Assessment of the banking rescue packages

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

The diversity of banking rescue packages implemented by European countries reflects the absence of a European coordinated response to the financial crisis. However, there is a consensus to require those banks that receive government capital to meet certain conditions on dividend policies, on executive remuneration and on the use of funds to support lending to corporations and households.

The limitation to executive remuneration is the easiest requirement imposed to banks, and the ban of variable compensation in recapitalised banks is broadly accepted. However, not all banks ask for a recapitalisation. Moreover, this requirement only concerns the highest level of management of banks. Hence, although this requirement is necessary to facilitate public acceptance of banking rescue packages, it has not a significant impact on the economy nor even on the potential burden (if any) imposed to taxpayers.

As far as the distribution of benefits is concerned, bans or limitations to dividend paradoxically serve the interests of existing shareholders, who usually support higher taxes for received dividends than for capital gains. Dividends are mainly a signal given by the company to the market. Managers tend to propose as stable as possible dividends. By imposing low dividends or no dividends, public authorities cancel this signal function. Hence, these requirements facilitate acceptance of rescue plans in the public opinion, but they have no significant impact on the sharing of efforts nor on market conditions.

Finally, the most significant issue is the use of funds provided to banks. Most recent figures indicate that the provision of credits to the economy did not decrease significantly in the euro area. On the contrary, a credit crunch is already predictable in the United Kingdom, where the outstanding loans to non-financial corporations and to households decreased by around 5% in only one month (November 2008). Nationalised banks which were in a first step required not to increase their volume of activity are now required to commit to support lending to small corporations and households.

Several factors tend put pressure on the provision of loans: the decrease of real estate prices, growing unemployment, higher capital requirements imposed by the market to cover credit risks. A key measure that would complement credit facilities, would be a fiscal incitation given to those households that buy shares of non-listed companies, either directly or through capital investment funds.

Although the European Commission published on October 2008 guidance on "how Member States can best support financial institutions in the current financial crisis whilst respecting EU state aid rules and so avoiding excessive distortions of competition", the diversity of banking rescue packages implemented by European countries reflects the absence of a European coordinated response to the financial crisis. This absence of a European policy was obvious from the very beginning, when Member States announced different levels and scopes of guarantee granted to banking deposits. The present paper for the European Parliament refers to banking rescue packages in five Member States: France, Germany, Italy, Spain and the United Kingdom.

Rescue plans include three components: government-supported recapitalisation of banks, temporary liquidity schemes either by directly of through a guarantee granted to the providers of refinancing, and temporary acquisitions of financial assets. Recapitalisation packages can be split into two categories: in the first category, insolvent banks issue ordinary shares subscribed by a governmental fund, whereas in the second category "fundamentally sound" banks needing to enhance their regulatory core tier one own funds ratios issue preference shares or subordinated instruments.

	Recapitalisation	**Refinancing**	**Guarantee on refinancing operations**	**Temporary acquisition of financial assets**
France	**Y**	**Y**	**Y (Dexia)**	
Germany	**Y**		**Y**	**Y**
Italy	**Y**	**Y**	**Y**	
Spain			**Y**	**Y**
United Kingdom	**Y**	**Y**	**Y**	

As long as all losses incurred by banks will not have been fully evaluated and disclosed, it will not be possible to be sure that these packages are sufficient to avoid a major systemic default. However, it is reassuring to note that national governments and the European Commission have proved to be rapid and flexible, contrary to the US authorities.

The first section of this paper assesses the relevance of symbolic issues (the remuneration of managers and limits to dividends). The second section assesses the efficiency of requirements imposed to banks for the use of funds they receive from the government.

I. Symbolic requirements imposed to banks

Ultimately, taxpayers will not necessarily lose money in the banking packages, as requirements imposed by the European Commission include a remuneration of funds provided to banks consistent with similar operations in normal market conditions.

However, the population suffers from the economic crisis, the origin of which is the burst of a financial bubble. In principle, it is legitimate to limit the revenue of those who benefitted from this bubble: managers in the financial area and shareholders of banks, even though inappropriate behaviours of market participants were only possible in the background of inappropriate regulation.

A. Remuneration of banks' managers

Banks benefiting from rescue packages in France, Germany, Italy and the United Kingdom are required to comply with stringent requirement concerning the compensation of executives. This has not been achieved by the law, but rather as a condition for receiving additional own funds.

In France, banks' managers are required to comply with the code of conduct issued by professional bodies (MEDEF and AFEP) on compensation of executives. This code more generally apply to all listed companies. Hence there is no new requirement as all major banks are listed. However this code is not legally compulsory. It was only as a condition to benefit from the second part of the recapitalisation plan (10,5 billion euros) in March 2009, that managers of banks had to announce in January 2009 that they would give up with the variable part of their compensation in 2008, whatever the financial performance of their bank.

In Germany, the rescue fund requires managers' remuneration to be capped (more than 500.000 euros being considered as "inappropriate"), and it bans any bonus except if the fixed salary is low. The President of Deutsche Bank announced that he voluntarily renounced to its variable remuneration.

In Italy, Unicredit announced that its executives would not receive any bonus in 2008, as they did not reach the objectives set to get a variable remuneration.

In the United Kingdom, managers of Royal Bank of Scotland, HBOS and Lloyds TSB were required by the government to renounce to the variable part of their compensation, and Barclays's executives voluntary renounced to it. Previous RBS's and HBOS's managers had to resign without receiving their contractual indemnity. The Prime Minister announced that the future remuneration of nationalised banks' remuneration would be based only on their performance and their long-term creation of value.

Finally, the limitation to the remuneration of managers is generally accepted in all countries where the government recapitalises banks. However, what is more difficult is to limit the variable part of the remuneration of market operators: Although the job market conditions obviously worsened, there is still competition between banks to hire the most competent and experienced operators and the salary remains a key parameter in that competition. Hence, even if the remuneration of some banks' managers reached astronomical levels – like the remuneration of many listed Blue-Chips -, the limitation to their remuneration will not have a significant economic impact.

B. Dividends

In the United Kingdom, companies benefiting from the rescue package were required to refrain from distributing any dividends to their shareholders. In Germany, banks benefiting from the rescue package had to suspend any payment of dividend, except to the rescue fund. In Italy, dividends are not limited, but the remuneration of subordinated debt instruments subscribed by the government increases in relation to the level of dividends.

In France, a first version of the rescue packages did not include any restriction on dividends. However, the European Commission made an observation, and a condition for the banks to benefit from the rescue package was finally to only distribute “moderate” dividends. Banks were also required to refrain from buying back their own shares as long as the government would hold securities, other than in the framework of occupational saving plans or technical ordinary management of corporate actions.

The limitation to the payment of dividends is a symbolic issue, rather than really sharing the burden of efforts. Not paying dividends or limiting dividends does not harm the interests of shareholders, as the amount of non-distributed benefits increases the value of the concerned company. If the latter is listed, the shareholder can easily withdraw liquidity by selling a portion of the shares he holds. As the tax on capital gains is usually lower than the income tax, the interest of the shareholder is to get capital gains rather than dividends.

The only exception to the observation made above is the case of a company that goes bankrupt: in that case, creditors will be able to recover a portion of their loans if previous benefits were not distributed. For that reason, it is frequent that creditors ask for covenants, forbidding any excessive distribution of dividends before the loan has been reimbursed by the issuing company.

