary banks. The Commission considers, in particular, that restrictions on payment of dividends are not needed where the level of pricing correctly reflects the banks' risk profile, and step-up clauses or comparable elements provide sufficient incentives for exit and the recapitalisation is limited in size.

Prevention of undue distortions of competition

(35) The Banking Communication stresses, in point 35, the need for safeguards against possible abuses and distortions of competition in recapitalisation schemes. Point 38 of the Banking Communication requires capital injections to be limited to the minimum necessary and not to allow the beneficiary to engage in aggressive commercial strategies which would be incompatible with the underlying objectives of recapitalisation ([4]).

(36) As a general principle, the higher the remuneration the less there is a need for safeguards, as the level of price will limit distortions of competition. Banks receiving State recapitalisation should also avoid advertising it for commercial purposes.

(37) Safeguards may be necessary to prevent aggressive commercial expansion financed by State aid. In principle, mergers and acquisitions can constitute a valuable contribution to the consolidation of the banking industry with a view to achieving the objectives of stabilising financial markets and ensuring a steady flow of credit to the real economy. In order not to privilege those institutions with public support to the detriment of competitors without such support, mergers and acquisitions should generally be organised on the basis of a competitive tendering process.

([1]) Taking into account the type of recapitalisation instrument and its classification by supervisory authorities.
([2]) This is all the more important as the method presented above may be affected by under-pricing of risk before the crisis.
([3]) Taking into account these considerations, restrictions on the payment of dividends could for example be limited in time or to a percentage of the generated profits, or linked to the contribution of new capital, (for example by paying out dividends in the form of new shares). Where the redemption of the State is likely to occur in several steps, it could also be envisaged to foresee the gradual relaxation on any restriction on dividends in tune with the progress of redemption.
([4]) Given the objectives of ensuring lending to the real economy, balance sheet growth restrictions are not necessary in recapitalisation schemes of fundamentally sound banks. This should in principle apply also to guarantee schemes, unless there is a serious risk of displacement of capital flows between Member States.

(38) The extent of behavioural safeguards will be based on a proportionality assessment, taking into account all relevant factors and, in particular, the risk profile of the beneficiary bank. While banks with a very low risk profile may require only very limited behavioural safeguards, the need for such safeguards increases with a higher risk profile. The proportionality assessment is further influenced by the relative size of the capital injection by the State and the reached level of capital endowment.

(39) When Member States use recapitalisation with the objective of financing the real economy, they have to ensure that the aid effectively contributes to this. To that end, in accordance with national regulation, they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy.

Review

(40) In addition, as indicated in the Banking Communication ([1]), recapitalisations should be subject to regular review. Six months after their introduction, Member States should submit a report to the Commission on the implementation of the measures taken. The report needs to provide complete information on:

(a) the banks that have been recapitalised, including in relation to the elements identified in point 12 to 15, Annex 1, and an assessment of the bank's business model, with a view to appreciating the banks' risk profile and viability;

(b) the amounts received by those banks and the terms on which recapitalisation has taken place;

(c) the use of the capital received, including in relation to (i) the sustained lending to the real economy and (ii) external growth and (iii) the dividend policy of beneficiary banks;

(d) the compliance with the commitments made by Member States in relation to exit incentives and other conditions and safeguards; and

(e) the path towards exit from reliance on State capital ([2]).

(41) In the context of the review, the Commission will assess, amongst others, the need for the continuation of behavioural safeguards. Depending on the evolution of market conditions, it may also request a revision of the safeguards accompanying the measures in order to ensure that aid is limited to the minimum amount and minimum duration necessary to weather the current crisis.

(42) The Commission recalls that where a bank that was initially considered fundamentally sound falls into difficulties after recapitalisation has taken place, a restructuring plan for that bank must be notified.

2.3. *Rescue recapitalisations of other banks*

(43) The recapitalisation of banks which are not fundamentally sound should be subject to stricter requirements.

(44) As far as remuneration is concerned, as set out above, it should in principle reflect the risk profile of the beneficiary and be higher than for fundamentally sound banks ([3]). This is without prejudice to the possibility for supervisory authorities to take urgent action where necessary in cases of restructuring. Where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. Notwithstanding the need to ensure financial stability, the use of State capital for these banks can only be accepted on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate. Therefore, either a comprehensive restructuring plan or a liquidation plan will have to be presented for these banks within six months of recapitalisation. As indicated in the Banking Communication, such a plan will be assessed according to the principles of the rescue and restructuring guidelines for firms in difficulties, and will have to include compensatory measures.

([1]) See points 34 to 42 of the Banking Communication. In line with the Banking Communication, individual recapitalisation measures taken in conformity with a recapitalisation scheme approved by the Commission do not require notification and will be assessed by the Commission in the context of the review and the presentation of a viability plan.
([2]) Taking into account the characteristics of the recapitalisation instrument.
([3]) See paragraph 28 on the extended price corridor implying increased rates of remuneration for distressed banks.

(45) Until redemption of the State, behavioural safeguards for distressed banks in the rescue and restructuring phases should, in principle, include: a restrictive policy on dividends (including a ban on dividends at least during the restructuring period), limitation of executive remuneration or the distribution of bonuses, an obligation to restore and maintain an increased level of the solvency ratio compatible with the objective of financial stability, and a timetable for redemption of State participation.

2.4. *Final remarks*

(46) Finally, the Commission takes into account the possibility that banks' participation in recapitalisation operations is open to all or a good portion of banks in a given Member State, also on a less differentiated basis, and aimed at achieving an appropriate overall return over time. Some Member States may prefer, for reasons of administrative convenience for instance, to use less elaborated methods. Without prejudice to the possibility for Member States to base their pricing on the methodology above, the Commission will accept pricing mechanisms leading to a level of a total expected annualised return for all banks participating in a scheme sufficiently high to cater for the variety of banks and the incentive to exit. This level should normally be set above the upper bound referred to in paragraph 27 for Tier 1 capital instruments ([1]). This can include a lower entry price and an appropriate step-up, as well as other differentiation elements and safeguards as described above ([2]).

([1]) The Commission has so far accepted recapitalisation measures with a total expected annualised return of at least 10 % for Tier 1 instruments for all banks participating in a scheme. For Member States with risk-free rates of return significantly divergent from the Eurozone average such a level may need to be adapted accordingly. Adjustments will also be necessary in function of developments of the risk-free rates.

([2]) See, as an example of a combination of a low entry price with such differentiation elements, the Commission Decision of 12 November 2008 in Case N 528/08 the Netherlands, *Aid to ING Groep N.V.* where for the remuneration of a sui generis capital instrument categorized as core Tier 1 capital a fixed coupon (8,5 %) is coupled with over-proportionate and increasing coupon payments and a possible upside, which results in an expected annualised return in excess of 10 %.

ANNEX

Pricing of equity

Equity (ordinary shares, common shares) is the best known form of core Tier 1 capital. Ordinary shares are remunerated by uncertain future dividend payments and the increase of the share price (capital gain/loss), both of which ultimately depend on the expectations of future cash flows/profits. In the current situation, a forecast of future cash flows is even more difficult than under normal conditions. The most noticeable factor, therefore, is the quoted market price of ordinary shares. For non-quoted banks, as there is no quoted share price, Member States should come to an appropriate market-based approach, such as full valuation.

If assistance is given in the issuance of ordinary shares (underwriting), any shares not taken up by existing or new investors will be taken up by the Member State as underwriter at the lowest possible price compared to the share price immediately prior to the announcement of placing an open offer. An adequate underwriting fee should also be payable by the issuing institution ([1]). The Commission will take into account the influence that previously received State aid may have on the share price of the beneficiary.

Indicators for the assessment of a bank's risk profile

In evaluating a bank's risk profile for the purpose of the appreciation of a recapitalisation measure under State aid rules, the Commission will take into account the bank's position in particular with respect to the following indicators:

(a) capital adequacy: The Commission will value positively the assessment of the bank's solvency and its prospective capital adequacy as a result of a review by the national supervisory authority; such a review will evaluate the bank's exposure to various risks (such as credit risk, liquidity risk, market risk, interest rate and exchange rate risks), the quality of the asset portfolio (within the national market and in comparison with available international standards), the sustainability of its business model in the long term and other pertinent elements;

(b) size of the recapitalisation: The Commission will value positively a recapitalisation limited in size, such as for instance no more than 2 % of the bank's risk weighted assets;

(c) current CDS spreads: The Commission will consider a spread equal or inferior to the average as an indicator of a lower risk profile;

(d) current rating of the bank and its outlook: The Commission will consider a rating of A or above and a stable or positive outlook as an indicator of a lower risk profile.

In the evaluation of these indicators, account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis, as shown, for instance, by the evolution of market indicators such as CDS spreads and share prices.

Table 1

Types of capital

Debt	**Tier 2**
	Fixed term debt instruments
	Perpetual Subordinated Debt instruments
Greater return required ↓	Cumulative preference shares or other similar instruments
	Tier 1
Greater loss absorbency	Non-cumulative preference shares or other similar instruments
	Other high quality hybrids
Equity	Reserves/Retained earnings
	Ordinary shares

([1]) See for example, Commission Decision of 13 October 2008 in Case N 507/08 *Financial Support Measures to the banking Industry in the UK*, at point 11, Commission Decision of 27 October 2008 in Case N 512/08 *Support measures for financial institutions in Germany*, at point 12.

II

(Information)

INFORMATION FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COMMISSION

Communication from the Commission on the treatment of impaired assets in the Community banking sector

(2009/C 72/01)

1. INTRODUCTION

1. Since mid-2007, the functioning of wholesale credit markets has been severely disrupted. The result has been a drying up of liquidity in the banking sector and a reluctance of banks to lend to each other and to the broader economy. As the disruption of credit markets has intensified over the past eighteen months, the financial crisis has intensified and the global economy has entered a severe recession.

2. It is difficult to envisage a resolution of the financial crisis and a recovery in the global economy without assured stability in the banking sector and the broader financial system. Only then will investor confidence return and banks resume their normal lending behaviour. Accordingly, Member States have put measures in place to support the stability of their banking sectors and underpin lending, notably the injection of new capital using public funds and the provision of government guarantees for bank borrowing. These measures were announced in October 2008 and have been gradually implemented over the past months.

3. Recently, several Member States have announced their intention to complement their existing support measures by providing some form of relief for impaired bank assets. Those announcements, in parallel with a similar initiative in the United States, have triggered a wider debate within the Community on the merits of asset relief as a government support measure for banks. In the context of that debate, this Communication has been prepared by the Commission, in consultation with the European Central Bank (ECB), and builds on the recommendations issued on 5 February 2009 by the Eurosystem (see Annex I).

4. This Communication focuses on issues to be addressed by Member States in considering, designing and implementing asset relief measures. At a general level, those issues include the rationale for asset relief as a measure to safeguard financial stability and underpin bank lending, the longer-term considerations of banking-sector viability and budgetary sustainability to be taken into account when considering asset relief measures and the need for a common and co-ordinated Community approach to asset relief, notably to ensure a level playing field. In the context of such a Community approach, this Communication also offers more specific guidance on the application of State-aid rules to asset relief, focusing on issues such as (i) transparency and disclosure requirements; (ii) burden sharing between the State, shareholders and creditors; (iii) aligning incentives for beneficiaries with public policy objectives; (iv) principles for designing asset relief measures in terms of eligibility, valuation and management of impaired assets; and (v) the relationship between asset relief, other government support measures and the restructuring of banks.

2. ASSET RELIEF AS A MEASURE TO SAFEGUARD FINANCIAL STABILITY AND UNDERPIN BANK LENDING

5. The immediate objectives of the Member State rescue packages announced in October 2008 are to safeguard financial stability and underpin the supply of credit to the real economy. It is too early to draw definitive conclusions on the effectiveness of the packages, but it is clear that they have averted the risk of financial meltdown and have supported the functioning of important inter-bank markets. On the other hand, the evolution in lending to the real economy since the announcement of the packages has been unfavourable, with recent statistics suggesting a sharp deceleration in credit growth ([1]). In many Member States, reports of businesses being denied access to bank credit are now widespread and it would seem that the squeeze on credit goes beyond that justified by cyclical considerations.

6. A key reason identified for the insufficient flow of credit is uncertainty about the valuation and location of impaired assets, a source of problems in the banking sector since the beginning of the crisis. Uncertainty regarding asset valuations has not only continued to undermine confidence in the banking sector, but has weakened the effect of the government support measures agreed in October 2008. For example, bank recapitalisation has provided a cushion against asset impairment but much of the capital buffer provided has been absorbed by banks in provisioning against future asset impairments. Banks have already taken steps to address the problem of impaired assets. They have recorded substantial write-downs in asset values ([2]), taken steps to limit remaining losses by reclassification of assets within their balance sheets and gradually put additional capital aside to strengthen their solvency positions. However, the problem has not been resolved to a sufficient degree and the unexpected depth of the economic slowdown now suggests a further and more extensive deterioration in credit quality of bank assets.

7. Asset relief would directly address the issue of uncertainty regarding the quality of bank balance sheets and therefore help to revive confidence in the sector. It could also help to avoid the risk of repeated rounds of recapitalisation of banks as the extent of asset impairment increases amid a deteriorating situation in the real economy. On this basis, several Member States are actively considering relief for impaired bank assets as a complement to other measures in implementing the strategy agreed by Heads of State and Government in October 2008.

