You Always Meet Twice: European Commission Prescribes Restructuring of Banks that Have Received State Aid to Survive Financial Crisis

July 24, 2009

On July 23, 2009, the European Commission published its fourth guidance communication on EU State aid rules for banks in the current financial crisis. The first three communications had set out the permissible types of aid (guarantees, recapitalization schemes, bad bank schemes, and controlled winding-up). The new communication prescribes the restructuring measures to be initiated within six months after granting such aid at the latest. The restructuring is subject to the three main requirements: restoration of long-term viability, burden sharing, and limitation of distortions of competition.

1. Previous Commission Communications on State Aid Given to Banks During the Financial Crisis

Since last fall, governments all over the world have sought to stabilize their domestic banks to help them survive the current financial crisis. In addition to the usual political and financial challenges that governments face in devising such support programs, EU governments face strict anti-subsidy rules. Under EU State aid law, any economic advantage granted by Member States to any individual industry or undertaking is subject to very strict limitations. Unless covered by certain, very strict safe harbors, any such support must be notified to and cleared by the European Commission.

Due to its severity, the financial crisis almost immediately raised concerns that State aid control would impede necessary State intervention and thus aggravate the downturn. In the political arena, calls for a temporary suspension of State aid rules were voiced. The Commission resisted these demands and instead issued several new guidance communications, which adapted the existing State aid rules temporarily in order to allow a greater flexibility to EC Member States. To justify this greater flexibility, the Commission invoked "a serious disturbance in the economy" pursuant to Article 87(3)(b) of the EC Treaty, a clause that had been previously only rarely applied.

In the first two communications, the so-called Banking Communication and the Recapitalization Communication, the Commission emphasized that normally, this clause shall only be applied to illiquid but otherwise fundamentally sound financial institutions. In contrast, banks with endogenous...
problems should normally be eligible for state support only under the general guidelines for rescue and restructuring aid ("R&R Guidelines").\textsuperscript{3} It is not very clear, however, how this distinction could be made operational in practice. Moreover, in the third communication, the so-called Impaired Assets Communication,\textsuperscript{4} the Commission did not mention the distinction between sound and unsound banks anymore.

In these three communications, the Commission considered the following types of State aid to banks to be acceptable during the financial crisis:

- **Guarantees.** Guarantee schemes protecting retail deposits (and debt held by retail clients) are a legitimate public policy response in the context of a systemic crisis. Conversely, guarantees going beyond retail deposits have to fulfill a number of stringent conditions aiming to avoid moral hazard. These conditions include the exclusion of certain forms of debt (e.g. subordinated debt, i.e. tier 2 capital), a limitation to the strict minimum quantity necessary and to a maximum duration of two years, a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee, and appropriate mechanisms to minimize distortions of competition and the potential abuses. These mechanisms should include an adequate combination of behavioral constraints concerning restrictions of commercial conducts, limitations to the size of the balance-sheet, and a prohibition of conduct that would be irreconcilable with the purpose of the guarantee, together with appropriate enforcement provisions.

- **Recapitalization.** The requirements for guarantee schemes described above apply *mutatis mutandis* also to recapitalization measures. Capital measures 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. Beneficiaries should contribute as much as possible through their own means, including private participation.

- **“Bad bank” asset relief.** The Commission has laid down general principles for relief measures concerning banks' impaired assets ("toxic assets") with the aim of cleaning banks' balance sheets and encouraging their lending activity. The Commission does not prescribe one specific Europe-wide "bad bank" model for such asset relief measures, but leaves the concrete design to the member states' discretion. The Commission, however, lays down stringent requirements in order to focus asset relief measures to a limited number of banks of systemic importance. Among those requirements are: (i) an obligation of full *ex ante* transparency and disclosure of impairments by eligible banks on the assets which will be covered by the relief measures, (ii) a correct valuation of assets prior to government intervention, and (iii) a correct remuneration of the State for the asset relief measure, whatever its form, so as to ensure equivalent shareholder responsibility and burden-sharing. Moreover, asset relief measures should be combined with necessary measures to remedy competition distortions.

- **Controlled winding-up.** A controlled winding-up of financial institutions may be carried out
in conjunction with a contribution of public funds. Such contributions have to comply with the requirements set out above for guarantee schemes. In addition, precautions have to be taken in order to minimize 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. Certain sales conditions therefore have to be respected when financial institution or parts of it are sold following a winding up. These conditions basically consist of an open and non-discriminatory sale on market terms. In case it is necessary to grant an aid to the economic activity to be sold, this aid will be examined individually according to the principles of the R&R Guidelines.

According to the three communications, all types of aid measures must be followed, three to six months after their implementation, by a comprehensive restructuring plan for the banks that have received the aid. This obligation is modeled on the general R&R Guidelines, which remain applicable alongside the special crisis instruments. In recent weeks, the Commission received, examined and approved the first such restructuring plans.