Hence, the main stake behind dividends is the signal they send to the market. Most listed companies strive to pay a regular dividend to avoid perturbations that would higher the volatility in the price of shares. Any signal of uncertainty makes further capital increases more expansive. Listed banks usually commit to distribute 30% to 50% of their benefits. However, limitation to dividends that result from compulsory requirements from the authorities has the effect that the amount of paid dividends cannot be interpreted as a signal of managers’ pessimism.

II. The use of funds provided to banks

The public debate relating to the use of funds provided to banks is concentrated on the case of recapitalisation by the government. However, it should be noted that the use of refinancing received by banks also raises questions. Indeed, it is not rare that banks getting liquidity from the Central Bank or from the interbank market, simply deposit their cash to an account in the books of the Central Bank. They do so only because they fear to be unable to get the liquidity they might need in the future.

Although the Commission first required nationalised banks in the United Kingdom and in Germany not to expand their activities to avoid any competition distortion, further recapitalisation packages have been conditioned by commitments concerning the volume of loans granted to corporations or households.

In France, banks benefiting from the second tranche of the rescue package had to commit to increase the provision of loans to corporations (especially exporting ones) in addition to their general commitment concerning the overall provision of credit to the economy. The professional association of banks (Fédération des Banques Françaises) committed to increase outstanding loans by 3% to 4% in 2009. A specific monthly reporting of loans to Small and Medium Sizes enterprises has been established.

In the United Kingdom, those banks that received government capital committed to support lending to small businesses and home buyers. RBS announced it would maintain outstanding loans at the level of 2007.

What is the actual trend of credit provision ? The most recent available data relate to November 2008, after the first recue plans were announced.

The production of new credits diminished in November, although the outstanding credits to non-financial agents was still 7.1% higher at end of November 2008 than 12 months earlier in the euro area.

In November 2008, the outstanding loans of Credit institutions to households diminished in Germany and Italy, but they slightly increased in France (2 billion Euros) and Spain (0,6 billion Euros). But these variations appear as relatively minor when compared to British figures: The outstanding loans to households decreased by 12 billion Euros in October and 55 billion in November.

The outstanding consumer credits diminished in all studied countries in November 2008. In the euro area, the worst decrease was observed in Germany and Italy, but the order of magnitude of this decrease is much lower than in the United Kingdom, where the outstanding consumer loans decreased by 10 billion Euros in only one month.

The outstanding amount of loans for house purchase is under the pressure of tighter financing conditions and a weakness of the demand in the background of declining real estate prices (which diminish the need of buyers for external financing) and a deteriorated general economic environment. In Germany, Spain and Italy, the outstanding loans for house purchase were stable in November 2008: the new credits approximately offset reimbursements. In France, it increased by 1,9 billion Euros, a much slower pace than in the previous months. The exposure of banks to the real estate market in the euro area is probably even higher as the securitisation market is frozen following the subprime crisis. Credit securities are increasingly borne by the balance sheets of banks.

Here again, the situation in the United Kingdom is much worse than in the euro area. In November 2008, outstanding mortgage loans diminished by 37 billion Euros and by more than 83 billion on the whole second semester of 2008. At end of November 2008, the outstanding mortgage credits were inferior by 14% to November 2007.

In November 2008, the stock of loans to non-financial corporations increased in Germany and France, and it was stable in Spain and Italy. Again the situation is much worse in the United Kingdom than in the euro area: the outstanding credits diminished by 34 billion Euros.

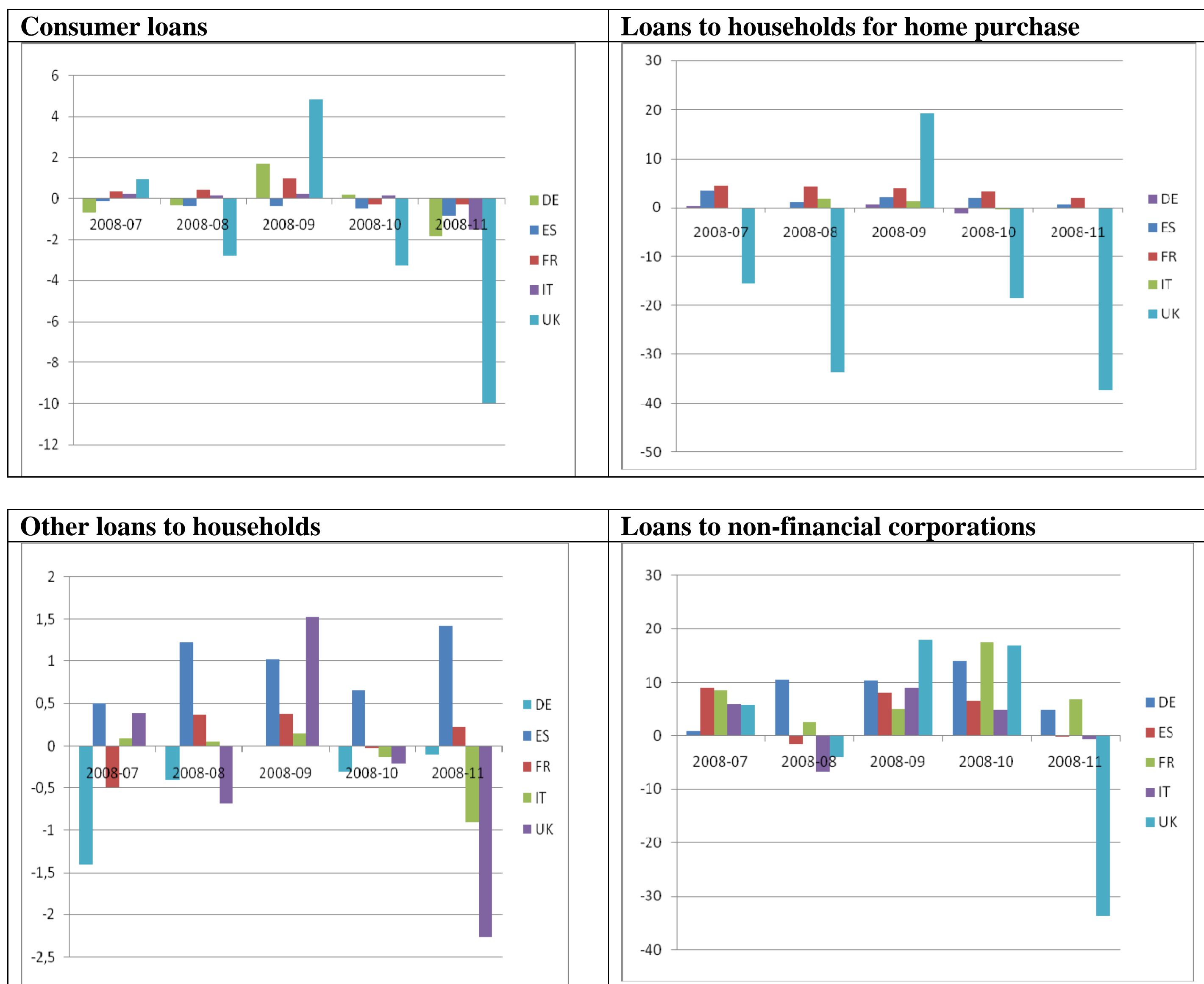
On the whole, households in the euro area suffered up to now, more than enterprises from the slowdown in the provision of credit to the economy. As mentioned in the last monthly bulletin of the ECB, “banks are still originating loans, with volumes smaller than those observed during the recent period of strong credit expansion, but comparable to those observed between late 2002 and early 2004.”