3. LONGER-TERM CONSIDERATIONS: A RETURN TO VIABILITY IN THE BANKING SECTOR AND SUSTAINABILITY OF PUBLIC FINANCES

8. Asset relief measures must be designed and implemented in the manner that most effectively achieves the immediate objectives of safeguarding financial stability and underpinning bank lending. An important issue to be addressed in this context is ensuring an adequate participation in the asset relief measures by setting appropriate pricing and conditions and through mandatory participation if deemed necessary. However, the focus in designing and implementing asset relief measures should not be limited to these immediate objectives. It is essential that longer-term considerations are also taken into account.

9. If asset relief measures are not carried out in such a way as to ring-fence the danger of serious distortions of competition among banks (both within Member States and on a cross-border basis) in compliance with the State aid rules of the Treaty establishing the European Community, including where necessary the restructuring of beneficiaries, the outcome will be a structurally weaker Community banking sector with negative implications for productive potential in the broader economy. Furthermore, it could lead to a recurrent need for government intervention in the sector, implying a progressively heavier burden on public finances. Such risks are serious given the likely scale of State exposure.

([1]) While official data for the euro area suggest that bank lending to businesses is still resilient, the underlying trend is weakening, with month-on-month growth rates in lending slowing markedly toward the end of 2008. In December 2008, bank loans to the private economy (loans to non-MFI excl. governments) fell by 0,4 % relative to November.

([2]) From mid-2007 to date, there has been a total of USD 1 063 billion in asset write-downs, of which USD 737,6 billion has been reported by US-based banks and USD 293,7 has been reported by European-based banks. Of the latter, USD 68 billion has been reported in Switzerland. Despite the scale of asset write-downs already reported, the IMF currently estimates that the total of bank losses related to asset impairment is likely to reach USD 2 200 billion. This estimate is based on global holdings of U.S.-originated and securitized mortgage, consumer, and corporate debt and has been steadily rising since the beginning of the crisis. Some market commentators suggest that total losses may be substantially higher. For example, Nouriel Roubini who has consistently argued that official estimates are too low now suggests that total losses could be USD 3 600 billion for the United States alone.

In order to limit the risk of such longer-term damage, government intervention in the banking sector should be appropriately targeted and accompanied by behavioural safeguards that align the incentives of banks with the objectives of public policy. Asset-relief measures should form part of an overall effort to restore the viability of the banking sector, based on necessary restructuring. The need for restructuring in the banking sector as a counterpart of government support is discussed in more detail in the context of State aid rules in Sections 5 and 6.

10. In considering the design and implementation of asset relief measures, it is also essential that Member States take account of the budgetary context. Estimates of total expected asset write-downs suggest that the budgetary costs — actual, contingent or both — of asset relief could be substantial — both in absolute terms and relative to gross domestic product (GDP) in Member States. Government support through asset relief (and other measures) should not be on such a scale that it raises concern about the sustainability of public finances such as over-indebtedness or financing problems. Such considerations are particularly important in the current context of widening budget deficits, rising public debt levels and challenges facing sovereign bond issuance.

11. More specifically, the budgetary situation of Member States will be an important consideration in the choice of management arrangement for assets subject to relief, namely asset purchase, asset insurance, asset swap or a hybrid of such arrangements ([1]). The implications for budgetary credibility may not differ significantly between the various approaches to asset relief, as financial markets are likely to discount potential losses on a similar basis ([2]). However, an approach requiring the outright purchase of impaired assets would have a more immediate impact on budgetary ratios and government financing. While the choice of management arrangement for impaired assets is the responsibility of each Member State, hybrid approaches whereby bad assets are segregated from the balance sheet of banks in a separate entity (either within or outside the banks) which benefits in some way from a government guarantee could be considered. Such an approach is attractive as it provides many of the benefits of the asset purchase approach from the perspective of restoring confidence in the banking system, while limiting the immediate budgetary impact.

12. In a context of scarce budgetary resources, it may be appropriate to focus asset relief measures on a limited number of banks of systemic importance. For some Member States, asset relief for banks may be severely constrained, due to their existing budgetary constraints and/or the size of their banks' balance sheet relative to GDP.

4. NEED FOR A COMMON AND CO-ORDINATED COMMUNITY APPROACH

13. In considering some form of asset relief measures, there is a need to reconcile the immediate objectives of financial stability and bank lending with the need to avoid longer-term damage to the banking sector within the Community, to the single market and to the broader economy. This can be achieved most effectively by a common and co-ordinated Community approach, with the following broad objectives:

(a) boosting market confidence by demonstrating a capacity for an effective Community-level response to the financial crisis and creating the scope for positive spillovers among Member States and on the wider financial markets;

(b) limiting negative spillovers among Member States, where the introduction of asset relief measures by a first-mover Member State results in pressure on other Member States to follow suit and risks launching a subsidy race between Member States;

([1]) These arrangements are discussed in more detail in Annex II.

([2]) Asset purchases by government need not imply heavy budgetary costs in the longer term if a sufficient portion of the acquired assets can be subsequently sold at a profit (see US and Swedish examples in Annex II). However, they imply an upfront budgetary outlay which would increase gross public debt and the government's gross financing requirements. An approach based on swapping government debt for impaired assets could be used to ease the operational problems relating to issuance, but would not avoid the impact on the budgetary ratios nor an increase in the supply of government debt in the market.

(c) protecting the single market in financial services by ensuring consistency in asset relief measures introduced by the Member States and resisting financial protectionism;

(d) ensuring compliance with State-aid control requirements and any other legal requirements by further ensuring consistency among asset relief measures, and by minimising competitive distortions and moral hazard.

14. Co-ordination among Member States would only be necessary at a general level and could be achieved while retaining sufficient flexibility to tailor measures to the specific situations of individual banks. In the absence of sufficient coordination *ex ante*, many of those objectives will only be met by additional State aid control requirements *ex post*. Common guidance on the basic features of relief measures would, therefore, help to minimise the need for corrections and adjustments as a result of assessment under the State aid rules. Such guidance is provided in the following Sections.

5. GUIDELINES ON THE APPLICATION OF STATE AID RULES TO ASSET RELIEF MEASURES

15. It is the normal duty of banks to assess the risk of the assets they acquire and to make sure they can cover any associated losses ([1]). Asset relief may, however, be considered to support financial stability. Public asset relief measures are State aid inasmuch as they free the beneficiary bank from (or compensate for) the need to register either a loss or a reserve for a possible loss on its impaired assets and/or free regulatory capital for other uses. This would notably be the case where impaired assets are purchased or insured at a value above the market price, or where the price of the guarantee does not compensate the State for its possible maximum liability under the guarantee ([2]).

16. Any aid for asset relief measures should, however, comply with the general principles of necessity, proportionality and minimisation of the competition distortions. Such assistance implies serious distortions of competition between beneficiaries and non-beneficiary banks and among beneficiary banks with different degrees of need. Non-beneficiary banks that are fundamentally sound may feel obliged to consider seeking government intervention to preserve their competitive position in the market. Similar distortions in competition may arise among Member States, with the risk of a subsidy race between Member States (trying to save their banks without regard to the effects on banks in other Member States) and a drift towards financial protectionism and fragmentation of the internal market. Participation in the asset relief scheme should therefore be conditioned upon clearly defined and objective criteria, in order to avoid that individual banks take unwarranted advantage.

17. The principles governing the application of the State aid rules and, in particular, Article 87(3)(b) of the Treaty to any support measure for banks in the context of the global financial crisis in were established in the 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* ([3]). More detailed guidance on the practical implementation of these principles to recapitalisation was subsequently provided in the Communication from the Commission — *The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition* ([4]). In the same vein, the guidelines set out in this Communication, based on the same principles, identify the key features of asset relief measures or schemes, which determine their effectiveness as well as their impact on competition. These guidelines apply to all banks that are granted asset relief, irrespective of

([1]) Banks typically hold a variety of assets, including: cash, financial assets (treasury bills, debt securities, equity securities, traded loans, and commodities), derivatives (swaps, options), loans, financial investments, intangible assets, property, plant and equipment. Losses may be incurred when assets are sold below their book value, when their value is decreased and reserves are created on possible loss or *ex post* when the revenue streams at maturity are lower than the book value.

([2]) A guarantee is presumed to constitute State aid when the beneficiary bank cannot find any independent private operator on the market willing to provide a similar guarantee. The amount of State aid is set at the maximum net liability for the State.

([3]) OJ C 270, 25.10.2008, p. 8.

([4]) OJ C 10, 15.1.2009, p. 2.

their individual situation, but the practical implications of their application may vary depending on the risk profile and viability of a beneficiary. The principles of these guidelines apply *mutatis mutandis* where two or more Member States coordinate measures to provide asset relief to cross-border banks.

18. This Communication aims to establish coordinated principles and conditions to ensure the effectiveness of asset relief measures in the single market as far as possible, taking account of the long-term objective of a return to normal market conditions, while remaining flexible enough so as to cater for specific features or provide additional measures or procedures at individual or national levels for reasons of financial stability. Effective asset relief measures should have as a consequence the maintenance of lending to the real economy.

5.1. **Appropriate identification of the problem and options for solution: full *ex ante* transparency and disclosure of impairments and an upfront assessment of eligible banks**

19. Any asset relief measure must be based on a clear identification of the magnitude of the bank's asset-related problems, its intrinsic solvency prior to the support and its prospects for return to viability, taking into due consideration all possible alternatives, in order to facilitate the necessary restructuring process, prevent distortion in the incentives of all players and avoid waste of State resources without contributing to resumption in the normal flow of credit to the real economy.

20. Therefore, in order to minimise the risk of a recurrent need for State interventions in favour of the same beneficiaries, the following criteria should be satisfied as a prerequisite for benefitting from asset relief:

(a) applications for aid should be subject to full *ex ante* transparency and disclosure of impairments by eligible banks on the assets which will be covered by the relief measures, based on adequate valuation, certified by recognised independent experts and validated by the relevant supervisory authority, in line with the principles of valuation developed in Section 5.5 ([1]); such disclosure of impairments should take place prior to government intervention; this should lead to the identification of the aid amount and of the incurred losses for the bank from the asset transfer ([2]);

(b) an application for aid by an individual bank should be followed by a full review of that bank's activities and balance sheet, with a view to assessing the bank's capital adequacy and its prospects for future viability (viability review); that review must occur in parallel with the certification of the impaired assets covered by the asset relief programme but, given its scale, could be finalised after the bank enters into the asset relief programme; the results of the viability review must be notified to the Commission and will be taken into account in the assessment of necessary follow-up measures (see Section 6).

5.2. **Burden-sharing of the costs related to impaired assets between the State, shareholders and creditors**

21. As a general principle, banks ought to bear the losses associated with impaired assets to the maximum extent. This requires, firstly, full *ex ante* transparency and disclosure, followed by the correct valuation of assets prior to government intervention and a correct remuneration of the State for the asset relief measure, whatever its form, so as to ensure equivalent shareholder responsibility and burden-sharing

([1]) Without prejudice to the necessity of making public the impact on the balance sheet of an asset relief measure implying appropriate burden-sharing, the terms 'transparency' and 'full disclosure' should be understood as meaning transparency *vis-à-vis* the national authorities, the independent experts involved and the Commission.

([2]) The aid amount corresponds to the difference between the transfer value of the assets (normally based on their real economic value) and the market price. In this paper, the incurred losses correspond to the difference between the transfer value and the book value of the assets. Actual losses will normally only be known *ex post*.

irrespective of the exact model chosen. The combination of those elements should lead to overall coherence concerning burden-sharing across various forms of State support, having regard to the specific distinctive features of different types of assistance ([1]).

22. Once assets have been properly evaluated and losses are correctly identified ([2]), and if this would lead to a situation of technical insolvency without State intervention, the bank should either be put into administration or be wound up, according to Community and national law. In such a situation, with a view to preserving financial stability and confidence, protection or guarantees to bondholders ([3]) may be appropriate.

23. Where putting a bank into administration or its orderly winding up appears unadvisable for reasons of financial stability ([4]), aid in the form of guarantee or asset purchase, limited to the strict minimum, could be awarded to banks so that they can continue to operate for the period necessary to allow to devise a plan for either restructuring or orderly winding-up. In such cases, shareholders should also be expected to bear losses at least until the regulatory limits of capital adequacy are reached. Nationalisation options may also be considered.

24. Where it is not possible to achieve full burden-sharing *ex ante*, the bank should be requested to contribute to the loss or risk coverage at a later stage, for example in the form of claw-back clauses or, in the case of an insurance scheme, by a clause of 'first loss', to be borne by the bank (typically with a minimum of 10 %) and a clause of 'residual loss sharing', through which the bank participates to a percentage (typically with a minimum of 10 %) of any additional losses ([5]).

25. As a general rule, the lower the contribution upfront, the higher the need for a shareholder contribution at a later stage, either in the form of a conversion of State losses into bank shares and/or in the form of additional compensatory measures to limit the distortion of competition when assessing necessary restructuring.

5.3. **Aligning incentives for banks to participate in asset relief with public policy objectives**

26. As a general feature, impaired asset relief programmes should have an enrolment window limited to six months from the launch of the scheme by the government. This will limit incentives for banks to delay necessary disclosures in the hope of higher levels of relief at a later date, and facilitate a rapid resolution of the banking problems before the economic downturn further aggravates the situation. During the six-month window, the banks would be able to present eligible assets baskets to be covered by the asset relief measures, with the possibility of rollover ([6]).