2. The Bank Restructuring Communication

Based on its experience with these first restructuring plans, on July 23, 2009, the Commission published its fourth Communication, called "The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules". This Bank Restructuring Communication complements the three abovementioned communications by explaining how the Commission will assess restructuring aid to banks. The Commission's assessment revolves around the three main requirements: restoration of long-term viability, burden sharing, and limitation of distortions of competition.

2.1 Restoration of Long-Term Viability

The restoration of long-term viability is the central aim of any restructuring aid. In order to be acceptable, restructuring plans should demonstrate how the bank will restore long-term viability without State aid as soon as possible, or, alternatively, how it will be wound up in an orderly fashion. These principles are not new; they already exist under the general R&R Guidelines.

In the case of bank restructuring plans, however, the Commission for the first time requests stress tests to be undertaken in order to prove the long-term viability of a bank. According to the Commission, stress testing should assess viability even in the present adverse circumstances, and should consider a range of scenarios, including a combination of stress events and a protracted global recession. In general, the restructuring period may last up to five years, whereas under the abovementioned pre-existing R&R Guidelines, only two to three years would be acceptable.

The sale of an ailing bank may also contribute to long-term viability. Any sale process will, however, be subject to the merger control scrutiny, as well as EU State aid law.
2.2 Burden Sharing

The costs associated with the restructuring should generally not only be 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. These contributions should prevent moral hazard and act as an incentive for future behavior. The Commission has refrained from setting any fixed thresholds for the own contribution of stakeholders. In practice, the own contributions requested by the Commission are as high as possible. This may involve, for instance, the sale of assets.

The Commission understands that banks have to be able to remunerate capital, also in the form of dividends and coupons on outstanding subordinated debt, in order to continue to have access to the capital market. On the other hand, according to the Commission, 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, is incompatible with the principle of burden sharing.

The Commission stresses that the burden sharing may be deferred to the future, for example, through claw-back clauses, if a bank is not immediately able to make a significant contribution of its own due to market conditions.

2.3 Limitation of Distortions of Competition

State interference to prevent companies in difficulties from leaving the market necessarily distorts competition. According to the Commission, the nature and shape of required measures limiting distortions of competition will depend on the amount and modalities of the aid and the circumstances under which it was granted and the characteristics of the market(s) on which the beneficiary bank will continue to operate. The Commission sets out the following main rules:

- **Near market-level remuneration.** One of the most appropriate limitations to distortions of competition consists in the appropriate pricing of State interventions. The higher the level of remuneration is set, the lower the aid element of the intervention will be, because only the proportion below market level will be considered to constitute State aid.

- **Reduction of business activities.** Banks benefiting from State aid may be required to undertake structural measures, such as divesting subsidiaries or branches, portfolios of customers or business units. In order to accept a restructuring plan, the Commission may request substantial reductions of business activities. For example, the Commission recently forced German Commerzbank to reduce its balance sheet by approximately 45 percent.6

- **Avoidance of anti-competitive behavior.** Measures must be taken to limit the ability of banks to use State aid for anti-competitive behavior. For a period of at least three years, aid
recipients must not acquire competitors, save for exceptional circumstances where such acquisitions are part of a consolidation process necessary to restore financial stability or to ensure effective competition. Moreover, 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. In addition, State aid should not be used to offer terms and conditions that cannot be matched by competitors who are not aid recipients. Furthermore, the Commission will generally examine the degree of market opening and the capacity of the sector to deal with bank failures.

- **One-time-last-time principle not applicable.** Under the general R&R Guidelines, companies are only eligible for restructuring aid once within 10 years. Due to the specifics of the financial crisis, the Commission will "not necessarily" apply this principle to banks in the financial crisis.

### 2.4 Procedural Requirements

A proper restructuring plan contains a considerable amount of information, including a thorough diagnosis of the bank's problems and, where applicable, details on treatment of impaired assets. The information required for the viability assessment may comprise both banks' internal data and reports as well as reports prepared by/for the Member State's authorities, including the regulatory authorities. The significant scope of the required information is illustrated by a three-page table of contents annexed to the Bank Restructuring Communication.

The Commission requests regular reports to monitor the implementation of the restructuring plans and compliance with the requirements set by the Commission. The first of those report should be issued not later than six months after approval of the restructuring plan.

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*WilmerHale’s integrated EU State aid team in Brussels, Frankfurt and Berlin is best placed to advise banks and other financial institutions in the context of aid applications and in the process of setting up restructuring plans and notifying them to the European Commission. WilmerHale has advised in some of the most prominent State aid cases in the context of the financial and economic crisis. Our EU State aid team cooperates closely with our other expert teams, in particular with WilmerHale’s Legal Strategy & Public Policy team as well as with our M&A/Corporate, Competition/Antitrust, and Regulatory experts.*


2 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, OJ 2009 C 10/2 (eur-lex.europa.eu/LexUriServ/LexUriServ.do?


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