In the United Kingdom, a goal of the first rescue plan was to maintain the access of households and corporation to a level of credit comparable to 2007. However figures reflect a credit crunch. Not only British banks are in a difficult position, but they also have to substitute for foreign banks (especially islander banks) which are traditionally active in that country. Furthermore, several banks decided not to use resources proposed by the government. The latter was not in a position to impose constraints to those banks. The outlook might change in the next months, as the British government now requires banks to increase their supply of credit, with a target figure for each of them. Northern Rock had been banned to provide new credits after its nationalisation, in order to reimburse the loan granted by the government and to avoid any competition distortions. This ban has been lifted in January 2009 when the government announced its second rescue plan.

One cannot be certain of the efficiency of the banking rescue packages to avoid a severe credit crunch in the future. Several considerations lead to be sceptical:

- The need for credits for home purchase diminishes with the prices of residential real estate
- The need for consumer credits might increase as a result of unemployment and of the slowdown in households' income. However, the principle of responsible lending requires banks to provide credits that households can reimburse without falling into overindebtedness.
- An increase or even a stabilisation of credits to non-financial corporations in the background of an economic recession raises the exposure of banks to the risks of defaults. This trend would increase again the need of banks for additional own funds to comply with prudential ratios. The risk exists all the more that the market consensus for the required ratio of own funds to credit risk increased from 8% to 9%. The only way to limit this risk would be to also increase the level of capital of companies receiving loans. For that purpose, it is necessary to fiscally incite households to buy shares of non listed companies, either directly or through capital investment funds. Such an incitation has been implemented in France and it proved to be useful in allocating significant flows of funds to small and medium companies.
- It is difficult to imagine what would be the sanction imposed to a bank that will not comply with its commitment to increase or maintain outstanding loans. The government will be able to influence behaviours of nationalised banks but it has not even one representative in the Board of banks which issued preference shares. Furthermore, a condition imposed by the European Commission for authorizing subscription by the government of preference shares and financing facilities is the provisional character of these measures. For example, the reimbursement of preference shares or subordinated loans by French, Italian and German banks to the government will be increased by a growing add-on (of 1% in the first year to 11% after de 6th year in France). Hence, the government will not have any leverage to convince banks to maintain the level of credits to the economy.

Monthly variation of outstanding loans to households and non-financial corporations (billion Euros) – Seasonally adjusted series



Source: ECB (seasonal adjustment by the OEE)

Assessment of the banking "rescue" packages and "recovery" plans of the Member States in the European Union

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

The present briefing paper is concentrated on a set of few representative plans and/or best practices pertaining to recovery and rescue plans, adopted by Member States as a response to the recent global financial crisis, in order to contribute to the stabilization of their banking systems (***see below, under 1***).

The typology of assistance measures varies significantly among the Member States. A *first distinction* should be made between:

(a) measures taken in order to ensure long-term viability of individual financial institutions with problems stemming from inefficiencies or excessive risk-taking, whose weaknesses are exposed and exacerbated by the crisis in the financial markets (these measures concern the minority of european financial institutions), and

(b) measures taken in order to support financial institutions that are fundamentally sound and whose difficulties are exogenous stemming exclusively from the general market conditions which have severely restricted access to liquidity (***see below, under 2***).

The *second distinction* includes the typology of the specific measures which should be taken according to the relevant guidelines of the Commission with respect to each of the above categories. The choice of the measures, their specific morphology as well as the way of their implementation is at the discretion of each Member State according to the particular characteristics and the needs of its market. In this respect, certain Member States have adopted only recovery plans, while other have adopted both recovery and rescue plans. However, all the measures had to fulfil the prerequisites defined by the Commission in order to be assessed under state aid rules (***see below, under 3***).

In assessing the possible impact of the assistance measures, we focus briefly (***see below, under 4***) on two aspects:

(a) the main issues dealt with in the rescue and recovery plans, i.e.:

- the avoidance of undue distortions of competition, and
- the avoidance of moral hazard,

(b) the main points of criticism to these plans, i.e.:

- taxpayers are “footing the bill”,
- slow implementation of the support measures, and
- the ongoing “credit squeeze”.

The paper is accompanied by **three Appendices** containing:

- a brief overview of selected recovery plans,
- a list of related opinions submitted by the European Central Bank, and
- a table on state aid cases.

1. The need for stabilization of the banking system

It is commonly accepted that at the root of the problems in the real economy lies the instability in the financial markets. In fact, as it is mentioned by the European Commission "*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*".[1]

The major problem which arises thereof is that such difficulties could affect:

- not only weak companies without solvency buffers, but also
- healthy companies which will find themselves facing a shortage or even unavailability of credit, a probability which will have negative effects in the short, medium and long term for the companies and their employees.[2]

The problem becomes even more serious for small and medium-sized enterprises (SMEs), which in any case face greater difficulties with access to finance than larger companies.[3]

Stabilising the banking system is therefore the first step towards halting the downturn and promoting a swift and sustainable recovery.[4] The main objective is that banks resume their normal role of:

- providing liquidity, and
- supporting investment in the real economy.

Member States should according to the European Commission use the major financial support provided to the banking sector:

- to encourage a return to normal lending activities, and
- to ensure that central interest rate cuts are passed on to borrowers.[5]

In the the EcoFin Council of 7 October 2008 it was decided that:

- on the one hand, all necessary measures should be taken in order to enhance the soundness and stability of the banking system and restore confidence and the proper functioning of the financial sector, and
- on the other hand, public intervention had to be decided on at national level but within a coordinated framework and on the basis of a number of EU common principles.[6]

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[1] **Communication from the Commission (2009)**: *Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis*, O.J. C 16/22.1.2009, p. 1.

[2] *Ibid*, p. 1.

[3] *Ibid*, p. 2.

[4] **Communication from the Commission to the European Council (2008)**: *A European Recovery Plan*, COM (2008) 800 final, 26.11.2008, p. 6.

[5] *Ibid*, p. 6.

[6] **Communication from the Commission (2008)**: *The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, O.J. C 270/25.10.2008, para. 3.

The common principles which should be followed by Member States are pursuant to the EcoFin Council conclusions the following:

- 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.

2. The distinction between "rescue" and "recovery" plans

For the reasons explained above (under 1), the current situation threatens:[7]

- on the one hand, individual financial institutions with problems stemming from inefficiencies or excessive risk-taking, whose weaknesses are exposed and exacerbated by the crisis in the financial markets. Long-term viability of these institutions (rather than liquidation) will require a far reaching restructuring of their operations, and
- on the other hand, financial institutions that are fundamentally sound and whose difficulties are exogenous stemming 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 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.[8]

3. Types of assistance measures[9]

3.1 Guarantees covering the liabilities of financial institutions

3.1.1 Material scope of application

- Provision of general guarantees protecting retail deposits (and debt held by retail clients) 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.

[7] *Ibid*, para. 2.

[8] *Ibid*, para. 14.

[9] Based mainly on the abovementioned Commission's Communication: *The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis.*

In the context of a systemic crisis, this measure can be a legitimate component of the public policy response. *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.*

- Provision of guarantees for 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 in order to address the drying-up of interbank lending due to an erosion of confidence between financial institutions. Such guarantees do 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.