27. Appropriate mechanisms may need to be devised so as to ensure that the banks most in need of asset relief participate in the government measure. Such mechanisms could include mandatory participation in the programme, and should include at least mandatory disclosure to the supervisory authorities. The obligation for all banks to reveal the magnitude of their asset-related problems will contribute to the clear identification of the need and necessary scope for an asset relief scheme at the Member State level.

([1]) Asset relief measures are somewhat comparable to capital injections insofar as they provide a loss absorption mechanism and have a regulatory capital effect. However, with the former the State generally incurs a larger risk, related to a specific portfolio of impaired assets, with no direct contribution of other bank's income generating activities and funds, and beyond its possible stake into the bank. In view of the larger down-side and more limited up-side remuneration for asset relief should normally be higher than for capital injections.

([2]) Comparing the book value of the assets with their transfer value (i.e. their real economic value).

([3]) Shareholder protection should, however, normally be excluded. See Decisions NN 39/08 (Denmark, Aid for liquidation of Roskilde Bank) and NN 41/08 (United Kingdom, Rescue aid to Bradford & Bingley).

([4]) That may be the case where the bank's size or type of activity would be unmanageable in an administrative or judiciary procedure or via an orderly winding-up without having dangerous systemic implications on other financial institutions or on lending to the real economy. A justification by the monetary and/or supervisory authority would be necessary in this respect.

([5]) Other factors, for example higher remuneration, may influence the appropriate level. Moreover, it has to be noted that *ex post* compensations may only occur several years after the measure has been introduced and may therefore unsatisfactorily prolong the uncertainty linked to the valuation of the impaired assets. Claw-back clauses based on *ex ante* valuation would not have this problem.

([6]) Case of enrolled assets that may mature afterwards.

28. Where participation is not mandatory, the scheme could include appropriate incentives (such as the provision of warrants or rights to existing shareholders so that they may participate in future private capital-raising at preferential terms) to facilitate take-up by the banks without derogating from the principles of transparency and disclosure, fair valuation and burden sharing.

29. Participation after the expiration of the six month enrolment window should be possible only in exceptional and unforeseeable circumstances for which the bank is not responsible ([1]), and subject to stricter conditions, such as higher remuneration to the State and/or higher compensatory measures.

30. Access to asset relief should always be conditional on a number of appropriate behavioural constraints. In particular, beneficiary banks should be subject to safeguards which ensure that the capital effects of relief are used for providing credit to appropriately meet demand according to commercial criteria and without discrimination and not for financing a growth strategy (in particular acquisitions of sound banks) to the detriment of competitors.

31. Restrictions on dividend policy and caps on executive remuneration should also be considered. The specific design of behavioural constraints should be determined on the basis of a proportionality assessment taking account of the various factors that may imply the necessity of restructuring (see Section 6).

5.4. **Eligibility of assets**

32. When determining the range of eligible assets for relief, a balance needs to be found between meeting the objective of immediate financial stability and the need to ensure the return to normal market functioning over the medium turn. Assets commonly referred to as 'toxic assets' (for example, US mortgage backed securities and associated hedges and derivatives), which have triggered the financial crisis and have largely become illiquid or subject to severe downward value adjustments, appear to account for the bulk of uncertainty and scepticism concerning the viability of banks. Restricting the range of eligible assets to such assets would limit the State's exposure to possible losses and contribute to the prevention of competition distortions ([2]). However, an overly narrow relief measure would risk falling short of restoring confidence in the banking sector, given the differences between the specific problems encountered in different Member States and banks and the extent to which the problem of impairment has now spread to other assets. This would plead in favour of a pragmatic approach including elements of flexibility, which would ensure that other assets also benefit from relief measures to an appropriate extent and where duly justified.

33. A common and coordinated Community approach to the identification of the assets eligible for relief measures is necessary to both prevent competitive distortions among Member States and within the Community banking sector, and limit incentives for cross-border banks to engage in arbitrage among different national relief measures. To ensure consistency in the identification of eligible assets across Member States, categories of assets ('baskets') reflecting the extent of existing impairment should be developed. More detailed guidance on the definition of those categories is provided in Annex III. The use of such categories of assets would facilitate the comparison of banks and their risk profiles across the Community. Member States would then need to decide which category of assets could be covered and to what extent, subject to the Commission's review of the degree of impairment of the assets chosen.

34. A proportionate approach would need to be developed to allow a Member State whose banking sector is additionally affected by other factors of such magnitude as to jeopardise financial stability (such as the burst of a bubble in their own real estate market) to extend eligibility to well-defined categories of assets corresponding to the systemic threat upon due justification, without quantitative restrictions.

([1]) An 'unforeseeable circumstance' is a circumstance that could in no way be anticipated by the company's management when making its decision not to join the asset relief programme during the enrolment window and that is not a result of negligence or error on the part of the company's management or decisions of the group to which it belongs. An 'exceptional circumstance' is to be understood as exceptional beyond the current crisis. Member States wishing to invoke such circumstances shall notify all necessary information to the Commission.

([2]) This would seem the approach chosen in the US for Citigroup and Bank of America.

35. Additional flexibility could further be envisaged by allowing for the possibility for banks to be relieved of impaired assets outside the scope of eligibility set out in paragraphs 32, 33 and 34 without the necessity of a specific justification for a maximum of 10-20 % of the overall assets of a given bank covered by a relief mechanism in view of the diversity of circumstances of different Member States and banks. However, assets that cannot presently be considered impaired should not be covered by a relief programme. Asset relief should not provide an open-ended insurance against future consequences of recession.

36. As a general principle, the wider the eligibility criteria, and the greater the proportion which the assets concerned represent in the portfolio of the bank, the more thorough the restructuring and the remedies to avoid undue distortions of competition will have to be. In any case, the Commission will not consider assets eligible for relief measures where they have entered the balance sheet of the beneficiary bank after a specified cut-off date prior to the announcement of the relief programme ([1]). To do otherwise could result in asset arbitrage and would give rise to inadmissible moral hazard by providing incentives for banks to abstain from properly assessing risks in future lending and other investments and thus repeat the very mistakes that have brought about the current crisis ([2]).

5.5. **Valuation of assets eligible for relief and pricing**

37. A correct and consistent approach to the valuation of assets, including assets that are more complex and less liquid, is of key importance to prevent undue distortions of competition and to avoid subsidy races between Member States. Valuation should follow a general methodology established at the Community level and should be closely co-ordinated *ex ante* by the Commission across the Member States in order to ensure maximum effectiveness of the asset relief measure and reduce the risk of distortions and damaging arbitrage, notably for cross-border banks. Alternative methodologies may need to be employed to take account of specific circumstances relating to, for example, timely availability of relevant data, provided they attain equivalent transparency. In any case, eligible banks should value their portfolios on a daily basis and make regular and frequent disclosures to the national authorities and to their supervisory authorities.

38. Where the valuation of assets appears particularly complex, alternative approaches could be considered such as the creation of a 'good bank' whereby the State would purchase the good rather than the impaired assets. Public ownership of a bank (including nationalisation) could be an alternative option, with a view to carrying out the valuation over time in a restructuring or orderly winding-up context, thus eliminating any uncertainty about the proper value of the assets concerned ([3]).

39. As a first stage, assets should be valued on the basis of their current market value, whenever possible. In general, any transfer of assets covered by a scheme at a valuation in excess of the market price will constitute State aid. The current market value may, however, be quite distant from the book value of those assets in the current circumstances, or non-existent in the absence of a market (for some assets the value may effectively be as low as zero).

40. As a second stage, the value attributed to impaired assets in the context of an asset relief program (the 'transfer value') will inevitably be above current market prices in order to achieve the relief effect. To ensure consistency in the assessment of the compatibility of aid, the Commission would consider a transfer value reflecting the underlying long-term economic value (the 'real economic value') of the assets, on the basis of underlying cash flows and broader time horizons, an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary. Uniform hair-cuts applicable to certain asset categories will have to be considered to approximate the real economic value of assets that are so complex that a reliable forecast of developments in the foreseeable future would appear impracticable.

([1]) Generally, the Commission considers that a uniform and objective cut-off date, such as the end of 2008, will ensure a level playing field among banks and Member States.

([2]) Where necessary, State support in relation to the risks of future assets can be tackled on the basis of the guarantee notice and the temporary framework.

([3]) This would be the case, for example, if the State swapped assets for government bonds in the amount of their nominal value but received contingent warrants on bank capital, the value of which depends on the eventual sales price of the impaired assets.

41. Consequently, the transfer value for asset purchase or asset insurance ([1]) measures should be based on their real economic value. Moreover, adequate remuneration for the State must be secured. Where Member States deem it necessary — notably to avoid technical insolvency — to use a transfer value of the assets that exceeds their real economic value, the aid element contained in the measure is correspondingly larger. It can only be accepted if it is accompanied by far-reaching restructuring and the introduction of conditions allowing the recovery of this additional aid at a later stage, for example through claw-back mechanisms.

42. The valuation process both with regard to the market value and the real economic value, as well as the remuneration of the State, should follow the same guiding principles and processes listed in Annex IV.

43. When assessing the valuation methods put forward by Member States for asset relief measures, and their implementation in individual cases, the Commission will consult panels of valuation experts ([2]). The Commission will also build on the expertise of existing bodies organised at Community level in order to ensure the consistency of valuation methodologies.

5.6. **Management of assets subject to relief measures**

44. It is for Member States to choose the most appropriate model for relieving banks from assets, from the range of options set out in Section 3 and Annex II, in the light of the extent of the problem of impaired assets, the situation of the individual banks concerned and budgetary considerations. The objective of State aid control is to ensure that the features of the selected model are designed so as to ensure equal treatment and prevent undue distortions of competition.

45. While the specific pricing arrangements for an aid measure may vary, their distinctive features should not have an appreciable impact on the adequate burden-sharing between the State and the beneficiary banks. On the basis of proper valuation, the overall financing mechanism of an asset management company, an insurance or a hybrid solution should ensure that the bank will have to assume the same proportion of losses. Claw-back clauses can be considered in this context. In general, all schemes must ensure that the beneficiary banks bear the losses incurred in the transfer of assets (see further paragraph 50 and footnote 10).

46. Whatever the model, in order to facilitate the bank's focus on the restoration of viability and to prevent possible conflicts of interest, it is necessary to ensure clear functional and organisational separation between the beneficiary bank and its impaired assets, notably as to their management, staff and clientele.

5.7. **Procedural aspects**

47. Detailed guidance on the implications of these guidelines on State aid procedure with regard to both the initial notification of aid and the assessment of restructuring plans, where necessary, is provided in Annex V.

6. **FOLLOW-UP MEASURES — RESTRUCTURING AND RETURN TO VIABILITY**

48. The principles and conditions in Section 5 set the framework for designing asset relief measures in compliance with State aid rules. State aid rules aim, in the present context, at ensuring the minimum and least distortive support for a removal of risks related to a separate category of assets from the beneficiary banks in order to prepare a solid ground for return to long-term viability without State support. While the treatment of impaired assets along the above principles is a necessary step for a return to viability for the banks, it is not in itself sufficient to achieve that goal. Depending on their particular situation and characteristics, banks will have to take appropriate measures in their own interest in order to avoid a recurrence of similar problems and to ensure sustainable profitability.

([1]) In the case of an insurance measure, the transfer value is understood as insured amount.
([2]) The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may have recourse to external expertise.

49. Under State aid rules and notably those for rescue and restructuring aid, asset relief amounts to a structural operation and requires a careful assessment of three conditions: (i) adequate contribution of the beneficiary to the costs of the impaired assets programme; (ii) appropriate action to guarantee the return to viability; and (iii) necessary measures to remedy competition distortions.

50. The first condition should normally be achieved by fulfilling the requirements set out in the Section 5, notably disclosure, valuation, pricing and burden-sharing. This should ensure a contribution by the beneficiary of at least the entirety of the losses incurred in the transfer of assets to the State. Where this is materially not possible, aid may still be authorised, by way of exception, subject to stricter requirements as to the other two conditions.

51. Requirements to return to viability and the need for remedies for competition distortion will be determined on a case-by-case basis. As regards the second condition, the need to return to long-term viability, it should be noted that asset relief may contribute to that objective. The viability review should certify the actual and prospective capital adequacy of the bank after a complete assessment and consideration of the possible factors of risk ([1]).

52. The Commission's assessment of the extent of necessary restructuring, following the initial authorisation of the asset relief measures, will be determined on the basis of the following criteria: criteria outlined in the Communication on the recapitalisation of financial institutions in the current financial crisis: *limitation of aid to the minimum necessary and safeguards against undue distortions of competition*, the proportion of the bank's assets subject to relief, the transfer price of such assets compared to the market price, the specific features of the impaired asset relief granted, the total size of State exposure relative to a bank's risk-weighted assets, the nature and origin of the problems of the beneficiary bank, and the soundness of the bank's business model and investment strategy. It will also take into account any additional granting of State guarantee or State recapitalisation, in order to draw a complete picture of the situation of the beneficiary bank ([2]).

53. Long-term viability requires that the bank is able to survive without any State support, which implies clear plans for redeeming any State capital received and renouncing State guarantees. Depending on the outcome of that assessment, restructuring will have to comprise an in-depth review of the bank's strategy and activity, including, for example, focussing on core business, reorientation of business models, closure or divestment of business divisions/subsidiaries, changes in the asset-liability management and other changes.

