

# EU Competition Briefing

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## Three Months Of EU State Aid Policy And Practice In The Financial Markets

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This briefing provides an overview of the European Commission's policy and practice on the application of EU State aid rules to national rescue plans for banks and financial institutions.

### The Commission's Response to the Financial Crisis

Since the height of the financial crisis in September, Member States have adopted emergency measures to rescue banking institutions. The measures should restore confidence in the financial sectors and provide necessary liquidity in financial markets. While certain measures have been taken to rescue individual banks (e.g. Fortis in Belgium and the Netherlands), other measures have been more 'systemic', i.e. they cover all banks experiencing liquidity problems.

The European Commission responded to the global financial crisis on 13 October with a 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' (the "Communication").<sup>1</sup>

The existing framework applying to undertakings in difficulty, in particular the Guidelines on Rescue and Restructuring Aid,<sup>2</sup> was considered somewhat ill-suited to address the specific needs of the financial sector. The Commission concluded that exceptional measures must be permitted in order to remedy serious disturbances in the economies of the Member States.<sup>3</sup>

The Communication specifically addresses State aid in the form of guarantees of banks' liabilities and recapitalisation of distressed banks (i.e. full or partial nationalisation). While the general principles laid down in the Guidelines on Rescue and Restructuring Aid will continue to apply, the Communication provides additional guidance to introduce more flexibility:

<sup>1</sup> OJ C 270, 25.10.2008, p. 8.

<sup>2</sup> OJ C 244, 01.10.2004, p. 2.

<sup>3</sup> See Article 87(3)(b) of the EC Treaty.

**Eligibility:** when devising rescue plans, governments should consider the systemic role played by beneficiary institutions in the national banking system and the economy generally. General rescue schemes should be available to all financial institutions, including subsidiaries of financial groups headquartered in third countries with significant activities in the Member State concerned.

**Duration:** the initial issuance period for loans and bonds covered by State guarantee is six months. However, guarantee schemes may be extended to two years or for as long as the crisis in the financial markets so requires (subject to the Commission's review and approval every six months).

**Coverage:** guarantees covering retail deposits are generally justifiable to prevent bank runs. Wholesale deposits may be covered in certain cases – particularly if they stimulate inter-bank lending. Guarantees should not, however, extend to subordinated debt (tier 2 capital) or cover all bank liabilities indiscriminately.

The injection of public resources for the provision of bank guarantees should be subject to an adequate contribution (i.e. remuneration) from beneficiary banks; that contribution will need to be significantly higher if banks draw upon the guarantee. For recapitalization of individual distressed banks, the share price should be based on a market-oriented valuation. The Commission views claw-back mechanisms or preference shares positively.

Behavioural safeguards: recipient banks should not be allowed to engage in expansion plans nor publicise the fact that they benefit from a particular rescue scheme, e.g. a State guarantee for certain deposits or loans and recapitalizations.

In principle, restructuring plans should be submitted to the Commission within six months of the scheme's activation.

Where central banks react to the banking crisis with general measures open to all comparable market players (e.g. those lending to the whole market on equal terms), rather than through selective measures in favour of individual banks, such general measures fall outside the scope of the State aid rules and do not need to be notified to the Commission. The Communication considers, for instance, that activities of central banks relating to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules.

The Commission has introduced a fast-track procedure for processing notifications, which ensures prompt vetting of State aid packages, if necessary within 24 hours and over the weekend.

## The Commission's Practice

Over the last two months, the Commission has approved more than twenty rescue schemes designed to support national financial stability and individual, systemic banks.<sup>4</sup> Only a handful of decisions are publicly available.<sup>5</sup>

While a comprehensive assessment of the Commission's decision-making practice over the past months is beyond the scope of this briefing, the Commission appears to have examined guarantee schemes and individual recapitalization of distressed banks on the basis of the following key criteria:

- In order to avoid favouring national banks to the detriment of other banking institutions operating in the Member State concerned, the Commission has insisted that guarantee schemes also cover subsidiaries of financial groups headquartered in third countries;<sup>6</sup>
- Guarantee schemes may apply to certain loans and other financial liabilities issued within six months of their entry into effect. Regarding the duration of the guarantee scheme itself, the Commission will permit it to last for two to three years; and
- The Commission requests an interest rate of at least 10%.<sup>7</sup> Since the Communication states that considerations made in relation to general guarantee schemes apply, mutatis mutandis, to individual recapitalization measures, the same interest rates can be expected to apply in relation to capital injections.