3.1.2 Prerequisites

- Temporal scope of the guarantee scheme: The duration and scope of any guarantee scheme going beyond retail deposit guarantee schemes must be limited to the minimum necessary.

- Aid limited to the minimum - private sector contribution: an adequate combination of some or all of the following elements would satisfy the requirement of aid being kept to the minimum:

(i) the guarantee scheme must be based on an adequate remuneration by the beneficiary financial institutions individually and/or the financial sector at large (the fees charged for the provision of the scheme should come as close as possible to what could be considered a market price).

(ii) 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,

(iii) 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: appropriate mechanisms to minimize distortions and the potential abuse of the preferential situations of beneficiaries brought about by a Member State guarantee and to avoid moral hazard:

(i) 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 (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, 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, 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),

(ii) 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: 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: In the assessment of a restructuring plan, the Commission will be guided by the requirements:

(i) to ensure the restoration of long-term viability of the financial institution in question,

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

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

3.2 Recapitilisation of financial institutions

3.2.1 Material scope of application and objective

The establishment of a recapitalisation scheme 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.

3.2.2 Prerequisites

- Objective and non-discriminatory criteria for eligibility, 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.

- Temporal scope of the scheme (limited to the minimum necessary).

- It 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. 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.

- Limitation of the aid to the strict necessary: 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.

- 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.

- 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.

3.3 Controlled winding-up of financial institutions

3.3.1 Material scope of application

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.

3.3.2 Prerequisites

- 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.

- 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.
- 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.
- 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:

(i) the sales process should be open and non-discriminatory,

(ii) the sale should take place on market terms,

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

(iv) 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.

- 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.

3.4 Other forms of liquidity assistance

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.

4. Assessment of the possible impact of the assistance measures

4.1 The main issues

(a) *Avoidance of undue distortions of competition*: this is intended by the adoption of behavioural constraints which were deemed necessary in order to ensure that financial institutions do not engage in aggressive expansion to the detriment of competitors not covered by such support.

In particular, it is intended to ensure that the measures taken serve their purposes, i.e.:

- alleviating risks associated with banks' assets,
- improving banks' solvency,
- enhancing confidence in banks, and
- supporting the financing of the economy.

(b) *Avoidance of moral hazard*: while recapitalization measures alleviate present tensions, *in extremis* they could be taken for granted in the future, thus leading to "imprudent behaviour" in the banking sector. Such a behaviour may also be spurred by governments' interference lending policy, as a direct consequence of their intervention in the capital of banks.

The avoidance of this moral hazard is pursued by:

- the temporal scope of measures,
- the restriction of the aid to the minimum necessary, and
- the adequate remuneration provisions .

4.2 Points of criticism exercised

The main points of criticism to these plans concentrate on the following:

(a) *Taxpayers are "footing the bill"*: this is, to our opinion, not true since adequate contribution from the financial sector and remuneration of the State are ensured.

(b) *Slow implementation of the support measures*: indeed, the entry into force of the measures requires specific procedural acts which have to be taken from both financial institutions concerned and the State.

(c) *The ongoing "credit squeeze"*: it reflects the downturn across the entire European economy; however, the plans are explicitly designed to overcome it.

Appendix 1: Selected recovery plans – A brief overview

FRANCE

State guarantee of wholesale debt obligations

Two schemes of state guarantee

First State guarantee

Purpose: It aims to re-inject liquidity into the economy. The State guarantee may be granted to debt securities issued by a refinancing company (SFEF) whose purpose is to raise funds on the capital markets and grant loans to credit institutions. Any funds raised by the SFEF (through the issuance of debt instruments with a maximum maturity of 5 years) before 31 December 2009 will be guaranteed by the French State up to EUR 265 billion.

Eligible institutions: Only credit institutions that satisfy the capital requirements under the Monetary and Financial Code may be granted funds by the refinancing company. In addition, the institutions concerned will enter into an agreement with the State specifying the consideration to be provided for the guarantee.

The SFEF has been set up with an initial share capital of Euro 50 million apportioned between the French State (1/3) and the seven largest French banks[10] (2/3). The SFEF is a private-law-governed company with no credit institution license and is neither subject to capital adequacy requirements nor immunity from bankruptcy laws. It is subject to the supervision of the French Banking Commission.

Eligibility criteria: Any credit institution requesting to benefit from financing granted by the SFEF will need to meet the following criteria:

- its regulatory capital will need to be sufficient,
- it will need to commit to a code of conduct (which provides, *inter alia*, for a ban on "golden parachutes"),
- it has to be involved in the financing of local authorities, SMEs and individuals (the rate of 3 to 4% of their loans origination is being discussed),
- credit institutions would be required to post collateral in favor of the SFEF of the type of those and in the proportion set out by the Financial Support Law and a Ministerial order.

Second State guarantee

Purpose: In addition, a State guarantee may be given in exceptional circumstances, in particular in urgent cases, in relation to securities issued by credit institutions against consideration and provided that the State receives collateral security (from the credit institution) equivalent to that which the refinancing company has.

[10] BNP Paribas, Crédit Agricole, Société Générale, Caisse Nationale des Caisses d'Epargne, Banques Populaires, Crédit Mutuel and HSBC France.

Recapitalization scheme

Purpose: It aims to reinforce the own funds of financial entities in order to guarantee the stability of the French financial system. The State guarantee may be granted to financing raised by a separate company whose sole shareholder is the State and whose aim is to subscribe to securities that have been issued by financial entities and which constitute regulatory own funds (SPPE). Any fund raising programs will be guaranteed, up to Euro 40 billion, by the French State each time under specific terms and conditions set out by the Minister of Economy.

Eligible institutions: The beneficiaries under the SPPE scheme are "financial institutions". This concept covers a wider scope than that of "credit institutions" and could include other types of regulated entities such as insurance companies or portfolio management companies[11].

The French State capital injection will be made in the form of perpetual Tier 1 regulatory capital (*titres super subordonnés à durée indéterminée*) which are non-voting, not dilutive and will not affect any existing dividend policy. The issue will benefit from a call option at a 5 year term. Such securities are interest bearing (5-year OAT yield + 400 basis points).

Credit institutions receiving capital from the French government would have to undertake to increase the amount of credit they are granting at an annual rate of 3 or 4 per cent. They would, also, have to provide monthly reports on how they are using their new money to finance the "real economy" and will have to respect pay curbs for top managers, with restrictions on severance payments and stock-options.

These securities will take the form of hybrid capital instruments (subordinated debt securities classified as non-core Tier 1 capital) and be remunerated at a fixed rate for the first five years and at a variable rate thereafter. The remuneration, which will average about 8%, will reflect the degree of solvency of each beneficiary bank via a credit default swap (CDS) component, whereby remuneration is modulated according to the risk of default.

Under the scheme notified, the intervention of the French authorities is capped at EUR 21 billion. The French authorities have announced that their intervention will initially be limited to EUR 10.5 billion.

Restrictions on participating banks: The scheme includes obligations for the beneficiary banks with regard to financing the real economy. Compliance with the obligations would be ensured by a mediation system. The beneficiary banks must also adopt measures concerning the remuneration of senior management, senior executives and market operators (including traders).

[11] Finance Minister Christine Lagarde announced, on 20 October 2008, that the French State would inject EUR 10.5 billion of regulatory capital into France's six largest private banks before year-end. The six banks concerned are Crédit Agricole (EUR 3 billion), BNP Paribas (EUR 2.55 billion); Société Générale (EUR 1.7 billion), Crédit Mutuel (EUR 1.2 billion), Caisse d'Epargne (EUR 1.1 billion) and Banque Populaire (EUR 0.95 billion).