54. The need for in-depth restructuring will be presumed where an appropriate valuation of impaired assets according to the principles set out in Section 5.5 and Annex IV would lead to negative equity/technical insolvency without State intervention. Repeated requests for aid and departure from the general principles set out in Section 5, will normally point to the need for such in-depth restructuring.

55. In-depth restructuring would also be required where the bank has already received State aid in whatever form that either contributes to coverage or avoidance of losses, or altogether exceeds 2 % of the total bank's risk weighted assets, while taking the specific features of the situation of each beneficiary in due consideration ([3]).

56. The timing of any required measures to restore viability will take account of the specific situation of the bank concerned, as well as the overall situation in the banking sector, without unduly delaying the necessary adjustments.

57. Thirdly, the extent of necessary compensatory measures should be examined, on the basis of distortions of competition resulting from the aid. This may involve downsizing or divestment of profitable business units or subsidiaries, or behavioural commitments to limit commercial expansion.

([1]) Compliance with the criteria set in paragraph 40 of the Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition would also need to be ensured as far as applicable.

([2]) For those banks already subject to the obligation of a restructuring plan, following the granting of previous State aid, such a plan would need to duly take into consideration the new aid and envisage all options from restructuring to orderly winding-up.

([3]) Participation in an authorised credit guarantee scheme, without the guarantee having had to be invoked to cover losses, are not to be taken into consideration for the purposes of this paragraph.

58. The need for compensatory measures will be presumed if the beneficiary bank does not fulfil the conditions set out in Section 5 and notably those of disclosure, valuation, pricing and burden sharing.

59. The Commission will assess the scope of the compensatory measures required, depending on its assessment of competition distortions resulting from the aid, and notably on the basis of the following factors: total amount of aid, including from guarantee and recapitalisation measures, volume of impaired assets benefiting from the measure, proportion of losses resulting from the asset, general soundness of the bank, risk profile of the relieved assets, quality of risk management of the bank, level of solvency ratios in the absence of aid, market position of the beneficiary bank and distortions of competition from the bank's continued market activities, and impact of the aid on the structure of the banking sector.

7. **FINAL PROVISION**

60. The Commission applies this Communication from 25 February 2009, the date on which it agreed in principle its content, having regard to the financial and economic context which required immediate action.

ANNEX I

Eurosystem guidance on asset support measures for banks

The Eurosystem has identified seven guiding principles for bank asset support measures:

1. *eligibility of institutions*, which should be voluntary, with possible priority for institutions with large concentrations of impaired assets in case of constraints;
2. relatively broad *definition of assets* eligible for support;
3. *valuation of eligible assets* which is transparent, preferably based on a range of approaches and common criteria to be adopted across Member States, based on independent third-party expert opinions, use of models which use micro-level inputs to estimate the economic value of, and probabilities attached to, the expected losses, and of asset-specific haircuts on book values of assets when the assessment of market value is particularly challenging, or when the situation requires swift action;
4. an adequate degree of *risk sharing* as a necessary element of any scheme in order to limit the cost to the government, provide the right incentives to the participating institutions and maintain a level playing field across these institutions;
5. sufficiently long *duration* of the asset-support schemes, possibly matching the maturity structure of the eligible assets;
6. *governance of institutions* which should continue to be run according to business principles, and favouring of schemes that envisage well defined exit strategies; and
7. *conditionality* of public support schemes to some measurable yardsticks, such as commitments to continue providing credit to appropriately meet demand according to commercial criteria.

ANNEX II

The different approaches to asset relief and experience with the use of bad-bank solutions in the United States, Sweden, France, Italy, Germany, Switzerland and the Czech Republic

I. **Possible approaches**

In principle, two broad approaches to managing assets subject to relief measures can be considered:

1. the segregation of impaired assets from good assets within a bank or in the banking sector as a whole. Several variants of this approach can be considered. An asset management company (bad bank or risk shield) could be created for each bank, whereby the impaired assets would be transferred to a separate legal entity, with the assets still managed by the ailing bank or a separate entity and possible losses shared between the good bank and the State. Alternatively, the State could establish a self-standing institution (often called an 'aggregator bank') to purchase the impaired assets of either an individual banks or of the banking sector as a whole, thereby allowing banks to return to normal lending behaviour unencumbered by the risk of asset write-downs. This approach could also involve prior nationalisation, whereby the State takes control of some or all banks in the sector before segregating their good and bad assets;

2. an asset insurance scheme whereby banks retain impaired assets on their balance sheets but are indemnified against losses by the State. In the case of asset insurance, the impaired assets remain on the balance sheet of banks, which are indemnified against some or all losses by the State. A specific issue concerning asset insurance is setting the appropriate premium for heterogeneous and complex assets, which should in principle reflect some combination of valuation and risk characteristics of the insured assets. Another issue is that insurance schemes are technically difficult to operate in a situation where the insured assets are spread across a large number of banks rather than concentrated in a few larger banks. Finally, the fact that the insured assets remain on the balance sheets of banks will allow for the possibility of conflicts of interest and remove the important psychological effect of clearly separating the good bank from the bad assets.

II. **Experience with bad banks**

In the United States, the Resolution Trust Corporation (RTC) was created as a government-owned asset-management company in 1989. The RTC was charged with liquidating assets (primarily real estate-related assets, including mortgage loans) that had been assets of savings and loan associations ('S&Ls') declared insolvent by the Office of Thrift Supervision, as a consequence of the Savings and Loan crisis (1989-1992). The RTC also took over the insurance functions of the former Federal Home Loan Bank Board. Between 1989 and mid-1995, the Resolution Trust Corporation closed or otherwise resolved 747 thrifts with total assets of USD 394 billion. In 1995, its duties were transferred to the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation. Overall, the cost to the taxpayers was estimated at USD 124 billion in 1995 dollars.

The RTC operated via so-called 'equity partnership programs'. All equity partnerships involved a private sector partner acquiring a partial interest in a pool of assets. By retaining an interest in asset portfolios, the RTC was able to participate in the extremely strong returns being realized by portfolio investors. Additionally, the equity partnerships enabled the RTC to benefit from the management and liquidation efforts of their private sector partners, and the structure helped assure an alignment of incentives superior to that which typically exists in a principal/contractor relationship. The various forms of equity partnerships are the following: Multiple Investment Fund (limited and selected partnership, unidentified portfolio of assets), N-series and S-series Mortgage Trusts (competitive bid for identified portfolio of assets), Land fund (to take profit from longer-term recovery and development of land), and JDC Partnership (selection of general partner on a 'beauty-contest' basis for claims unsecured or of questionable value).

In Sweden, two bank asset management corporations (AMCs), *Securum* and *Retriva*, were set up to manage the non-performing loans of financial institutions as part of the resolution policy for the financial crisis in 1992/1993. The assets of an ailing bank were split into 'good' and 'bad' assets, with the bad assets then transferred to one of the asset management corporations, mainly to *Securum*. An important feature of the Swedish programme was to force banks to disclose expected loan losses in full and assign realistic values to real estate and other assets. For this, the Financial Supervisory Authority tightened its rules for the definition of probable loan losses as well as for the valuation of real estate. In order to obtain uniform valuation of the real estate holdings of banks applying for support, the Authority set up a Valuation Board with real estate experts. The low market values assigned to the assets in the due diligence process, effectively helped setting a floor for asset values. As market participants did not expect prices to fall below that level, trading was

maintained ([1]). In the long run, the two bank asset management corporations turned out to be successful in the sense that the budgetary cost of supporting the financial system was roughly balanced by the revenues received by the bank asset management corporations from the liquidation of their asset holdings.

In France, a public body enjoying an institutional unlimited State guarantee was created in the 1990s to take over and liquidate over time the bad assets of Credit Lyonnais. The bad bank financed the acquisition of the assets by means of a loan from Credit Lyonnais. The latter, therefore, could avoid recording losses on the assets and free capital for an equivalent amount of risk-weighted assets, as the loan to the bad bank could enjoy a 0 % risk weight in view of the State guarantee. The Commission approved the bad bank as restructuring aid. A feature of the model was the neat separation between the good and the bad bank in order to prevent conflicts of interest and the 'better fortunes clause' on the good bank's profit to the benefit of the State. After a few years, the bank was successfully privatised. However, transfer of the assets to the bad bank at book value sheltered the shareholders from responsibility for the losses and implied high cost for the State over time.

A few years later in Italy, Banco di Napoli was split into a bad bank and a good bank after the absorption of the losses by existing shareholders and a Treasury recapitalisation to the extent necessary to keep the bank afloat. Banco Napoli financed the bad bank's acquisition of the discounted but still impaired assets via a subsidised loan of the Central Bank counter-guaranteed by the Treasury. The cleaned bank was privatised one year later. In neither the case of Credit Lyonnais nor that of Banco di Napoli was there an immediate budgetary outlay for the Treasury for the acquisition of the bad assets, over and above the provision of capital to the banks.

A soft form of bad bank has been recently used by Germany in dealing with the bad assets of their Landesbanken. In the SachsenLB case, the beneficiary was sold as a going concern after the bad assets of around EUR 17,5 billion were channelled into a special purpose vehicle (SPV) with the purpose to hold the assets until maturity. The former owners, the Land of Saxony, gave a loss guarantee for around 17 % of the nominal value, which was considered as the absolute maximum of possible losses in a stress test (the base case was estimated only at 2 %). The new owner took over most of the refinancing and covered the remaining risk. The aid amount was at least considered to go up to the worst case estimate of around 4 %. In the WestLB case, a portfolio of assets of EUR 23 billion was channelled into an SPV and equipped with a government guarantee of EUR 5 billion so as to cover eventual losses and protect the balance sheet of adjusting the value of the assets according to IFRS. This allowed WestLB to remove the market volatility of the assets from its balance sheet. A guarantee fee of 0,5 % was paid to the State. The risk shield is still in place and is considered to be State aid.

In Switzerland, the government has created a new fund to which UBS has transferred a portfolio of toxic assets that was valued by a third party prior to the transfer. To ensure financing of this fund, Switzerland first injected capital into UBS (in the form of notes convertible into UBS shares), which UBS immediately wrote off and transferred to the Fund. The remainder of the financing of the Fund was ensured by a loan from the Swiss National Bank.

In the late 1990s, the Czech banks' lending conditions to corporations were very loose. The Czech banks were severely damaged by that and they had to be bailed out in the late 1990s by the government. Major rounds of cleaning up banks' balance sheets were undertaken in order to establish a healthy banking industry.

In February 1991, the Czech government created a consolidation bank (Konsolidační banka, KOB), established in order to take on bad loans from the banking sector accumulated before 1991 — such as debts inherited from the centrally planned economy, especially those related to trading within the Soviet bloc. In September 2001, the special bank turned into an agency that also had to absorb bad loans connected to 'new innovative' loans (especially so-called privatization loans, nonperforming loans and fraudulent loans).

Starting in 1991, larger banks were freed from bad loans and as of 1994 emphasis shifted to smaller banks. In particular, the failure of Kreditní banka in August 1996, and a subsequent partial run on Agrobanka, caused some strain on the Czech banking system. The programmes concerned led only to a temporary increase of State ownership in banking in 1995, and again in 1998, due to the revocation of the license of Agrobanka. Overall, the government share in banking rose to 32 % at the end of 1995 from 29 % in 1994.

Moreover, to support the small banks, another programme — the Stabilisation Programme — was approved in 1997. This essentially consisted of replacing poor-quality assets with liquidity of up to 110 % of each participating bank's capital through the purchase of poor-quality assets from the bank by a special company called Česká finanční, with subsequent repurchase of the residual amount of these assets within 5 to 7-year horizon. Six banks joined the programme, but five of these were excluded after failing to comply with its criteria and subsequently went out of business. Thus, the Stabilisation Programme was not successful and was halted.

([1]) This is in sharp contrast to the Japanese policy setting too high values for 'bad' assets, thus freezing the real estate market for about a decade.

By the end of 1998, 63 banking licences had been granted (60 of these before the end of 1994). As of end-September 2000, 41 banks and branches of foreign banks remained in business, 16 were under extraordinary regimes (8 in liquidation, 8 involved in bankruptcy proceedings), 4 had merged with other banks, and the licence of one foreign bank had been revoked because it had failed to start its operations. Out of the 41 remaining institutions (including CKA) 15 were domestically controlled banks and 27 foreign-controlled banks, including foreign subsidiaries and foreign branches.

In May 2000, the amended Act on Bankruptcy and Settlement and the Act on Public Auctions became effective, which aimed at accelerating bankruptcy proceedings and balancing creditors' and debtors' rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements.

ANNEX III

The definition of categories ('baskets') of eligible assets and full disclosure concerning the impaired assets as well as the entire business activities of a bank

I. **The definition of categories ('baskets') of eligible assets**

The definition of baskets of impaired financial assets of banks should be a common denominator based on categories that are already used for:

1. prudential reporting and valuation (Basel pillar 3 = CRD Annex XII; FINREP and COREP);

2. financial reporting and valuation (IAS 39 and IFRS 7 in particular);

3. Specialised *ad hoc* reporting on the credit crisis: IMF, FSF, Roubini and CEBS work on transparency.

Using a common denominator of existing reporting and valuation categories for defining asset baskets will:

1. prevent any additional reporting burden for banks;

2. make it possible to assess the basket of impaired assets of individual banks to Community and global estimates (which can be relevant for determining the 'economic value' at a point in time); and

3. provide objective (certified) starting points for the valuation of impaired assets.

