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The Commission's Guidelines On Restructuring Aid To Banks

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Introduction

In the wake of the financial crisis many banks in the EU have received substantial State aid (i.e. national subsidies) in order to stay in business. EU governments have intervened to safeguard financial stability and underpin the supply of credit to the real economy. Banks have received injections of public capital, benefited from government guarantees for bank borrowing and enjoyed measures to relieve them from toxic assets. However, this State support has not been unconditional. Banks have known that if they were to enjoy these support measures beyond a period of six months they would be obliged to undergo restructuring. Now the time has come for many banks either to repay the State aid or to restructure their business.

Faced with a large number of bank restructuring cases[1], on 22 July 2009 the Commission issued a Communication setting out its guidelines in assessing restructuring aid to banks ("the new Guidelines")[2]. The new Guidelines set out what kind of restructuring the Commission will require from banks that have been bailed out with public money. The new Guidelines will apply until the end of 2010[3]. They complement the guidance on the assessment of State aid for banks that the Commission adopted at the beginning of the financial crisis concerning guarantees[4], recapitalization[5] and the treatment of impaired assets[6].

1 The Commission has to deal with approximately 30 impending restructuring cases.

2 Commission Communication: "The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules". Link to the new Guidelines: http://ec.europa.eu/competition/state_aid/legislation/restructuring_paper_en.pdf The final version of the Communication will shortly be published in the Official Journal of the EU.

3 According to the Commission, after that date, the normal rules on rescue and restructuring, based on Article 87(3)(c) of the EC Treaty, should resume.

4 Communication from the Commission – The application of the State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ("the Banking Communication"), OJ 2008 C 270, page 8. Please refer also to Steptoe's EU Competition Briefing – December 2008 on this Communication.

5 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 Recapitalization Communication"), OJ 2009 C 10, page 2.

6 Communication from the Commission on the treatment of impaired assets in the Community banking sector ("the Impaired Assets Communication"), OJ 2009 C 72, page 1.

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Which Banks Have To Undergo Restructuring?

The Commission distinguishes between fundamentally sound financial institutions solely affected by the current restrictions on access to liquidity ("non–distressed banks") and financial institutions that are suffering from more structural solvency problems linked for instance to their particular business model or investment strategy ("distressed banks").

Banks are subject to restructuring, where a Member State has recapitalized a distressed bank, or when a bank benefiting from asset relief has already received State aid in whatever form that contributes to coverage or avoidance of losses (except for participation in a guarantee scheme) which altogether exceeds 2% of the total bank's risk–weighted assets.

By contrast, for non–distressed banks that have received a limited amount of aid, no restructuring would be required. However, Member States will have to submit a report to the Commission, to enable it to assess the viability of these banks, the use of the capital received and the terms for withdrawal of State support.

The Restructuring Criteria

Bank restructuring is subject to three fundamental criteria:

- aided banks must be made viable in the long term without further state support,
- aided banks and their owners must carry a fair burden of the restructuring costs and
- measures must be taken to limit distortions of competition in the EU.

Restructurings have to be presented to the Commission in the form of a comprehensive, detailed and coherent restructuring plan for each individual bank. In the annex to the new Guidelines the Commission has provided an indicative model for a restructuring plan.

Restoring long–term viability (stress test)

The restructuring plan has to demonstrate how the bank will restore its long–term viability without State aid as soon as possible. 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 account of the risk profile of the bank. A restructured bank should be able to compete in the marketplace for capital on its own merits in compliance with relevant regulatory requirements.

To this end, the restructuring plan will need to include a thorough diagnosis of the bank's problems, including a stress test and, where applicable, details on treatment of impaired assets. The plan should contain information on the business model and should provide analysis of the viability of each business activity and profit centre with necessary breakdowns.

The stress test[7] requires a diagnosis of the bank's strengths and weaknesses, which might in turn lead to re–thinking the bank's business model, disclosing and dealing with impaired assets and withdrawing from loss making activities. In some cases, the approach may require a bank to be taken over by a viable competitor or to be closed down.

Appropriate burden sharing

The new Guidelines make clear that aided banks and their capital holders must bear adequate responsibility for their past behavior and contribute to the restructuring of the bank as much as possible with their own resources.

The bank's own contribution to the costs of restructuring could, on a case–by–case assessment, be lower than 50%[8]. This low requirement reflects difficulties in gaining access to private capital in the current context. Where significant burden sharing was not possible due to the market circumstances at the time of the rescue, this would need to be addressed at a later stage of the implementation of the restructuring plan.