GERMANY

State guarantee of wholesale debt obligations

Guaranteeing of liabilities

Eligible period: End 2009.

Purpose: Provision, in return for an appropriate remuneration, of a guarantee up to an amount of EUR 400 billion for financial sector enterprises' newly issued debt instruments with a term of up to 36 months.

The Federal Government has established the Financial Market Stabilization Fund (SoFFin). The Financial Market Stabilization Authority (FMSA) acts for the account of SoFFin. The German Government is liable for the Fund's liabilities.

Guarantees may be provided for new debt instruments issued or other liabilities (i.e. debt capital and non-Tier 1 and -Tier 2 capital) created by financial sector enterprises between the entry into force of the FMStG and 31 December 2009 and having a term of up to 36 months.

A remuneration of an appropriate amount per year is to be charged for the provision of guarantees. Such remuneration will be regarded as normal market remuneration if it includes a margin consisting as a rule of a provision premium of 0.5%, plus in all cases of debt instruments and other liabilities with a term of more than one year a risk premium corresponding to the individual financial institution's credit default swap spread, being not less than the median of the financial institution's five-year credit default swap spread between 1 January 2007 and 31 August 2008. According to the German authorities' commitments, the minimum amount of the premium will be not less than the amount described by the European Central Bank in points 3-8 of its recommendations of 20 October 2008[12].

Restrictions of participating banks: Financial institutions will avoid restrictions of competition as part of their activities by refraining in particular from advertising to the public using references to the provision of the guarantee. Financial institutions will also have to review their commercial policy and its sustainability. In the event of the guarantee being called by an enterprise, the latter will present a restructuring or liquidation plan within six months.

Recapitalization of enterprises

Purpose: Participation in enterprises in the financial sector. Acquisition of shares, silent participations or other items constituting own resources up to a maximum of EUR 80 billion.

The Fund can participate in the recapitalization of enterprises in the financial sector in any suitable form. In particular, it can in return for a capital contribution acquire shares or silent participations and other items constituting the own resources of such enterprises. The ceiling for participation in own resources items is set at a total of EUR 80 billion.

[12] State aid scheme No N 512/2008 – Germany Rescue package for credit institutions in Germany, Brussels, 27.10.2008, C(2008) 6422

The ceiling for participation in respect of individual financial sector enterprises is set in principle at EUR 10 billion. If the ceiling for participation in respect of individual enterprises is exceeded, a restructuring plan will be presented to the Commission.

The Fund is to receive normal market remuneration. As a rule, a form of remuneration will be sought which takes precedence over the profit sharing rights of the other shareholders in the beneficiary enterprise, e.g. in particular a preference dividend or an interest payment.

The German authorities have given a further commitment that in the case of preferred shares a normal market remuneration will be assured which will be not less than 10% a year, unless the Federal Government makes the capital injection with significant private sector involvement (at least [> 25]%) on the same terms.

Restrictions on participating banks: The stabilization measures are combined with various behavioral safeguards designed in particular to increase the accountability of the present owners and management. Thus, financial institutions participating in the recapitalization will be required:

- To review their commercial policy and its sustainability. In this connection the Fund may seek to ensure that especially risky lines of business are reduced or abandoned.
- To take account of the borrowing requirements of domestic industry, and in particular, of small and medium-sized enterprises.
- To limit the remuneration of their executives and shareholders to that which is reasonable. “Reasonable” implies in principle a cash remuneration of EUR 500 000 a year.
- Not to pay any bonuses as long as the enterprise is benefiting from stabilization measures.
- Beneficiary enterprises will have to fulfill further appropriate conditions with respect to their activities in order to avoid distortions of competition due to the stabilization measures.
- Financial institutions participating in the stabilization measures do not, either individually or together, exceed a certain balance sheet growth rate based on previous years.
- Lastly, the German authorities have given a commitment with respect to enterprises supported by a recapitalization measure to present a restructuring plan six months after the recapitalization if the enterprise does not undertake to buy back the shares within six months.

Asset swap “risk assumption”

Purpose: SoFFin may acquire or otherwise secure risk positions acquired by financial sector enterprises before 13 October 2008, including in particular receivables, transferable securities, derivative financial instruments, rights and obligations under loan commitments or warranties and participations, in each case including the related collateral.

Eligible period: End December 2009.

A joint ceiling totaling EUR 80 billion is to apply to the risk assumption and to the participation in own resources items. The ceiling for participation in respect of individual financial sector enterprises is set in principle at EUR 5 billion. The German authorities have also committed to present a restructuring plan where the risk assumption exceeds 2% of an enterprise’s balance sheet total.

The German authorities have also given a commitment, that an appropriate remuneration will be paid to the Fund for the liquidity made available through the risk assumption of at least 12 months Euribor plus 50 basis points on the amount made available plus a risk premium corresponding to the individual financial institution's Credit Default Swap spread (being not less than the median of the financial institution's five-year credit default swap spread in the last 12 months).

Restrictions on participating banks: During the period of the assumption of risk, the enterprise will have adequate own funds, the duration of the risk assumption will not exceed that of the risk positions and that, should it prove impossible to make compensatory payments for losses of market value upon expiry of the agreed term, a restructuring plan will be presented within six months in so far as no such plan has yet been presented.

Lastly, the extensive behavioral safeguards governing recapitalization will apply *mutatis mutandis* to the risk assumption, with the exception of paragraph referring to "borrowing requirements of domestic industry, and in particular, of small and medium-sized enterprises".

GREECE

State guarantee of wholesale debt obligations

Eligible period/instruments: The Greek law is making available a State guarantee to the credit institutions covering new debt issued after 19 November 2008. The guarantees cover all debt, except for subordinated debt and interbank deposits, issued in the following six months. The debt is further limited in so far as only debt with duration from three months up to three years is eligible.

Purpose: The Greek Government will provide, in return for an appropriate remuneration, a State guarantee for debt instruments with a maturity of between three months and three years designed to reopen the market for short and medium term wholesale funding. The compliance with the measures is safeguarded by the new established Supervisory Council (SC)[13].

State guarantee scheme: The overall limit allocated to the scheme is set at EUR 15 billion. This amount will be distributed per credit institution based on the following criteria:

- The liquidity and capital adequacy position of the credit institution and the likelihood its capital adequacy to be affected. The weighting of this criterion is set at 0,5 of the total evaluation.
- The size of the credit institution as derived by its market share in the general financing of the economy, as well as its importance in maintaining financial stability. The weighting of this criterion is set at 0,3 of the total evaluation.
- The size of the residual maturity of the financial institution's liabilities until 31/12/2009. The weighting of this criterion is set at 0,1 of the total evaluation.
- The contribution of the credit institution in financing small and medium sized enterprises and home loans. The weighting of this criterion is set at 0,1 of the total evaluation.

Fee: The guarantee will be provided for an appropriate fee. There will be a measure of institution-specific risk coupled with an additional per annum mark-up to cover the Greek State's credit risk:

- For guarantees with duration of 3-12 months there will be a fee of 50 basis points or 25 basis points when collateral is provided.
- Guarantees with duration of more than 1 year will be priced based on the median of five year CDS spreads of the credit institution concerned for the period 1.1.2007-31.8.2008 with an additional mark-up of 50 basis points when there is no collateral or 25 basis points when collateral is provided.