Taking into account the above the Commission suggests the following baskets of financial assets as an entry point for determining the 'economic value' and the asset impairment relief:

Table 1

I. **Structured finance/securitised products**

	Type of product	Accounting category	Valuation basis for the scheme			Comments
			Market value	Economic Value	Transfer Value	
1	RMBS	FVPL/AFS (*)				Further refined into: geographic area, seniority of tranches, ratings, sub-prime or Alt-A related, or other underlying assets, maturity/ vintage, allowances and write-offs
2	CMBS	FVPL/AFS				
3	CDO	FVPL/AFS				
4	ABS	FVPL/AFS				
5	Corporate debt	FVPL/AFS				
6	Other loans	FVPL/AFS				
			Total			

II. **Non securitised loans**

	Type of product	Accounting category	Valuation basis for the scheme			Comments
			Cost (**)	Economic Value	Transfer Value	
7	Corporate	HTM/L&R (*)	Cost (**)			Further refinement on: geographic area, counter-party risk (PD) credit risk mitigation (collateral) and maturity structures; allow-ances and write-offs.
8	Housing	HTM/L&R	Cost			
9	Other personal	HTM/L&R	Cost			
			Total			

(*) FVPL = Fair value through profit and loss = trading portfolio + fair value option); AFS = available for sale, HTM = Held to Maturity, L&R = loans and receivables.
(**) Cost means the carrying amount of the loans minus impairment.

II. **Full disclosure concerning impaired assets and the related business activities**

On the basis of the asset baskets shown in Table 1, the information provided on the impaired assets of a bank which should be covered by an asset relief measure should be presented with a further degree of granularity as suggested in the comment column of Table 1.

On the basis of good practices observed by the Committee of European Banking Supervisors [1] (CEBS) for disclosures on activities affected by the market turmoil, information on the bank's activities related to the impaired assets that would feed into the viability review referred to in Section 5.1 could be structured as follows:

Table 2

CEBS observed good practices	Senior Supervisors Group (SSG): Leading Practice Disclosures
Business model	
— Description of the business model (i.e. of the reasons for engaging in activities and of the contribution to value creation process) and, if applicable of any changes made (e.g. as a result of crisis). — Description of strategies and objectives. — Description of importance of activities and contribution to business (including a discussion in quantitative terms). — Description on the type of activities including a description of the instruments as well as of their functioning and qualifying criteria that products/investments have to meet. — Description of the role and the extent of involvement of the institution, i.e. commitments and obligations.	— Activities (SPE) (*). — Nature of exposure (sponsor, liquidity and/or credit enhancement provider) (SPE). — Qualitative discussion of policy (LF).
Risks and risk management	
— Description of the nature and extent of risks incurred in relation to the activities and instruments. — Description of risk management practices of relevance to the activities, of any identified weaknesses of any corrective measures that have been taken to address these. — In the current crisis, particular attention should be given to liquidity risk.	
Impact of the crisis on results	
— Qualitative and quantitative description of results, with a focus on losses (where applicable) and write-downs impacting the results. — Breakdown of the write-downs/losses by types of products and instruments affected by the crisis (CMBS, RMBS, CDO, ABS and LBO further broken down by different criteria). — Description of the reasons and factors responsible for the impact incurred. — Comparison of (i) impacts between (relevant) periods; and of (ii) income statement balances before and after the impact of the crisis. — Distinction of write-downs between realised and unrealised amounts. — Description of the influence the crisis had on the firm's share price. — Disclosure of maximum loss risk and description how the institution's situation could be affected by a further downturn or by a market recovery. — Disclosure of impact of credit spread movements for own liabilities on results and on the methods used to determine this impact.	— Change in exposure from the prior period, including sales and write-downs (CMB/LF)

[1] Source: CEBS (Committee of European Banking Supervisors) report on banks' transparency on activities and products affected by the recent market turmoil, 18 June 2008.

CEBS observed good practices	Senior Supervisors Group (SSG): Leading Practice Disclosures
Exposure levels and types	

— Nominal amount (or amortised cost) and fair values of outstanding exposures.
— Information on credit protection (e.g. through credit default swaps) and its effect on exposures.
— Information on the number of products
— Granular disclosures of exposures with breakdowns provided by;
  — level of seniority of tranches,
  — level of credit quality (e.g. ratings, investment grade, vintages),
  — geographic origin,
  — whether exposures have been originated, retained, warehoused or purchased,
  — product characteristics: e.g. ratings, share of sub-prime mortgages, discount rates, attachment points, spreads, funding,
  — characteristics of the underlying assets: e.g. vintages, loan-to-value ratios, information on liens, weighted average life of the underlying, prepayment speed assumptions, expected credit losses.
— Movement schedules of exposures between relevant reporting periods and the underlying reasons (sales, disposals, purchases etc.).
— Discussion of exposures that have not been consolidated (or that have been recognised in the course of the crisis) and the related reasons.
— Exposure to monoline insurers and quality of insured assets:
  — nominal amounts (or amortized cost) of insured exposures as well as of the amount of credit protection bought,
  — fair values of the outstanding exposures as well as of the related credit protection,
  — amount of write-downs and losses, differentiated into realised and unrealised amounts,
  — breakdowns of exposures by ratings or counterparty.
	— Size of vehicle versus firm's total exposure (SPE/CDO).
	— Collateral: type, tranches, credit rating, industry, geographic distribution, average maturity, vintage (SPE/CDO/CMB/LF).
	— Hedges, including exposures to monolines, other counterparties (CDO). Creditworthiness of hedge counterparties (CDO).
	— Whole loans, RMBS, derivatives, other (O).
	— Detail on credit quality (such as credit rating, loan-to-value ratios, performance measures) (O).
	— Change in exposure from the prior period, including sales and write-downs (CMB/LF).
	— Distinction between consolidated and non consolidated vehicles. Reason for consolidation (if applicable) (SPE).
	— Funded exposure and unfunded commitments (LF).

Accounting policies and valuation issues	

— Classification of the transactions and structured products for accounting purposes and the related accounting treatment.
— Consolidation of SPEs and other vehicles (such as VIEs) and a reconciliation of these to the structured products affected by the sub-prime crisis.
— Detailed disclosures on fair values of financial instruments:
  — financial instruments to which fair values are applied,
  — fair value hierarchy (a breakdown of all exposures measured at fair value by different levels of the fair value hierarchy and a breakdown between cash and derivative instruments as well as disclosures on migrations between the different levels),
  — treatment of day 1 profits (including quantitative information),
  — use of the fair value option (including its conditions for use) and related amounts (with appropriate breakdowns).
— Disclosures on the modelling techniques used for the valuation of financial instruments, including discussions of the following:
  — description of modelling techniques and of the instruments to which they are applied,
  — description of valuation processes (including in particular discussions of assumptions and input factors the models rely on),
  — type of adjustments applied to reflect model risk and other valuation uncertainties,
  — sensitivity of fair values, and
  — stress scenarios.
	— Valuation methodologies and primary drivers (CDO).
	— Credit valuation adjustments for specific counterparties (CDO).
	— Sensitivity of valuation to changes in key assumptions and inputs (CDO).

CEBS observed good practices	Senior Supervisors Group (SSG): Leading Practice Disclosures
Other disclosure aspects — Description of disclosure policies and of the principles that are used for disclosures and financial reporting.	
Presentation issues — Relevant disclosures for the understanding of an institution's involvement in a certain activity should as far as possible be provided in one place. — Where information is spread between different parts or sources clear cross-references should be provided to allow the interested reader to navigate between the parts. — Narrative disclosures should to the largest extent possible be supplemented with illustrative tables and overviews to improve the clarity. — Institutions should ensure that the terminology used to describe complex financial instruments and transactions is accompanied by clear and adequate explanations.	

(*) In the SSG Report, each feature refers to an specific type of SPE, or to all of them as a whole, being SPE (Special Purpose Entities in general), LF (Leveraged Finance), CMB (Commercial Mortgage-Backed Securities), O (Other sub-prime and Alt-A Exposures), CDO (Collateralised Debt Obligations)

ANNEX IV

Valuation and pricing principles and processes

I. **Valuation methodology and procedure**

For the purposes of asset relief measures, assets should be classified along the lines of the illustrative tables 1 and 2 in Annex III.

The determination of the real economic value for the purposes of this Communication (see Section 5.5) should be based on observable market inputs and realistic and prudent assumptions about future cash flows.

The valuation method to be applied to eligible assets should be agreed at the Community level and could vary with the individual assets or baskets of assets concerned. Whenever possible, such valuation should be re-assessed in reference to the market at regular intervals over the life of the asset.

In the past, several valuation options have been applied more or less successfully. Simple reverse auction procedures proved useful in the case of categories of assets where market values are reasonably certain. However, this approach failed in valuing more complex assets in the United States. More sophisticated auction procedures are more adapted where there is less certainty about market values and a more exact method of price discovery of each asset would be needed. Unfortunately, their design is not straightforward. The alternative of model-based calculations for complex assets presents the drawback of being sensitive to the underlying assumptions ([1]).

The option of applying uniform valuation haircuts to all complex assets simplifies the process of valuation overall, although it results in less accurate pricing of individual assets. Central banks have substantial experience regarding possible criteria and parameters for collateral pledged for refinancing, which could serve as a useful reference.

Whatever the model chosen, the valuation process and particularly the assessment of the likelihood of future losses should be based on rigorous stress-testing against a scenario of protracted global recession.

The valuation must be based on internationally recognised standards and benchmarks. A common valuation methodology agreed at the Community level and consistently implemented by Member States could greatly contribute to mitigating concerns regarding threats to a level playing field resulting from potentially significant implications of discrepant valuation systems. When assessing the valuation methods put forward by Member States for asset relief measures, the Commission will, in principle, consult panels of valuation experts ([2]).

II. **The pricing of State support on the basis of valuation**

The valuation of assets must be distinguished from the pricing of a support measure. A purchase or insurance on the basis of the established current market value or the 'real economic value', factoring in future cash flow projections on a hold-to-maturity basis, will in practice often exceed the present capacities of beneficiary banks for burden-sharing ([3]). The objective of the pricing must be based on a transfer value as close to the identified real economic value as possible. While implying an advantage as compared to the current market value and thus State aid, pricing on the basis of the 'real economic value' can be perceived as counterbalancing current market exaggerations fuelled by current crisis conditions which have led to the deterioration or even collapse of certain markets. The greater any deviation of the transfer value from the 'real economic value', and thus the amount of aid, the greater the need for remedial measures to ensure accurate pricing over time (for example, through better fortune clauses) and for more in-depth restructuring. The admissible deviation from the result of valuation should be more restricted for assets the value of which can be established on the basis of reliable market input than for those for which markets are illiquid. Non-compliance with these principles would represent a strong indicator for the necessity of far-reaching restructuring and compensatory measures or even an orderly winding-up.

In any event, any pricing of asset relief must include remuneration for the State that adequately takes account of the risks of future losses exceeding those that are projected in the determination of the 'real economic value' and any additional risk stemming from a transfer value above the real economic value.

Such remuneration may be provided by setting the transfer price of assets at below the 'real economic value' to a sufficient extent so as to provide for adequate compensation for the risk in the form of a commensurate upside, or by adapting the guarantee fee accordingly.

([1]) In any case, an auction would only be possible for homogeneous classes of assets and where there exist a sufficiently large number of potential sellers. In addition a reserve price would need to be introduced to ensure the protection of the interest of the State and claw back mechanism in case the final losses would exceed the reserve price, so as to ensure a sufficient contribution by the beneficiary bank. In order to assess such mechanisms, comparative scenarios with alternatives guarantee/purchase schemes will have to be submitted, including stress tests, in order to guarantee their global financial equivalence.

([2]) The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may have recourse to external expertise.

([3]) See Section 5.2.

Identifying the necessary target return could be 'inspired' by the remuneration that would have been required for recapitalisation measures to the extent of the capital effect of the proposed asset relief. This should be in line with the Commission Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, while taking into account the specific features of asset relief measures and particularly the fact that they may involve higher exposure than capital injections ([1]).

The pricing system could also include warrants for shares in the banks equal in value to the assets (implying that a higher price paid will result in a higher potential equity stake). One model for such a pricing system could be an asset purchase scenario, in which such warrants will be returned to the bank once the assets are sold by the bad bank and if they have earned the necessary target return. If the assets do not yield such a return, the bank should pay the difference in cash to reach the target return. If the bank does not pay the cash, the Member State will sell the warrants to achieve the target return.

In an asset guarantee scenario, the guarantee fee could be paid in the form of shares with a fixed cumulative interest representing the target return. Where the guarantee needs to be drawn upon, the Member State could use the warrants to acquire shares corresponding to the amounts that had to be covered by the guarantee.

Any pricing system would have to ensure that the overall contribution of beneficiary banks reduces the extent of net State intervention to the minimum necessary.

([1]) In an asset guarantee scenario, it would also have to be taken into consideration that in contrast to recapitalisation measures, no liquidity is provided.

ANNEX V

State aid procedure

Member States notifying asset relief measures must provide the Commission with comprehensive and detailed information on all the elements of relevance for the assessment of the public support measures under the State aid rules as set out in this Communication ([1]). This includes notably the detailed description of the valuation methodology and its intended implementation involving independent third-party expertise ([2]). Commission approval will be granted for a period of 6 months, and conditional on the commitment to present either a restructuring plan or a viability review for each beneficiary institution within 3 months from its accession to the asset relief programme.

