EU Communication

STATE AID FOR BANKS

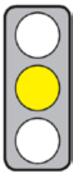
cep**Policy Brief** No. 2013-04

Centrum für Europäische Politik

KEY ISSUES

Objective of the Communication: The Commission lays down the criteria that it will use to approve State aid to banks prior to the European rules on bank recovery and resolution coming into force (BRRD).

Affected parties: Shareholders, hybrid investors and subordinated creditors of banks, tax payers.



Pro: (1) The Commission strengthens the liability principle by imposing creditor involvement ("bail in") as a condition for the approval of State aid.

(2) The Commission deals with the problem of "moral hazard" by tightening the conditions for recapitalisation and impaired asset measures and for government guarantees.

Contra: (1) The provisions on the approval of State aid are inferior per se to a basic ban on State aid - which would however require EU-wide rules on bank recovery and resolution.

(2) The provision of "emergency liquidity assistance" (ELA) represents a loophole. Particularly problematic is the fact that there is no duty for the ELA to submit recovery or resolution plans. The ELA should be replaced by rescue aid.

CONTENT

Title

Communication from the Commission C(2013) 216/01 of 30 July 2013 on the application, from 1 August 2013, of **State aid** rules to support measures **in favour of banks** in the context of the financial crisis ("Banking Communication")

Brief Summary

► **General points and objective of the Communication**
- In principle, Member States have to obtain approval from the Commission before granting State aid ("Ex-ante Examination", Art. 108 (3) TFEU, cf. cepPolicyBrief).
- In the Communication, the Commission lays down the criteria that it will use to approve State aid to banks prior to the European rules on bank recovery and resolution coming into force (BRRD) cf. cep**PolicyBrief**). After the BRRD comes into force, the Commission intends to submit permanent regulations on Sate aid. (Para. 24)
- In the Communication, the Commission lays down when the following types of State aid are permitted:
  - equity-effective aid, particularly State recapitalisations or the takeover of the impaired assets of an ailing bank by the State ("impaired asset measures"),
  - equity-effective rescue aid in the case of an acute and severe risk to financial stability,
  - guarantees and national liquidity assistance,
  - liquidity assistance by central banks ("Emergency Liquidity Assistance", ELA) and
  - liquidation aid granted in the case of a bank resolution.
- In the Commission's view, State aid has, in the past, led to false incentives for banks, for example, delaying restructuring of the business in order to re-establish profitability (para. 23).
- By way of its criteria for the approval of State aid, the Commission wants to "minimise" distortions of competition between banks (para. 2).
- "Where appropriate" the State aid criteria can also be applied to State aid for insurance companies (para. 26).

► **Principle: Burden-sharing by shareholders, creditors and tax-payers**
- In principle, State aid to banks will only be approved where there is "adequate" burden-sharing ("bail in"; para. 41)
  - by the shareholders and
  - by the hybrid capital holders and subordinated creditors.
- Exceptions are permitted where there is a risk to financial stability or to prevent "disproportionate results" (para.45).
- Contributions from senior creditors - e.g. from investors - is not obligatory for the approval of State aid (para. 42).

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- **Equity-effective aid ("Recapitalisation and impaired asset measures")**
  - The Commission only wants to approve State aid in the form of recapitalisation and impaired asset measures where a capital shortfall is established, such as by way of a stress-test (para. 28).
  - For the assessment of the admissibility of State aid, the Member State must submit to the Commission (para. 29, para. 34):
    - a capital raising plan which has been approved by the competent supervisory authority - ECB or national banking supervisory authority,
    - a draft restructuring plan showing how the bank will be able to operate profitably in the long term without State support.
  - The capital raising plan must contain measures (para. 32, para. 35, para. 47)
    - to prevent the outflow of funds, such as a stop on dividend payments or on the acquisition of interests in other undertakings,
    - to raise capital, such as capital-generating sales of assets or earnings retention, and
    - to share the burden by involving shareholders, hybrid capital holders and subordinated creditors ("bail in").
  - Only after the bank has implemented the capital raising plan "as far as possible" and the Commission has agreed with the Member State on the restructuring plan, will the Commission approve State aid in the amount of the remaining capital shortfall. (Para. 35, in conjunction with para. 49).
  - A bank which receives State aid must
    - "normally" replace the Chief Executive Officer, as well as other board members if appropriate, where recourse to State aid could have "reasonably" been averted through appropriate and timely management action (para. 37),
    - restrict the total remuneration of every member of staff to 15 times the national average salary in the Member State where the bank is incorporated, or to 10 times the average salary of bank employees (para. 38),
    - refrain from making severance payments in excess of what is required by law or contract (para. 39).