The implementing law reserves the right to adjust the fee rate by a decision of the Minister of Economy and Finance according to market conditions but only upon approval of the European Commission.

[13] The Supervisory Council is chaired by the Minister of Economy and Finance with the participation of the Governor of the Bank of Greece, the Deputy Minister of Economy and Finance responsible for the General Accounting Office and the State's Representatives at the Board of Directors of the credit institutions participating in the scheme. The Council will convene once a month in order to coordinate the correct and effective implementation of the law and secure that the liquidity created is used to the benefit of depositors, the borrowers and the Greek economy in general.

Restrictions on participating banks: The representative of the Greek State will participate in the Board of Directors of the credit institutions until the expiry of the guarantee provided. Behavioural conditions referred to under the recapitalization scheme (see below) will be also imposed to credit institutions.

Recapitalization Scheme

Purpose: The Greek Government will make available Tier 1 capital by acquiring preference shares in order to build and maintain an adequate buffer of capital for each credit institution.

The 'Recap Scheme': The Greek Government is prepared to acquire preference shares up to an overall maximum of EUR 5 billion in the credit institutions that choose to enter the recapitalization scheme. Those institutions wishing to participate in the recapitalization scheme must issue the preference shares by 19 May 2009, i.e. 6 months after the approval of this scheme. The window to issue the preference shares can be extended up to 31 December 2009, upon the Commission's approval.

The amount of preference shares purchased by the Greek State will be based upon a Decision of the Minister of Economy and Finance. The Minister's decision will be based on a recommendation from the Governor of the Bank of Greece as to the amount to be allocated per credit institution for acquiring these shares. This recommendation shall be based on the following supervisory criteria:

- The capital required to reach the capital adequacy level of the credit institution as defined by the Bank of Greece. More specifically, the target Tier 1 ratio after Recapitalization will be between 8% and 10%. The weighting of this criterion is set at 0,5 of the total evaluation.
- The size of the credit institution relating to its market share in the general financing of the economy and to its importance in maintaining financial stability. The weighting of this criterion is set at 0,4 of the total evaluation.
- The contribution of the credit institution in financing small and medium sized enterprises and home loans. The weighting of this criterion is set at 0,1 of the total evaluation.

Restrictions on participating banks: Greek State will be represented in the Board of Directors by a representative who is appointed as a member to the Board of Directors. The State representative is present at the General Assembly of ordinary shareholders and has the power to veto any decision related to dividends distribution and to the policy regarding remuneration of the President, the Managing Director and other members of the Board of Directors, General Directors and Deputy General Directors. The following behavioural conditions to participating credit institutions in the Recap Scheme are imposed:

a) The remuneration of the President, the Managing Director and other members of the Board of Directors, General Directors and Deputy General Directors of the participating credit institutions cannot exceed the total amount of the remuneration of the Governor of the Bank of Greece.

b) All additional bonuses of the abovementioned persons are abolished for the period of the application of the recapitalization measures.

c) Dividends will in principle be paid out during the time that the State participates in the institution up to 35% maximum.

d) Participating credit institutions will inform the Bank of Greece every three months of the precise use of the amounts of the funds received. The Governor of the Bank of Greece informs the Supervisory Council for the Implementation of the Scheme.

e) Each participating credit institution is obliged not to undertake aggressive market strategies including advertising with the guaranteed status of the beneficiary bank, especially against those competitors not receiving the same coverage/ not participating in the scheme.

f) Participating credit institutions are also obliged to abstain from expanding their activities or pursuing other purposes in a way that unduly distorts competition. For this purpose, the participating credit institutions are obliged to ensure that during the implementation period the average increase of the total assets does not exceed the highest amount among:

- the annual growth rate of the Greek nominal GDP on the previous year, or
- the average rate of increase of the Greek banking sector's total assets for the period 1987-2007, or
- the average rate of increase of the EU banking sector's total assets for the previous six months.

Bond Loan Scheme

Purpose: Support through the issuance of Greek State special purpose securities to credit institutions. The Greek Government will, in return for remuneration and appropriate collateral, issue and lend Greek State securities in order to enable the institutions to obtain immediate liquidity from the ECB and interbank markets.

The Bond Loan Scheme: The Greek State authorizes the Public Debt Management Office to issue Greek Government special purpose securities, i.e. bonds, with a maturity of up to three years, which will be lent to eligible credit institutions, in order to use them as collateral in the refinancing transactions or marginal lending facilities of the ECB and/or as collateral in interbank transactions for liquidity purposes. The overall limit allocated is EUR 8 billion.

The securities have zero coupons. Their lending to the credit institutions is materialized in tranches of 1.000.000 Euros. The securities are lent in their nominal value directly and exclusively to the credit institutions, transmitting to them the legal ownership of titles for the whole period of lending. This amount will essentially be distributed per financial institution based on same criteria as the guarantee scheme, with the difference that the activity of the credit institution in the money market and its ability to redistribute liquidity that will be taken into account in the order of 0,3 of the total evaluation.

Fee/collateral: The fee is payable at the beginning of the six months period or at the beginning of the remaining period up to the expiry of the securities if the remaining period is less than six months. The fee and collateral are equal to what the credit institution would pay for receiving a State guarantee (see above).

Restrictions on participating banks: The credit institutions in possession of these special purpose securities are obliged to use the product of their liquidation for granting home loans and loans to small and medium-sized enterprises under competitive terms. Also the behavioral conditions referred to the above cases apply.

IRELAND

State guarantee of wholesale debt obligations

Eligible period: The Minister for Finance has introduced The Credit Institutions (Financial Support) Scheme 2008. Under the Scheme, the Minister for Finance has guaranteed certain "covered liabilities" of "covered institutions" from 30 September 2008 to 29 September 2010 inclusive.

Purpose: The Scheme is only open to systemically important credit institutions and certain named subsidiaries of such credit institutions[14]. Individual institutions formally join the Scheme once they have executed a "guarantee acceptance deed"[15] and have then been specified in an order made by the Minister for Finance. There is no monetary cap on the guarantee. It covers all covered liabilities of covered institutions to 29 September 2010 inclusive.

State guarantee scheme (September 2008): Provision of financial support for credit institutions provides that the Minister may provide financial support in respect of the borrowings, liabilities and obligations to the Central Bank or any person, of any credit institution or subsidiary which the Minister may specify by order. Financial support will not be provided beyond 29 September 2010.

Financial support may be in such form and manner and on such commercial or other terms and conditions as the Minister sees fit. Conditions attaching to financial support may include stipulations to require the institution or subsidiary to fulfill all requirements of the Financial Regulator or relevant authority, as well as conditions to regulate the conduct of business and the competitive behavior of the credit institution or subsidiary. The Minister may subscribe for, take an allotment of or purchase shares and any other securities in a credit institution or subsidiary to which financial support is provided on such terms as the Minister sees fit.

[14] The list of "covered institutions" (as of 16 December 2008) is:

(a) Allied Irish Banks, p.l.c. and its subsidiaries AIB Mortgage Bank, AIB Bank (CI) Limited, AIB Group (UK) p.l.c. and Allied Irish Banks North America Inc.,

(b) Anglo Irish Bank Corporation p.l.c. and its subsidiary Anglo Irish Bank Corporation (International) p.l.c.,

(c) The Governor and Company of the Bank of Ireland and its subsidiaries Bank of Ireland Mortgage Bank, ICS Building Society and Bank of Ireland (I.O.M.) Limited,

(d) EBS Building Society and its subsidiary EBS Mortgage Finance,

(e) Irish Life and Permanent p.l.c. and its subsidiary Irish Permanent (IOM) Limited,

(f) Irish Nationwide Building Society and its subsidiary Irish Nationwide (I.O.M.) Limited,

(g) Postbank Ireland Limited.