Where a bank is granted aid either as an individual measure or under an approved asset relief scheme, the Member State must provide the Commission, at the latest in the individual notification concerning the restructuring plan or viability review, with detailed information regarding the assets covered and its valuation at the time such individual aid is granted, as well as the certified and validated results of the disclosure of impairments concerning the assets covered by the relief measure ([3]). The full review of the bank's activities and balance sheet should be provided as soon as possible to initiate discussions on the appropriate nature and extent of restructuring well in advance of the formal presentation of a restructuring plan with a view to accelerating this process and providing clarity and legal certainty as quickly as possible.

For banks that have already benefited from other forms of State aid, whether under approved guarantee, asset swaps or recapitalisation schemes or individual measures, any assistance granted under the asset relief scheme must be reported first under existing reporting obligations so that the Commission has a complete picture of multiple State aid measures benefiting an individual aid recipient and can better appreciate the effectiveness of the previous measures and the contribution that the Member State proposes to introduce in a global assessment.

The Commission will reassess the aid granted under temporary approval in the light of the adequacy of the proposed restructuring and the remedial measures ([4]), and will take a view on its compatibility for longer than 6 months through a new decision.

Member States must also provide a report to the Commission every six months on the functioning of the asset relief programmes and on the development of the banks' restructuring plans. Where the Member State is already subject to a reporting requirement for other forms of aid to its banks, such a report must be complemented with the necessary information concerning the asset relief measures and the banks' restructuring plans.

([1]) Pre-notification contact is encouraged.
([2]) See Section 5.5 and Annex IV.
([3]) A letter from the head of the supervisory authority certifying the detailed results must be provided.
([4]) In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring/winding-up cases. The Commission may consider that there is no need to submit a plan for the pure winding up of an institution, or where the size of the institution is negligible.

Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules

(Text with EEA relevance)

(2009/C 195/04)

1. INTRODUCTION

1. At its meetings on 20 March 2009 and on 18 and 19 June 2009, the European Council confirmed its commitment to restoring confidence and the proper functioning of the financial market, which is an indispensable precondition for recovery from the current financial and economic crisis. In view of the systemic nature of the crisis and the interconnectivity of the financial sector, a number of actions have been initiated at Community level to restore confidence in the financial system, preserve the internal market and secure lending to the economy ([1]).

2. Those initiatives need to be complemented by action at the level of individual financial institutions to enable them to withstand the current crisis and return to long-term viability without reliance on State support in order to perform their lending function on a sounder basis. The Commission is already dealing with a number of State aid cases resulting from interventions by Member States to avoid liquidity, solvency or lending problems. The Commission has provided guidance, in three successive communications, on the design and implementation of State aid in favour of banks ([2]). Those communications recognised that the severity of the crisis justified the granting of aid, which can be considered compatible pursuant to Article 87(3)(b) of the Treaty establishing the European Community, and provided a framework for the coherent provision of public guarantees, recapitalisation and impaired asset relief measures by Member States. The primary rationale of those rules is to ensure that rescue measures can fully attain the objectives of financial stability and maintenance of credit flows, while also ensuring a level playing-field between banks ([3]) located in different Member States as well as between banks which receive public support and those which do not, avoiding harmful subsidy races, limiting moral hazard and ensuring the competitiveness and efficiency of European banks in Community and international markets.

3. State aid rules provide a tool to ensure the coherence of measures taken by those Member States which have decided to act. However, the decision whether to use public funds, for example to shelter banks from impaired assets, remains with the Member States. In some instances, financial institutions will be in a position to handle the current crisis without major adjustment or additional aid. In other cases, State aid may be necessary, in the form of guarantees, recapitalization or impaired asset relief.

4. Where a financial institution has received State aid, the Member State should submit a viability plan or a more fundamental restructuring plan, in order to confirm or re-establish individual banks' long-term viability without reliance on State support. Criteria have already been established to delineate the conditions under which a bank may need to be subject to more substantial restructuring, and when measures are needed to cater for distortions of competition resulting from the aid ([4]). This Communication does not alter those criteria. It complements them, with a view to enhancing predictability and ensuring a coherent approach, by explaining how the Commission will assess

([1]) In its Communication to the European Council of 4 March 2009 on 'Driving the European Recovery' COM(2009) 114 final, the Commission announced a reform programme to address more general weaknesses in the regulatory framework applicable to financial institutions which operate in the Community.

([2]) See the 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 ('the Banking Communication') (OJ C 270, 25.10.2008, p. 8), the Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('the Recapitalisation Communication') (OJ C 10, 15.1.2009, p. 2) and the Communication from the Commission on the Treatment of Impaired assets in the Community Banking Sector ('the Impaired Assets Communication') (OJ C 72, 26.3.2009, p. 1). For an overview of the Commission's decision-making practice, see State aid Scoreboard — Spring 2009 Update, Special edition on State aid interventions in the current financial and economic crisis, COM(2009) 164 final of 8 April 2009.

([3]) The application of this Communication is limited to financial institutions as referred to in the Banking Communication. Guidance provided in this Communication refers to banks for ease of reference. However it applies, *mutatis mutandis*, to other financial institutions where appropriate.

([4]) The criteria and specific circumstances which trigger the obligation to present a restructuring plan have been explained in the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. They refer in particular, but not exclusively, to situations where a distressed bank has been recapitalised by the State, or where a bank benefiting from asset relief has already received State aid in whatever form that contributes to coverage or avoidance of losses (except participation in a guarantee scheme) which altogether exceeds 2 % of the total bank's risk weighted assets. The degree of restructuring will depend on the seriousness of the problems of each bank. By contrast, in line with those Communications (in particular point 40 of the Recapitalisation Communication and Annex V to the Impaired Assets Communication), where a limited amount of aid has been given to banks which are fundamentally sound, Member States are required to submit a report to the Commission on the use of State funds comprising all the information necessary to evaluate the bank's viability, the use of the capital received and the path towards exit from reliance on State support. The viability review should demonstrate the risk profile and prospective capital adequacy of these banks and evaluate their business plans.

the compatibility of restructuring aid ([1]) granted by Member States to financial institutions in the current circumstances of systemic crisis, under Article 87(3)(b) of the Treaty.

5. The Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication recall the basic principles set out in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty ([2]). Those principles require, first and foremost, that restructuring aid should lead to the restoration of viability of the undertaking in the longer term without State aid. They also require restructuring aid to be accompanied, to the extent possible, by adequate burden sharing and by measures to minimise distortions of competition, which would in the longer term fundamentally weaken the structure and the functioning of the relevant market.

6. The integrity of the internal market and the development of banks throughout the Community must be a key consideration in the application of those principles; fragmentation and market partitioning should be avoided. European banks should be in a strong global position on the basis of the single European financial market, once the current crisis has been overcome. The Commission also reaffirms the need to anticipate and manage change in a socially responsible way and underlines the need to comply with national legislation implementing Community Directives on information and consultation of workers that apply under such circumstances ([3]).

7. This Communication explains how the Commission will examine aid for the restructuring of banks in the current crisis, taking into account the need to modulate past practice in the light of the nature and the global scale of the crisis, the systemic role of the banking sector for the whole economy, and the systemic effects which may arise from the need of a number of banks to restructure within the same period:

— The restructuring plan will need to include a thorough *diagnosis* of the bank's problems. In order to devise sustainable strategies for the restoration of viability, banks will therefore be required to stress test their business. This first step in the restoration of viability should be based on common parameters which will build to the extent possible on appropriate methodologies agreed at Community level. Banks will also be required, where applicable, to disclose impaired assets ([4]).

— Given the overriding goal of financial stability and the prevailing difficult economic outlook throughout the Community, special attention will be given to the design of a restructuring plan, and in particular to ensuring a sufficiently flexible and realistic timing of the necessary implementation steps. Where the immediate implementation of structural measures is not possible due to market circumstances, intermediate behavioural safeguards should be considered.

— The Commission will apply the basic principle of appropriate burden sharing between Member States and the beneficiary banks with the overall situation of the financial sector in mind. Where significant burden sharing is not immediately possible due to market circumstances at the time of the rescue, this should be addressed at a later stage of the implementation of the restructuring plan.

— Measures to limit distortion of competition by a rescued bank in the same Member State or in other Member States should be designed in a way that limits any disadvantage to other banks while taking into account the fact that the systemic nature of the current crisis has required very widespread State intervention in the sector.

([1]) That is to say, aid which was temporarily authorised by the Commission as rescue aid under the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (OJ C 244, 1.10.2004, p. 2) or aid temporarily authorised under Article 87(3)(b) of the Treaty, as well as any new aid that may be notified as needed for restructuring. This Communication will therefore be applied instead of the Guidelines on State aid for rescuing and restructuring firms in difficulty for the assessment of restructuring aid to banks in the current circumstances of systemic crisis.

([2]) In the past, the Commission has adopted a number of decisions relating to restructuring aid (compatible under Article 87(3)(c) of the Treaty) to ailing banks, on the basis of a comprehensive restructuring process which allowed the beneficiaries to regain their long-term viability without the aid unduly harming competitors. Typical restructuring strategies included reorientation of business models, closure or divestments of businesses divisions, subsidiaries or branches, changes in the asset-liabilities management, sale as a going concern or break-up and sale of different parts of business to viable competitors. See for instance Commission Decision 98/490/EC of 20 May 1998 concerning aid granted by France to the Crédit Lyonnais group (OJ L 221, 8.8.1998, p. 28), Commission Decision 2005/345/EC of 18 February 2004 on restructuring aid implemented by Germany for Bankgesellschaft Berlin AG (OJ L 116, 4.5.2005, p. 1), Commission Decision 2009/341/EC of 4 June 2008 on State aid C 9/2008 (ex NN 8/2008, CP 244/07) implemented by Germany for Sachsen LB (OJ L 104, 24.4.2009, p. 34) and the autumn 2006 State Aid Scoreboard, COM(2006) 761 final, p. 28 (http://ec.europa.eu/comm/competition/state_aid/studies_reports/2006_autumn_en.pdf), with a special survey on rescue and restructuring aid.

([3]) See also: Communication on 'Restructuring and Employment' of 31 March 2005 (COM(2005) 120 final of 31 March 2005) and the good practice on restructuring agreed by the European social partners in November 2003.

([4]) In accordance with the Impaired Assets Communication.

— Provision of additional aid during the restructuring period should remain a possibility if justified by reasons of financial stability. Any additional aid should remain limited to the minimum necessary to ensure viability.

8. Section 2 applies to cases where the Member State is under an obligation to notify a restructuring plan ([1]). The principles underlying section 2 apply by analogy to cases where the Member State is not under a formal obligation to notify a restructuring plan, but is nonetheless required to demonstrate viability ([2]) of the beneficiary bank. In the latter case, and save situations where there are doubts, the Commission will normally request less detailed information ([3]). In case of doubt, the Commission will, in particular, seek evidence of adequate stress testing, in accordance with point 13, and of validation of the results of the stress testing by the competent national authority. Sections 3, 4 and 5 only apply to cases where the Member State is under an obligation to notify a restructuring plan. Section 6 deals with the temporal scope of this Communication and applies both to Member States required to notify a restructuring plan for the aid beneficiary and to Member States required only to demonstrate the viability of aid beneficiaries.

2. RESTORING LONG-TERM VIABILITY

9. Where, on the basis of previous Commission guidance or decisions, a Member State is under an obligation to submit a restructuring plan ([4]) that plan should be comprehensive, detailed and based on a coherent concept. It should demonstrate how the bank will restore long-term viability without State aid as soon as possible ([5]). The notification of any restructuring plan should include a comparison with alternative options, including a break-up, or absorption by another bank, in order to allow the Commission to assess ([6]) whether more market oriented, less costly or less distortive solutions are available consistent with maintaining financial stability. In the event that the bank cannot be restored to viability, the restructuring plan should indicate how it can be wound up in an orderly fashion.

10. The restructuring plan should identify the causes of the bank's difficulties and the bank's own weaknesses and outline how the proposed restructuring measures remedy the bank's underlying problems.

11. The restructuring plan should provide information on the business model of the beneficiary, including in particular its organisational structure, funding (demonstrating viability of the short and long term funding structure ([7])), corporate governance (demonstrating prevention of conflicts of interest as well as necessary management changes ([8])), risk management (including disclosure of impaired assets and prudent provisioning for expected non-performing assets), and asset-liability management, cash-flow generation (which should reach sufficient levels without State support), off-balance sheet commitments (demonstrating their sustainability and consolidation when the bank bears a significant exposure ([9])), leveraging, current and prospective capital adequacy in line with applicable supervisory regulation (based on prudent valuation and adequate provisioning), and the remuneration incentive structure ([10]), (demonstrating how it promotes the beneficiary's long-term profitability).

12. The viability of each business activity and centre of profit should be analysed, with the necessary breakdown. The return to viability of the bank should mainly derive from internal measures. It may be based on external factors such as variations in prices and demand over which the undertaking has no great influence, but only if the market assumptions made are generally acknowledged. Restructuring requires a withdrawal from activities which would remain structurally loss making in the medium term.