- **Equity-effective rescue aid to maintain financial stability**
  - For exceptional cases, the Commission wants to allow State aid in the form of recapitalisation and impaired asset measures without a capital raising plan or restructuring plan. For this, the supervisory authorities must confirm that (para. 50)
    - the bank has a capital shortfall which would result in withdrawal of the banking licence, and
    - there is "exceptional" risk to financial stability which cannot be averted with private capital within a sufficiently short period of time, or by any other less distorting measure than State aid.
  - The Member State must submit to the Commission, within two months of the approval of rescue aid, a restructuring plan for the relevant bank containing a plan for burden-sharing by the shareholders, hybrid capital holders and subordinated creditors ("bail in") (para. 52 and 53).

- **Guarantees and national liquidity assistance**
  - The Commission basically wants to restrict approval for guarantees and national liquidity assistance to banks without a capital shortfall (para. 60 a).
  - In specific cases, however, the Commission also wants to approve national liquidity assistance for banks with a capital shortfall. If the bank fails to repay the assistance within two months, the Member State must submit a restructuring plan or a wind-down plan for the relevant bank (para. 58).
  - Government guarantees are only permitted for (para. 59 and para. 60)
    - new issues of senior debt,
    - unsecured debt instruments with maturities of between three months and five years
    - covered bonds with maturities of a maximum of seven years.
  - For any bank which calls upon the government guarantee, the Member State must submit an individual restructuring or wind-down plan (para. 59 e).

- **Liquidity assistance from central banks**
  - "The ordinary activities" of central banks - such as open market operations and standing facilities - do not generally constitute State aid. (para. 62).
  - Liquidity assistance provided by central banks in crisis situations ("emergency liquidity assistance" - ELA) "may" constitute State aid unless the following conditions are met (para. 62 a-d):
    - At the moment of the liquidity provision, the bank is temporarily illiquid but solvent .
    - The liquidity assistance is "fully" secured by collateral - e.g. government loans or stocks - to which appropriate haircuts have been applied.
    - The bank pays a penal interest rate.
    - The liquidity assistance was taken at the central bank's own initiative.
    - The State provides no guarantee for the liquidity assistance.

- **Liquidation aid to maintain financial stability**
  - The Member States "should encourage the exit of non-viable players" and work towards an orderly liquidation.

– The Commission "recognises" that State measures to support liquidations ("liquidation aid") may be necessary to safeguard financial stability (para. 65 and para. 66).
– Requirements for approval of liquidation aid by the Commission are, inter alia:
  - the submission by the Member State concerned of a liquidation plan (para. 69),
  - contributions from the shareholders, hybrid capital holders and subordinated creditors ("bail in"); (para. 66 in conjunction with para. 44),
  - evidence from the Member State that the State aid actually facilitates the orderly liquidation and is limited to the minimum necessary (para. 72),
  - the creation of incentives by the bank to be liquidated to encourage customers to change banks (para. 75).
– The sale of a bank during the liquidation procedure may, in principle, be supported by way of State aid. This does not apply, however, where the sale takes place in an open and unconditional competitive tender and the assets are sold to the highest bidder. (Para. 79)
– The Commission must examine whether liquidation financing from resolution funds, deposit guarantee schemes or other funds is "equivalent to" State aid (para. 64).
– Compensation to investors by way of deposit guarantee schemes does not constitute State aid (para. 63).

Policy Context

Since the beginning of the financial crisis, the Commission, in six Communications, has established criteria for the approval of State aid to banks. This Communication replaces the first Communication from 2008 and supplements the other Communications. The Commission already announced permanent State aid regulations for the banking sector in 2011 [C(2011) 356/02]. It gives as reasons for the delay the negative market situation and the planned European rules on bank recovery and resolution (BRRD) [COM(2012) 280, cf. cep**PolicyBrief**]. In spring 2014 - before taking on its supervisory role - the ECB will carry out stress-testing of banks ("asset quality review") as part of the centralisation of banking supervision for the Euro Zone [Single Supervisory Mechanism, cf. cep**PolicyBrief**]. In order to make up for any capital shortfalls which this uncovers, State aid is likely to be necessary.