[15] By entering into a guarantee acceptance deed, a covered institution and in certain circumstances a group company party to a guarantee acceptance deed, shall agree to pay a quarterly charge to the Exchequer for the guarantee. The aggregate amount of the charge is based on the increased debt servicing costs that the State bears as a result of providing the guarantee. Current estimates are that over the two years of the Scheme the charge to the covered institutions for the guarantee will yield €1bn. By joining the Scheme, a covered institution will also agree to indemnify the Minister in respect of any payments made, or costs incurred, by the Minister in respect of the guarantee relating to that covered institution. A covered institution is not required to indemnify the Minister in respect of any payments made by the Minister under a guarantee given to any other covered institution which is not a member of its corporate group.

The Minister may withdraw or revoke financial support provided to a credit institution or a subsidiary under this section in accordance with the terms or conditions of the financial support as the Minister thinks fit. The Minister may create and issue securities: (a) bearing interest at such rate as he or she thinks fit, or no interest, (b) for such cash or non-cash deferred consideration as he or she thinks fit, and (c) subject to such terms and conditions as to repayment, repurchase, cancellation and redemption or any other matter as he or she thinks fit. All money to be paid out or non-cash assets to be given by the Minister under this section may be paid out of the Central Fund or the growing produce thereof.

Liabilities covered by the Scheme are known as "covered liabilities". They comprise: (a) all retail and corporate deposits (to the extent not covered by existing deposit protection schemes in Ireland or any other jurisdiction), (b) interbank deposits, (c) senior unsecured debt, (d) covered bonds (including asset covered securities) and (e) dated subordinated debt (Lower Tier 2). The Explanatory Memorandum to the Scheme clarifies that any covered liabilities held as collateral by the ECB and other central banks and any deposits made by the ECB with covered institutions as part of the ECB's investment operations fall within the Scheme. Intra-group borrowing and any debt due to the European Central Bank arising from Eurosystem monetary operations are excluded from the Scheme.

The guarantee is unconditional, irrevocable and ensures timely payment of the covered liabilities of the covered institutions. In the event of any default of a covered institution in respect of a covered liability, the Minister for Finance will pay to the relevant creditor, on demand, an amount equal to the unpaid covered liabilities.

Risk weighting: The Financial Regulator has deemed that, under the Standardised Approach, covered liabilities would qualify for zero risk weighting for capital adequacy purposes during the period of the guarantee.

Recapitalisation of Credit Institutions (December 2008): The Government has decided either through the National Pensions Reserve Fund or otherwise and subject to terms and conditions, to support, alongside existing shareholders and private investors, a recapitalisation programme for credit institutions in Ireland of up to €10 billion.

The State's investment may take the form of preference shares and/or ordinary shares and the State may where appropriate participate on an underwriting basis. In principle, existing shareholders will be expected to have the right to subscribe for new capital on the same terms as the Government. A key principle in the operation of such a fund will be to secure the interests of the taxpayers through an appropriate return on, and appropriate terms for, the investment.

THE NETHERLANDS

State guarantee of wholesale debt obligations

Purpose: As of 23 October 2008 credit institutions can make use of the Credit Guarantee Scheme**.** It is expected that the implementation of the Scheme will improve the financing of financial institutions, thereby safeguard corporate and household loans. The Credit Guarantee Scheme should be seen in connection with earlier measures to protect the financial sector.

The total volume of the guarantee scheme is 200 billion euro.

Eligible period: The Netherlands committed to notify to the Commission in due course any prolongation of the scheme for the period after 30 June 2009. As under the scheme only debt instruments with a tenor of a maximum of 3 years are eligible and as they are guaranteed until maturity, all the guarantees issued under the scheme will have ended on 30 June 2012.

Eligible institutions: All the solvent financial institutions with significant activities in The Netherlands are eligible, including the subsidiaries of foreign banks. The bank must have, in the opinion of the Guarantor, a substantial business in the Netherlands. The bank has a solvency ratio to the satisfaction of the Guarantor, taking into account the requirements of the FMSA[16]and any agreement of the bank with, or any directive or request to the bank from, the Dutch Central Bank.

Eligible instruments: The guarantee scheme covers only newly issued unsecured senior short and medium term debt instruments. The Dutch State will grant guarantees on senior unsecured debt securities. These are the loans to banks, which are not subordinated and which are not secured by collateral. The instrument must have a tenor of not less than 3 months and no more than 3 years. Both the principal as the interests are covered. The scheme is limited to the following debt instruments: a) commercial paper, b) commercial deposits and c) Medium Term Notes. It has to be denominated in Euro, Sterling or US Dollar.

Fee: The guarantee fee is dependant on the creditworthiness of the bank involved and is based on historical credit default swap spreads, with an addition of 50 basis points. For maturities of less than 1 year, only 50 basis points will be charged. The CDS-spreads are maximised per rating category. For tenor up to one year, a fixed guarantee premium of 50 basis points will be charged. For longer tenor, the annual guarantee fee charged by the Dutch authorities will be the addition of a fixed (50 basis points) and a variable component, which is the relevant Eligible Bank's CDS Spread.

If no representative CDS spread is available for a bank with a rating, the fee will be calculated on the basis on a comparison with a peer group for which data are available. For other banks, the premium will be determined by the Dutch central bank as supervisory authority. The premium will be paid annually and in advance.

Restrictions on participating banks: Participating banks must commit themselves to use their best efforts to ensure that each of its managing or executive directors shall unconditionally and irrevocably waive entitlement to any bonuses or other incentives, and waive entitlement to any payment under any severance in excess of an amount equal to his fixed salary for one year. The growth of the balance sheet of the participating banks will also be limited.

[16] Dutch Financial Markets Supervision Act.

Re-capitalization schemes

Purpose: To inject funds into financially healthy credit institutions and insurance companies. More specifically, EUR 20 billion has been made available by the Dutch government to financial institutions and insurance companies (including foreign institutions with their seat in The Netherlands) until 20 January 2009 in the form of participation, preference shares or by other means agreed.

Recapitalization of ING Group and Aegon N.V.: As part of this recapitalization scheme, it has been announced that ING Group will issue 1 billion non-voting core Tier-1 securities to the Dutch State at a price of EUR 10 per security, i.e. 10 billion EUR.

In addition, the Dutch insurance company Aegon N.V. has secured EUR 3 billion in additional capital in an agreement involving both the Dutch government and the company. The scheme adopted is similar to the one adopted for ING.

UNITED KINGDOM

State guarantee of wholesale debt obligations

Purpose: The 2008 Credit Guarantee Scheme forms part of the Government's measures announced on 8 October 2008, to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers.[17] The guarantee provided is to cover eligible liabilities for which an eligibility certificate has been issued by HM Treasury, following an application made by the eligible institution and the payment of a fee.

Eligible period: The term of the guaranteed instruments must not exceed three years. The guarantee will terminate at midnight on 13 April 2012, unless extended at the discretion of HM Treasury.