13. Long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking into account the risk profile of the bank. The restructured bank should be able to compete in the marketplace for capital on its own merits in compliance with relevant regulatory requirements. The expected results of the planned restructuring need to be demonstrated under a base case scenario as well as under 'stress' scenarios. For this, restructuring plans need to take account, inter alia, of the current state and future prospects of the financial markets, reflecting base-case and worst-case assumptions. Stress testing should consider a range of scenarios, including a combination of stress events and a protracted global recession. Assumptions should be compared with appropriate sector-wide benchmarks, adequately amended to take account of the new elements of the current crisis in financial markets. The plan should include measures to

([1]) In accordance with the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. See point 4 of this Communication.

([2]) In accordance with the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication, where a limited amount of aid is granted to fundamentally sound banks, Member States are required to submit a viability review to the Commission.

([3]) In accordance, in particular, with point 40 of the Recapitalisation Communication and Annex V to the Impaired Assets Communication.

([4]) As explained in point 8 of this Communication, where section 2 refers to a restructuring plan, the principles underlying section 2 apply by analogy also to viability reviews.

([5]) An indicative model for a restructuring plan is reproduced in the Annex.

([6]) Where appropriate the Commission will ask for the advice of an external consultant to examine the notified restructuring plans in order to assess viability, burden sharing and minimising competition distortions. It may also request certification of various elements by supervisors.

([7]) See for instance, Commission Decision of 2 April 2008 in case NN 1/2008 *Northern Rock* (OJ C 135, 3.6.2008, p. 21), and Decision 2009/341/EC in Case C 9/2008 *Sachsen LB*.

([8]) See Decision 2009/341/EC in Case C 9/2008 *Sachsen LB*.

([9]) Except in duly justified circumstances. See Commission Decision of 21 October 2008 in case C 10/2008 *IKB*, not yet published.

([10]) In accordance with Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector (OJ L 120, 15.5.2009, p. 22).

address possible requirements emerging from stress testing. The stress testing should, to the extent possible, be based on common parameters agreed at Community level (such as a methodology developed by the Committee of European Banking Supervisors) and, where appropriate, adapted to cater for country- and bank-specific circumstances.

14. In the current crisis governments have recapitalised banks on terms chosen primarily for reasons of financial stability rather than for a return which would have been acceptable to a private investor. Long-term viability therefore requires that any State aid received is either redeemed over time, as anticipated at the time the aid is granted, or is remunerated according to normal market conditions, thereby ensuring that any form of additional State aid is terminated. As the Treaty is neutral as to the ownership of property, State aid rules apply irrespective of whether a bank is in private or public ownership.

15. While the restructuring period should be as short as possible so as to restore viability quickly, the Commission will take into account the current crisis conditions and may therefore allow some structural measures to be completed within a longer time horizon than is usually the case, notably to avoid depressing markets through fire sales ([1]). However, restructuring should be implemented as soon as possible and should not last more than five years ([2]) to be effective and allow for a credible return to viability of the restructured bank.

16. Should further aid not initially foreseen in the notified restructuring plan be necessary during the restructuring period for the restoration of viability, this will be subject to individual *ex ante* notification and any such further aid will be taken into account in the Commission's final decision.

Viability through sale of a bank

17. The sale of an ailing bank to another financial institution can contribute to the restoration of long-term viability, if the purchaser is viable and capable of absorbing the transfer of the ailing bank, and may help to restore market confidence. It may also contribute to the consolidation of the financial sector. To this end, the purchaser should demonstrate that the integrated entity will be viable. In the case of a sale, the requirements of viability, own contribution and limitations of distortions of competition also need to be respected.

18. A transparent, objective, unconditional and non-discriminatory competitive sale process should generally be ensured to offer equal opportunities to all potential bidders ([3]).

19. Furthermore, without prejudice to the merger control system that may be applicable, and while recognising that the sale of an aided ailing bank to a competitor can both contribute to the restoration of long-term viability and result in increased consolidation of the financial sector, where such a sale would result *prima facie* in a significant impediment of effective competition, it should not be allowed unless the distortions of competition are addressed by appropriate remedies accompanying the aid.

20. The sale of a bank may also involve State aid to the buyer and/or to the sold activity ([4]). If the sale is organised via an open and unconditional competitive tender and the assets go to the highest bidder, the sale price is considered to be the market price and aid to the buyer can be excluded ([5]). A negative sale price (or financial support to compensate for such a negative price) may exceptionally be accepted as not involving State aid if the seller would have to bear higher costs in the event of liquidation ([6]). For the calculation of the cost of liquidation in such circumstances, the Commission will only take account of those liabilities which would have been entered into by a market economy investor ([7]). This excludes liabilities stemming from State aid ([8]).

21. An orderly winding-up or the auctioning off of a failed bank should always be considered where a bank cannot credibly return to long-term viability. Governments should encourage the exit of non-viable players, while allowing for the exit process to take place within an appropriate time frame that preserves financial stability. The Banking Communication provides for a procedure in the

([1]) Understood as selling large quantities of assets at current low market prices which could lower the prices further.

([2]) The Commission practice has been to accept two to three years as the duration of a restructuring plan.

([3]) See also point 20.

([4]) See for example Decision 2009/341/EC in Case C 9/2008 *Sachsen LB*.

([5]) The absence of the tender as such does not automatically mean that there is State aid to the buyer.

([6]) This would normally result in an aid to the sold economic activity.

([7]) Joined Cases C-278/92, C-279/92 and C-280/92 *Hytasa* [1994] ECR I-4103, paragraph 22.

([8]) See Case C-334/99 *Gröditzer Stahlwerke* [2003] ECR I-1139, paragraph 134 *et seq.* and Commission Decision 2008/719/EC of 30 April 2008 on State aid C 56/2006 (ex NN 77/2006) *Bank Burgenland* (OJ L 239, 6.9.2008, p. 32).

framework of which such orderly winding up should take place ([1]). Acquisition of the 'good' assets and liabilities of a bank in difficulty may also be an option for a healthy bank as it could be a cost effective way to expand deposits and build relationships with reliable borrowers. Moreover, the creation of an autonomous 'good bank' from a combination of the 'good' assets and liabilities of an existing bank may also be an acceptable path to viability, provided this new entity is not in a position to unduly distort competition.

3. OWN CONTRIBUTION BY THE BENEFICIARY (BURDEN SHARING)

22. In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour.

Limitation of restructuring costs

23. Restructuring aid should be limited to covering costs which are necessary for the restoration of viability. This means that an undertaking should not be endowed with public resources which could be used to finance market-distorting activities not linked to the restructuring process. For example, acquisitions of shares in other undertakings or new investments cannot be financed through State aid unless this is essential for restoring an undertaking's viability ([2]).

Limitation of the amount of aid, significant own contribution

24. In order to limit the aid amount to the minimum necessary, banks should first use their own resources to finance restructuring. This may involve, for instance, the sale of assets. State support should be granted on terms which represent an adequate burden-sharing of the costs ([3]). This means that the costs associated with the restructuring are not only borne by the State but also by those who invested in the bank, by absorbing losses with available capital and by paying an adequate remuneration for State interventions ([4]). Nonetheless, the Commission considers that it is not appropriate to fix thresholds concerning burden-sharing *ex ante* in the context of the current systemic crisis, having regard to the objective of facilitating access to private capital and a return to normal market conditions.

25. Any derogation from an adequate burden-sharing *ex ante* which may have been exceptionally granted in the rescue phase for reasons of financial stability must be compensated by a further contribution at a later stage of the restructuring, for example in the form of claw-back clauses and/or by farther-reaching restructuring including additional measures to limit distortions of competition ([5]).

26. Banks should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities. However, banks should not use State aid to remunerate own funds (equity and subordinated debt) when those activities do not generate sufficient profits. Therefore, in a restructuring context, the discretionary offset of losses (for example by releasing reserves or reducing equity) by beneficiary banks in order to guarantee the payment of dividends and coupons on outstanding subordinated debt, is in principle not compatible with the objective of burden sharing ([6]). This may need to be balanced with ensuring the refinancing capability of the bank and the exit incentives ([7]). In the interests of promoting refinancing by the beneficiary bank, the Commission may favourably regard the payment of coupons on newly issued hybrid capital instruments with

([1]) See points 43 to 50 of the Banking Communication. In order to enable such orderly exit, liquidation aid may be considered compatible, when for instance needed for a temporary recapitalisation of a bridge bank or structure or satisfying claims of certain creditor classes if justified by reasons of financial stability. For examples of such aid and conditions under which it was found compatible, see Commission Decision of 1 October 2008 in case NN 41/2008 UK, *Rescue aid to Bradford&Bingley* (OJ C 290, 13.11.2008, p. 2) and the Commission Decision of 5 November 2008 in case NN 39/2008 DK, *Aid for liquidation of Roskilde Bank* (OJ C 12, 17.1.2009, p. 3).

([2]) See Case T-17/03 Schmitz-Gotha [2006] ECR II-1139.

([3]) As already developed in previous Commission Communications, in particular the Impaired Assets Communication, see points 21 *et seq.*

([4]) The Commission has provided detailed guidance regarding the pricing of State guarantees, recapitalisations and asset relief measures respectively in the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication. To the extent that such a price is being paid, the shareholders of the bank see their position diluted in a financial sense.

([5]) Impaired Asset Communication, points 24 and 25. See also Section 4 of this Communication.

([6]) See Commission Decision of 18 December 2008 in case N 615/2008 *Bayern LB* (OJ C 80, 3.4.2009, p. 4). However, this does not prevent the bank from making coupon payments when it is under a binding legal obligation to do so.

([7]) See Impaired Asset Communication, point 31, and the nuanced approach to dividend restrictions in the Recapitalisation Communication, points 33, 34 and 45, reflecting that although temporary dividend or coupon bans may retain capital within the bank and increase the capital cushion and hence improve the solvency of the bank, they may equally impede the bank's access to private finance sources, or at least increase the cost of new future financing.

greater seniority over existing subordinated debt. In any case, banks should not normally be allowed to purchase their own shares during the restructuring phase.

27. Provision of additional aid during the restructuring period should remain a possibility if justified by reasons of financial stability. Any additional aid should remain limited to the minimum necessary to ensure viability.

4. LIMITING DISTORTIONS OF COMPETITION AND ENSURING A COMPETITIVE BANKING SECTOR

Types of distortion

28. Whilst State aid can support financial stability in times of systemic crisis, with wider positive spillovers, it can nevertheless create distortions of competition in various ways. Where banks compete on the merits of their products and services, those which accumulate excessive risk and/or rely on unsustainable business models will ultimately lose market share and, possibly, exit the market while more efficient competitors expand on or enter the markets concerned. State aid prolongs past distortions of competition created by excessive risk-taking and unsustainable business models by artificially supporting the market power of beneficiaries. In this way it may create a moral hazard for the beneficiaries, while weakening the incentives for non-beneficiaries to compete, invest and innovate. Finally, State aid may undermine the single market by shifting an unfair share of the burden of structural adjustment and the attendant social and economic problems to other Member States, whilst at the same time creating entry barriers and undermining incentives for cross-border activities.

29. Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to State aid play an important role, inter alia for the following reasons. First, banks across the Community have been hit by the crisis to a very varying degree and State aid to rescue and restructure distressed banks may harm the position of banks that have remained fundamentally sound, with possible negative effects for financial stability. In a situation of financial, economic and budgetary crisis, differences between Member States in terms of resources available for State intervention become even more pronounced, and harm the level-playing field in the single market. Second, national interventions in the current crisis will, by their very nature, tend to focus on the national markets and hence seriously risk leading to retrenchment behind national borders and to a fragmentation of the single market. Market presence of aid beneficiaries needs to be assessed with a view to ensuring effective competition and preventing market power, entry barriers and disincentives for cross-border activities to the detriment of European businesses and consumers. Third, the current scale of the public intervention necessary for financial stability and the possible limits to normal burden sharing are bound to create even greater moral hazard that needs to be properly corrected to prevent perverse incentives and excessively risky behaviour from reoccurring in the future and to pave the way for a rapid return to normal market conditions without State support.

Applying effective and proportionate measures limiting distortions of competition

30. Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Commission takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in section 2. Depending on the nature of the distortion of competition, it may be addressed through measures in respect of liabilities and/or in respect of assets [1]. The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

31. As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. In this context, the amount of State aid will be assessed both in absolute terms (amount of capital received, aid element in guarantees and asset relief measures) and in relation to the bank's risk-weighted assets. The Commission will consider the total amount of aid granted to the beneficiary including any kind of rescue aid. In the same vein, the Commission will take into account the extent of the beneficiary's own contribution and burden sharing over the restructuring period. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard. Therefore, the need for further measures is reduced [2].

[1] See point 21.

[2] If the Commission has, pursuant to Banking Communication, the Recapitalisation Communication or the Impaired Assets Communication, exceptionally accepted aid that departed from the principles required by those communications, the resulting additional distortion of competition will require additional structural or behavioural safeguards; see point 58 of the Impaired Assets Communication.

32. As regards the second criterion, the Commission will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. If the restructured bank has limited remaining market presence, additional constraints, in the form of divestments or behavioural commitments, are less likely to be needed. The measures will be tailored to market characteristics ([1]) to make sure that effective competition is preserved. In some areas, divestments may generate adverse consequences and may not be necessary in order to achieve the desired outcomes, in which case the limitation of organic growth may be preferred to divestments. In other areas, especially those involving national markets with high entry barriers, divestments may be needed to enable entry or expansion of competitors. Measures limiting distortions of competition should not compromise the prospects of the bank's return to viability.