Limiting distortion of competition

Banks may not use State aid to the detriment of competitors which do not enjoy similar public support. Prolonging a bank's inadequate or excessively risky past behavior and/or from maintaining its market presence to the detriment of competitors may cause distortions. The new Guidelines analyze the distortions of competition resulting from the State aid to banks and present measures to limit them. The nature and form of such measures depends on two criteria: first, on the amount of the aid and the conditions and circumstances under which it was granted and, second, on the characteristics of the market or markets on which the aided bank operates.

7 Stress tests have established themselves as a quantitative element of investment risk management. They simulate the impact of variations in capital markets on the balance sheet and are intended to prompt undertakings to boost their risk–bearing capacity in good time if the results of the test are negative. The stress test shows whether in a simulated crisis situation the undertaking can meet its contractual obligations without taking countermeasures.

8 This is also the threshold fixed in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 2004 C 244, page 2.

Significant state support may require some adjustments including structural measures, such as divestitures (which can be spread over a number of years in the current crisis), or behavioral measures, such as constraints on acquisitions or on aggressive pricing and marketing strategies funded by State aid.

Banks should not use State aid for the acquisition of competing business. This condition applies 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. However, in exceptional circumstances, the Commission may authorize an acquisition where it is part of a consolidation process necessary to restore financial stability or to ensure effective competition.

Implementation of the restructuring plan

Given the overriding goal of financial stability and the prevailing difficult economic outlook throughout the EU, the Commission will ensure a sufficiently flexible and realistic timing for the implementation of the restructuring measures. In the Commission's view, the implementation of the restructuring plan could last up to five years, compared to the usual practice of two to three years.

Undertakings are only eligible for restructuring aid once in 10 years. However, the Commission would not necessarily apply this "one time last time" rule to restructuring aid to banks in times of crisis, reflecting *inter alia* the uncertainty about the recovery outlook. According to the new Guidelines, provision of additional aid during the restructuring period remains a possibility if justified to ensure financial stability.

In order to verify that the restructuring plan is properly implemented, the Commission requires detailed regular reports. The first report must be submitted not later than six months after approval of the restructuring plan.

Procedural issues

Upon notification of the restructuring plan the Commission will assess whether the plan is in compliance with the above restructuring criteria. Where it has serious doubts as to the compliance of the restructuring plan with these criteria, the Commission must open a formal investigation procedure, giving third parties (for example competitors) the possibility to comment on the measures and thereby ensuring a transparent and coherent approach. However, the new Guidelines also state: *"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 [their] compatibility .... 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 above conditions ...".*

Comments

State aid to individual undertakings in difficulties is normally assessed under Article 87(3)(c) of the EC Treaty[9] and the Community Guidelines on State aid for rescuing and restructuring firms in difficulty[10]. However, the new Guidelines are based on Article 87(3)(b) of the EC Treaty, which authorizes State aid in case of a serious disturbance in the economy. Still, the new Guidelines do not depart completely from the Commission's approach in traditional rescue and restructuring cases. The new Guidelines rely to a great extent on the basic principles of the traditional rescue and restructuring rules. This explains the hybrid character of the new Guidelines.

According to the Commission, invoking Article 87(3)(b) of the EC Treaty is possible only in truly exceptional circumstances where the entire functioning of the financial markets is jeopardized. However, the Commission omits to specify the criteria where the failure of a bank would indeed jeopardize the entire functioning of the financial markets. The new Guidelines do not distinguish between banks which have a systemic relevance for the functioning of the financial markets and banks which should be subject to the traditional rescue and restructuring regime.

Bank restructurings are "classic" cases for opening formal investigation procedures, because of their importance, complexity and the necessity for receiving comments from market players. Nevertheless, the Commission has indicated that there might be cases where the opening of formal investigations could be avoided. Philip Lowe, the Commission's Director–General for Competition, said that the department would be "*wary of a public debate*" and believed the behind–the–scenes activity would still "*silently install a discipline*" on ailing banks[11]. This approach seems illusory. It is difficult to imagine that a Member State will be able to design a complex bank restructuring plan that the Commission will immediately accept. If, however, the Commission and the Member State start negotiating the restructuring plan or if the Commission wants to impose conditions on a particular restructuring, the Commission is obliged to open the formal investigation procedure and allow third party comments.

9 Article 87(3)(c) of the EC Treaty allows for aid for the development of certain economic activities or areas where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

10 OJ 2004 C 244, page 2. These Guidelines have been recently extended until 9 October 2012 (OJ 2009 C 156, page 3).

11 Financial Times article on "Stress tests for banks receiving state aid" (23 July 2009).

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