At a meeting of Ministers of Finance (ECOFIN) in Brussels on 2 December, Competition Commissioner Kroes stated:

*“The role of the Commission in the field of competition policy has been to support financial stability not only by giving legal certainty to the measures taken by Member States in rapid circumstances. It has also been to contribute to maintain a level playing field and to make sure that national measures would not simply export problems to other Member States. [...]”*<sup>8</sup>

<sup>4</sup> The Commission has approved the following national schemes: (i) guarantee schemes (DK, FI, PT, IRL, NL, SWE, FR, IT); (ii) asset purchase schemes (ES); and (iii) schemes combining the above measures (DE, UK, GR). Furthermore, the Commission has also approved the following individual measures: (i) recapitalization of ING and Parex; (ii) guarantees for Fortis and Dexia; and (iii) one recapitalization of an insurance company (Aegon).

<sup>5</sup> See Commission decisions on the Irish and UK schemes (13 October), on the German scheme (27 October), on the Swedish scheme (29 October) and on the Dutch scheme (30 October).

<sup>6</sup> For example, the Irish guarantee scheme explicitly states that “foreign branches having a systemic significance would also have access to the guarantee”.

<sup>7</sup> For example, the Commission explicitly states with respect to the German guarantee scheme that interest rates should at least be between 10% and 12.5%.

<sup>8</sup> The press release of Commissioner Kroes intervention can be accessed under the following link: <http://europa.eu/rapid>.

Simply put, the Commission requires consistency across the EU with respect to all types of national rescue schemes. Some have voiced concern and criticism that consistency might restrict flexibility.

### **Recent Complaints by certain Member States**

Following adoption of the Communication, several Member States have complained about the Commission's rigid attitude towards rescue measures proposed for their financial institutions. The most recent complaints have come from Germany and France.

Germany's Finance Minister recently argued that his government did not approve of the Commission's procedure, nor its (lack of) speed with respect to the Commission's delayed decision on Germany's capital injection into Commerzbank, Germany's second largest commercial bank. The rescue measure for Commerzbank provides for an interest rate of 8.5% on a first tranche of government capital and 5.5% on a second tranche.

The Commission considered that these proposed rates fell well below the rates it expected and, therefore, conflicted with its approach to State aid.

Germany's criticism was echoed by France. In the case of France, it is feared that French assistance to its 'fundamentally sound' banks is the cheapest bank finance available in the EU. The proposed interest rate for subordinated debt is set at 8%, which is even lower than the rate proposed for Commerzbank. The Commission has sought to ensure that the French scheme was on similar terms as in other EU Member States. France argued, however, that the capital injection was needed to restore credit availability.

### **Conclusion**

Looking back at the chronology of events, the Communication was inspired by common measures decided at the European Council on 15/16 October – measures that reflect earlier proposals by the Eurogroup countries on 12 October and by Gordon Brown, the UK Prime Minister, on 8 October.

The Commission's Communication does not create a new test for State aid enforcement in relation to financial institutions. It restates the principles laid down in the Guidelines on Rescue and Restructuring Aid and incorporates the approaches of the Eurogroup and the UK. Practice to date shows that the Commission seeks consistency throughout the EU. To a certain extent, due to the fact that the Commission is under sometimes extreme pressure to act swiftly upon receipt of a proposed rescue packages, it is arguable that the Commission has engaged in a 'one size fits all' approach, namely by imposing:

- An interest rate of at least 10% as adequate remuneration for rescue schemes; and
- A duration extended from six months to two years (with scope for extensions, if circumstances so require).

Partly in response to the French criticism, the Commission addressed the issue of recapitalization of fundamentally sound banks with a new Communication on 5 December.<sup>9</sup> However, it appears that this second Communication does not present a significantly new approach either.

Under this second Communication, the Commission will take the pricing formula proposed by the ECB for fundamentally sound banks as a minimum price, which then has to be adjusted upwards depending on the risk profile of each beneficiary bank. Incentives for redeeming the capital injection are encouraged and Member States should introduce behavioural safeguards to avoid boosting profits of beneficiary banks or distorting competition in the relevant market.

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<sup>9</sup> See Commission Communication Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition. Available at: [http://ec.europa.eu/competition/state\\_aid/legislation/recapitalisation\\_communication.pdf](http://ec.europa.eu/competition/state_aid/legislation/recapitalisation_communication.pdf).

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