33. Finally, the Commission will pay attention to the risk that restructuring measures may undermine internal market and will view positively measures that help to ensure that national markets remain open and contestable. While aid is granted to maintain financial stability and lending to the real economy in the granting Member State, where such aid is also conditional upon the beneficiary bank respecting certain lending targets in Member States other than the State which grants the aid, this may be regarded as an important additional positive effect of the aid. This will particularly be the case where the lending targets are substantial relative to a credible counterfactual, where achievement of such targets is subject to adequate monitoring (for example, through cooperation between the home and host State supervisors), where the banking system of the host State is dominated by banks with headquarters abroad and where such lending commitments have been coordinated at Community level (for example, in the framework of liquidity assistance negotiations).

Setting the appropriate price for State aid

34. Adequate remuneration of any State intervention generally is one of the most appropriate limitations of distortions of competition, as it limits the amount of aid. Where the entry price has been set at a level significantly below the market price for reasons of financial stability, it should be ensured that the terms of the financial support are revised in the restructuring plan ([2]) so as to reduce the distortive effect of the subsidy.

Structural measures — divestiture and reduction of business activities

35. On the basis of an assessment in accordance with the criteria of this Section, banks benefiting from State aid may be required to divest subsidiaries or branches, portfolios of customers or business units, or to undertake other such measures ([3]), including on the domestic retail market of the aid beneficiary. In order for such measures to increase competition and contribute to the internal market, they should favour the entry of competitors and cross-border activity ([4]). In line with the requirement of restoration of viability, the Commission will take a positive view of such structural measures if they are undertaken without discrimination between businesses in different Member States, thus contributing to the preservation of an internal market in financial services.

36. A limit on the bank's expansion in certain business or geographical areas may also be required, for instance via market-oriented remedies such as specific capital requirements, where competition in the market would be weakened by direct restrictions on expansion or to limit moral hazard. At the same time, the Commission will pay particular attention to the need to avoid retrenchment within national borders and a fragmentation of the single market.

37. Where finding a buyer for subsidiaries or other activities or assets appears objectively difficult, the Commission will extend the time period for the implementation of those measures, if a binding timetable for scaling down businesses (including segregation of business lines) is provided. However, the time period for implementing those measures should not exceed five years.

38. In assessing the scope of structural remedies required to overcome distortions of competition in a given case, and with due regard to the principle of equal treatment, the Commission will take into account the measures provided for in cases relating to the same markets or market segments at the same time.

([1]) In particular, concentration levels, capacity constraints, the level of profitability, barriers to entry and to expansion will be taken into account.

([2]) For example by favouring early redemption of State aid.

([3]) See for example Commission Decision of 21 October 2008 in Case C 10/2008 *IKB*, not yet published and Commission Decision of 7 May 2009 in case N 244/2009 *Capital injection into Commerzbank* (OJ C 147, 27.6.2009, p. 4).

([4]) It should be noted that balance-sheet reductions due to asset write-offs, which are partly compensated with State aid, do not reduce the bank's actual market presence and cannot therefore be taken into account when assessing the need for structural measures.

Avoiding the use of State aid to fund anti-competitive behaviour

39. State aid must not be used to the detriment of competitors which do not enjoy similar public support [1].

40. Subject to point 41, banks should not use State aid for the acquisition of competing businesses [2]. This condition should apply for at least three years and may continue until the end of the restructuring period, depending on the scope, size and duration of the aid.

41. In exceptional circumstances and upon notification, acquisitions may be authorised by the Commission where they are part of a consolidation process necessary to restore financial stability or to ensure effective competition. The acquisition process should respect the principles of equal opportunity for all potential acquirers and the outcome should ensure conditions of effective competition in the relevant markets.

42. Where the imposition of divestitures and/or the prohibition of acquisitions are not appropriate, the Commission may accept the imposition by the Member State of a claw-back mechanism, for example in the form of a levy on the aid recipients. This would allow recovery of part of the aid from the bank after it has returned to viability.

43. Where banks receiving State support are requested to fulfil certain requirements as to lending to the real economy, the credit provided by the bank must be on commercial terms [3].

44. State aid cannot be used to offer terms (for example as regards rates or collateral) which cannot be matched by competitors which are not in receipt of State aid. However, in cases where limitations on the pricing behaviour of the beneficiary may not be appropriate, for example because they may result in a reduction of effective competition, Member States should propose other, more suitable, remedies to ensure effective competition, such as measures that favour entry. In the same vein, banks must not invoke State support as a competitive advantage when marketing their financial offers [4]. These restrictions should remain in place, depending on the scope, size and duration of the aid, for a period ranging between three years and the entire duration of the restructuring period. They would then also serve as a clear incentive to repay the State as soon as possible.

45. The Commission will also examine the degree of market opening and the capacity of the sector to deal with bank failures. In its overall assessment the Commission may consider possible commitments by the beneficiary or commitments from the Member State concerning the adoption of measures [5] that would promote more sound and competitive markets, for instance by favouring entry and exit. Such initiatives could, in appropriate circumstances, accompany the other structural or behavioural measures that would normally be required of the beneficiary. The Member State's commitment to introduce mechanisms to deal with bank difficulties at an early stage may be regarded positively by the Commission as an element promoting sound and competitive markets.

5. MONITORING AND PROCEDURAL ISSUES

46. In order to verify that the restructuring plan is being implemented properly, the Commission will request regular detailed reports. The first report will normally have to be submitted to the Commission not later than six months after approval of the restructuring plan.

47. Upon notification of the restructuring plan the Commission has to assess whether the plan is likely to restore long term viability and to limit distortions of competition adequately. Where it has serious doubts as to the compliance of the restructuring plan with the relevant requirements, the Commission is required to open a formal investigation procedure, giving third parties the possibility to comment on the measure and thereby ensuring a transparent and coherent approach while respecting the confidentiality rules applicable in State aid proceedings [6].

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(1) See for example Commission Decision of 19 November 2008 in case NN 49/2008, NN 50/2008 and NN 45/2008 *Guarantees to Dexia* (not yet published), point 73, Commission Decision of 19 November 2008 in case N 574/2008 *Guarantees to Fortis Bank* (OJ C 38, 17.2.2009, p. 2), point 58 and Commission Decision of 3 December 2008 in case NN 42/2008, NN 46/2008 and NN 53/A/2008 *Restructuring aid to Fortis Bank and Fortis Bank Luxembourg* (OJ C 80, 3.4.2009, p. 7), paragraph 94. For instance a bank may, in certain circumstances, be prohibited from proposing the highest interest rates offered on the market to retail depositors.

(2) It is recalled that restructuring costs have to be limited to the minimum necessary for the restoration of viability. See point 23.

(3) Credit provided on non-commercial terms might constitute State aid and might be authorised by the Commission, upon notification, if it is compatible with the common market, for example under the Communication from the Commission — Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis (OJ C 83, 7.4.2009, p. 1).

(4) Commission Decision of 12 November 2008 in Case N 528/2008 *ING* (OJ C 328, 23.12.2008, p. 10), point 35.

(5) See for example Commission Decision 2005/418/EC of 7 July 2004 on the aid measures implemented by France for Alstom (OJ L 150, 10.6.2005, p. 24), point 204.

(6) Commission communication C(2003) 4582 of 1 December 2003 on professional secrecy in State aid decisions (OJ C 297, 9.12.2003, p. 6).

48. Nevertheless the Commission does not have to open formal proceedings where the restructuring plan is complete and the measures suggested are such that the Commission has no further doubts as to compatibility in the sense of Article 4(4) of Council Regulation EC No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty [1]. This might, in particular, be the case where a Member State has notified the Commission of an aid accompanied by a restructuring plan which meets all of the conditions set out in this Communication, in order to obtain legal certainty as to the necessary follow-up. In such cases the Commission might adopt a final decision stating that rescue aid as well as restructuring aid is compatible under Article 87(3)(b) of the Treaty.

6. TEMPORARY SCOPE OF THE COMMUNICATION

49. This Communication is justified by the current exceptional financial sector crisis and should therefore only be applied for a limited period. For the assessment of restructuring aid notified to the Commission on or before 31 December 2010, the Commission will apply this Communication. As regards non-notified aid, the Commission notice on the determination of the applicable rules for the assessment of unlawful State aid [2] will apply. The Commission will therefore apply this Communication when assessing the compatibility of non-notified aid granted on or before 31 December 2010.

50. Bearing in mind that this Communication is based on Article 87(3)(b) of the Treaty, the Commission may review its content and duration according to the development of market conditions, the experience gathered in the treatment of cases and the overriding interest in maintenance of financial stability.

[1] OJ L 83, 27.3.1999, p. 1.

[2] OJ C 119, 22.5.2002, p. 22.

ANNEX

Model restructuring plan

Indicative table of contents for restructuring plan [1]

1. Information on the financial institution (description of its structure etc.)

(NB: Information previously submitted may be reproduced but shall be integrated into this document and where necessary updated)

2. Market description and market shares

2.1. Description of the main relevant product markets (distinction at least between: retail, wholesale, capital markets etc.)

2.2. Calculations of market shares (e.g. national and European wide, depending on the geographical scope of the relevant markets)

3. Analysis of the reasons why the institution run into difficulty (internal factors)

4. Description of the State intervention and assessment of State aid

4.1. Information on whether the financial institution or its subsidiaries have already received a rescue or restructuring aid in the past

4.2. Information on form and amount of the State support or financial advantage related to support. Information should contain all State aid received as individual aid or under a scheme during the restructuring period

(NB: All aid needs to be justified within the restructuring plan as indicated in the following)

4.3. Assessment of State support under the State aid rules and quantification of aid amount

5. Restoration of viability

5.1. Presentation of the different market assumptions

5.1.1. Initial situation in the main product markets

5.1.2. Expected market development in the main product markets

5.2. Presentation of the scenario without the measure

5.2.1. Required adjustment to the initial business plan

5.2.2. Past, current and future capital ratios (tier 1, tier 2)

5.3. Presentation of the proposed future strategy for the financial institution and how this will lead to viability

5.3.1. Starting position and overall framework

5.3.2. Individual frameworks per business line of the financial institution

5.3.3. Adoptions to changes in regulatory environment (enhancement of risk management, increased capital buffers, etc.)

5.3.4. Confirmation regarding full disclosure of impaired assets

5.3.5. If adequate, change in ownership structure

[1] Information required for the viability assessment may comprise bank's internal data and reports as well as reports prepared by/for the Member State's authorities, including the regulatory authorities.

5.4. Description and overview of the different measures planned to restore viability, their costs and their impact on the P&L/balance sheet

5.4.1. Measures at group level

5.4.2. Measures per business lines

5.4.3. Impact of each measure on the P&L/balance sheet

5.5. Description of effect of the different measures to limit distortions of competition (cf. point 7) in view of their costs and their impact on the P&L/balance sheet

5.5.1. Measures at group level

5.5.2. Measures in the fields of business

5.5.3. Impact of each measure on the P&L/balance sheet

5.6. Comparison with alternative options and brief comparative evaluation of the economic and social effects on the regional, national and Community level (elaboration is mainly required where bank may not meet prudential requirements in the absence of aid)

5.6.1. Alternative options: orderly winding up, break up, or absorption by another bank and resulting effects

5.6.2. General Economic Effects

5.7. Timetable for the implementation of the different measures and the final deadline for implementation of the restructuring plan in its entirety (please indicate issues of confidentiality)

5.8. Description of the repayment plan of the State aid

5.8.1. Underlying assumptions to the exit planning

5.8.2. Description of the State's exit incentives

5.8.3. Exit or repayment planning until full repayment/exit

5.9. Profit and loss accounts/balance sheets for the last three and next five years including key financial ratios and sensitivity study based on best/worst case

5.9.1. Base case

5.9.1.1. Profit and Loss Statement/balance sheet group level

5.9.1.2. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

5.9.1.3. Profit and Loss Statement/balance sheet per business unit

5.9.1.4. Key Financial ratios per business unit (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

5.9.2. Best case scenario

5.9.2.1. Underlying assumptions

5.9.2.2. Profit and Loss Statement/balance sheet group level

5.9.2.3. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

5.9.3. Worst case scenario — where a stress test has been performed and/or validated by the national supervisory authorities, the methodologies, the parameters, and the results of such a test will have to be provided [1]

5.9.3.1. Underlying assumptions

5.9.3.2. Profit and Loss Statement/balance sheet group level

5.9.3.3. Key Financial ratios on group level (RAROC as a benchmark for internal criteria for risk adjusted profitability, CIR, ROE, etc.)

6. Burden sharing — contribution to restructuring by the financial institution itself and other shareholders (accounting and economic value of holdings)

6.1. Limitation of restructuring costs to those necessary for restoring viability

6.2. Limitation of the amount of aid (including information on eventual provisions for limiting dividends and interest payments on subordinated debt)

6.3. Provision of significant own contribution (including information on the size of contribution from shareholders or subordinated creditors)

7. Measures to limit distortion of competition

7.1. Justification of scope of measures in view of the size and effect of the State aid

7.2. Structural measures, including proposal on timing and milestones for divestments of assets or subsidiaries/branches or other remedies

7.3. Behavioral commitments, including to refrain from mass marketing invoking State aid as an advantage in competitive terms

8. Monitoring (possible arrangement of a trustee)

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[1] The stress testing should to the extent possible be based on common parameters agreed at Community level (such as a methodology developed by the Committee of European Banking Supervisors) and where appropriate adapted to cater for country- and bank-specific circumstances. Where appropriate, reverse stress tests or other equivalent exercises could also be considered.