Options for Influencing the Political Process

Leading Directorate General	DG Competition

Main Changes to the Status Quo

- ► Until now, the Commission granted State aid even without the prior involvement of shareholders, hybrid capital holders or subordinated creditors ("bail in").
- ► Until now, capital raising plans were not mandatory.
- ► Until now, when rescue aid was claimed, Member States had to submit a restructuring plan for the relevant banks within six months if the Commission did not request it earlier. In future, Member States will have to submit this within no more than two months.
- ► Until now, when government guarantees were called upon, Member States did not have to submit either a restructuring plan or a liquidation plan for the relevant banks. In future they will have to submit these plans within no more than two months.

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

State aid for banks distorts competition. It leads to effectively insolvent banks remaining in the market, weakens the banks' sense of responsibility and as a result, they take too many risks ("moral hazard"). The ideal answer would be to do without state aid altogether. That is the only way to make banks fully liable for the risks they take and to force them to pursue business strategies whose risks they are able to bear independently if necessary.
However, uncontrolled bank failures can destabilise the financial market and, as a consequence, bring about huge distortions for the real economy as well. **Doing without State aid to banks** therefore **means there has to be credible rules on bank resolution.** Effectively insolvent banks must - if possible without recourse to taxpayers' money - be able to leave the market and in doing so should not be able to jeopardise financial stability. **This is the aim of the Commission's proposal for a Directive on bank recovery and resolution** (BRRD, cf. cep**PolicyBrief**), which should be agreed by the Council and the European Parliament as soon as possible. **These State aid provisions are intended as a** temporary **stop-gap measure** until the BRRD Directive comes into force **and as such are therefore inferior.**
Nevertheless, they do strengthen the liability principle by imposing a "bail in", i.e. making the involvement of the shareholders, hybrid capital holders and subordinated creditors a condition for approval of State aid, **and they tackle the problem of "moral hazard".** The requirement that equity-effective

recapitalisation and impaired asset measures are only possible where there is agreement on capital raising and restructuring plans, may - rightly - give rise to substantial obligations on the part of the receiving bank. In the course of its State aid assessments, therefore, the Commission should avoid declaring it to be rescue aid; in the case of rescue aid, negotiations on the restructuring plan are held only after the aid has been paid over. This weakens the Commission's position.

The duty to submit restructuring or wind-down plans in the case of government guarantees increases the likelihood of substantial obligations and counteracts the effect of moral hazard.

As from entry into force of the rules on bank recovery and resolution (BRRD), the Commission should only - if at all - **approve rescue and liquidation aid** for safeguarding the stability of financial markets, the need for which cannot be completely ruled out even in the case of an orderly liquidation. Rescue aid is unavoidable where there is an extensive systemic risk to the financial market because such a scenario pushes even the concept of orderly liquidation to its limits.

The provision of liquidity by central banks, in the form of "**emergency liquidity assistance" (ELA) constitutes a loophole**, through which non-viable banks can restore their liquidity and remain in the market. Firstly, the Commission is often not informed of ELA and can only therefore examine the case - if at all - ex post. Secondly, the criteria laid down by the Commission only stipulate when ELA should be regarded as State aid. When exactly such State aid may be permitted remains unclear. Thirdly, particularly **problematic is the fact that - although in effect it is equivalent to State aid - there is no obligation to submit restructuring or liquidation plans for ELA. The ELA instrument should therefore be replaced by rescue aid** from the Member States - including the accompanying obligations.

Legal Assessment

Legislative Competency

The Commission can regard State aid to remedy a serious disturbance in the economy of a Member State as being compatible with the internal market (Art. 107 (3) b), second alternative TFEU). The ECJ has recognised that, in exercising this discretion it can be bound by its own acts if they contain rules on the "policy" which it is pursuing and it acts within the framework of the treaties (ECJ, Case C-288/96 of 5 October 2000, Germany/Commission, para. 62). It may therefore adopt the Communication.

Subsidiarity

Unproblematic.

Proportionality

Unproblematic.

Compatibility with EU Law in other Respects

Unproblematic.

Conclusion

State aid for banks distorts competition and weakens the banks' sense of responsibility. Doing without state aid to banks means there must be credible rules on bank resolution. This is the aim of the proposal for a Directive on bank recovery and resolution (BRRD). These State aid provisions are intended as a stop-gap measure and as such are therefore inferior. Nevertheless, they do strengthen the liability principle because they make the involvement of creditors ("bail in") a condition for the approval of State aid and tackle the problem of "moral hazard". After entry into force of the rules on bank recovery and resolution (BRRD), the Commission should only approve rescue and liquidation aid. The provision of "emergency liquidity assistance" (ELA) represents a loophole. Particularly problematic is the fact that there is no obligation to submit recovery or resolution plans for ELA. The ELA should be replaced by rescue aid.

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