Eligible institutions: Unless Guarantor (HM Treasury) decides otherwise, the institution must be: a) an authorised UK deposit-taker (including a UK incorporated subsidiary of a foreign institution) which, in the view of the Guarantor, has a substantial business in the UK or a UK building society, b) the institution must have Tier 1 capital in an amount determined by the Guarantor as at a date to be specified by the Guarantor. The guarantee is only available to one entity per banking group.

Eligible instruments: Eligible instruments are senior unsecured debt instruments with standard market terms, and not being complex instruments, and falling within one of the following categories: a) certificates of deposit, b) commercial paper, c) bonds or notes, only denominated in Euro, Sterling or US Dollars.

Fee: A fee based on a per annum rate of 50 basis points plus 100 per cent of the eligible institution's median five-year credit default swap (CDS) spread determined by the Guarantor, in its discretion, from publicly available data, during the 12 month period ended on (and including) 7 October 2008, for the issuance of an Eligibility Certificate. There may also be an incremental fee payable for guarantees of issues denominated in a currency other than sterling.

[17] In summary these measures are intended to: a) provide sufficient liquidity in the short term, b) make available new capital to UK banks and building societies to strengthen their resources, permitting them to restructure their finances, while maintaining their support for the real economy; and c) ensure that the banking system has the funds necessary to maintain lending in the medium term.

Re-capitalization schemes

Purpose: To facilitate increases of Tier 1 capital in participating banks in order to strengthen the financial institutions' capital base against possible future losses[18].

Eligible period: There is a formal time window of six months for the *Recap Scheme.*

Eligible institutions: Financial institutions that want to join the scheme have to commit to increasing their total Tier 1 capital ratio in excess of 9%. Participation in the Recapitalization Scheme *(Recap Schem*e) is not compulsory in order to be able to participate in the Guarantee Scheme. Provided institutions fulfill commitments to increase their Tier 1 capital ratios to the level described above, they will be eligible for the latter, whether this is achieved through existing shareholders or under the *Recap Scheme*.

To facilitate the capital increases the UK will make available a £25 billion cash facility, to be drawn on if required, for the purchase of preference shares or, for building societies which cannot issue preference shares, permanent interest bearing shares (hereinafter "PIBS") or to assist in the raising of ordinary equity.

In addition the UK has indicated its willingness to provide a further maximum of £25 billion to support eligible institutions in the form of preference shares, PIBS or to assist in raising ordinary equity.

In the event that the UK provides capital, the issue of securities or the underwriting of an issue will be on terms which will vary depending on the particular circumstances of the institution. If preference shares are subscribed they will contain a fixed interest element and an element based on the particular institution's risk profile. This resulting interest rate will be in the region of 12%.

The preference shares are unlikely to carry voting rights and are to be redeemable at the option of the issuer, i.e. the financial institution.

Restrictions on participating banks: The UK will impose the following behavioural conditions to participating institutions in the Recap Scheme:

a) no cash bonuses to be paid to Directors for the current year's performance,

b) compliance with an Association of British Insurers best practice code on executive pay, commitment to a new FSA code on risk based remuneration at the nonexecutive level, and remuneration structures to be reviewed to ensure that incentives reflect long-term value creation and risk, rather than short term indicators such as profit and revenues,

c) where a Board member loses the confidence of the Board, they can be dismissed at reasonable and fair cost,

d) the UK will work with the Board on its appointment of new independent directors (the number to be commensurate with the scale of financial support),

e) commitments to maintain, over the next three years, the availability and active marketing of competitively priced lending to homeowners and to small businesses, at a level at least equivalent to that of 2007,

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[18] On 13 October 2008, the UK government announced capital investments to the Royal Bank of Scotland (RBS) and to HBOS and Lloyds TSB totaling GBP 37 billion. They will be re-capitalized through the Bank Reconstruction Fund.

f) commitments to support schemes to help people struggling with mortgage payments to stay in their homes, and to support the expansion of financial capability initiatives,

g) the activity of all participating banks (ie across all banks in total receiving financial support, whether recapitalization or guarantee only) will be limited to the higher of the average historical growth of the balance sheets in the UK banking sector during the period 1987 - 2007, or the annual rate of growth of UK nominal GDP in the preceding year. If the thresholds are exceeded the UK authorities will take the necessary measures to re-establish the discipline, unless there is evidence that the thresholds are exceeded for reasons unrelated to the recapitalization or wholesale funding guarantee schemes.

DENMARK

State guarantee of wholesale debt obligations

Eligible period: The Danish Act on Financial Stability is effective as of 5 October 2008 until 30 September 2010. It was adopted by the Danish Parliament on 10 October 2008.

Purpose: The Kingdom of Denmark unconditionally guarantees unsubordinated creditors' claims against losses in Danish banks to the extent such claims are not otherwise covered, e.g. by the Danish Deposit Guarantee Scheme.

State guarantee scheme: A guarantee scheme is set up, which provides that the Danish government shall unconditionally guarantee the claims of unsecured creditors against losses in Danish and Danish banks' liabilities to creditors, to the extent that such claims are not otherwise covered, related to covered bonds or subordinated debt. For the purpose of the present Act, unsecured creditors shall mean depositors and creditors whose claims are not covered by sections 132 and 136 of the Danish Financial Business Act. That means that the guarantee scheme covers claims from all depositors and other creditors except a) claims based on tier 1 and 2 capital in the form of hybrid core capital and subordinate loan capital and b) claims based on covered bonds (SDO creditors).

The guarantee scheme comprises banks which, on or before 13 October 2008, have applied for membership of the Private Contingency Association for the Winding up of Distressed Banks, Savings Banks and Cooperative Banks (the *Private Contingency Association*). The above mentioned banks may agree with the Private Contingency Association that their branches in other countries operating a scheme corresponding to the guarantee scheme pursuant to the present Act shall be comprised by the guarantee scheme. Failure to comply with risk restrictions[19] or other reckless behavior may lead to exclusion from the guarantee scheme. It will not be possible for such bank or branch to re-enter.

The Act also provides that the Ministry of Economic and Business Affairs will establish a winding-up company (the *Winding-Up Company*). The objective of the Winding-Up Company is to ensure that creditors in Danish banks and foreign branches of Danish banks participating in the scheme are covered in full. Participating Danish banks through the Private Contingency Association will contribute up to DKK 35 billion (approximately 4.7 billion Euro) to the Winding-Up Company and the government will cover any losses incurred by the Winding-Up Company of up to DKK 10 billion (approximately 1.4 billion Euro).

If a participant does not fulfill the statutory capital requirements of the Danish Financial Business Act, he must declare to the Winding-up Company that he will commit to a sale to a buyer selected by the Winding-up Company, if the capital requirements are not met within a deadline set by the Danish FSA.

[19] *The Minister of Economic and Business Affairs is authorised to issue regulations which restrict the exposure that can be assumed by banks participating in the guarantee scheme. Such regulations must be objective and quantitative, e.g. a maximum increase in loans and guarantees expressed as a percentage per year or a maximum exposure to a single industry.However, the Act also states that within the framework of their ordinary business, banks which are part of a group may freely organize their business with respect to capital and liquidity as well as exposure.*

As an alternative, the Winding-up Company may subscribe for share capital in a bank which takes over assets and liabilities from the distressed bank, set up a subsidiary to wind up the distressed bank or engage in other solutions within its purpose. Share capital, hybrid core capital and subordinate loan capital will remain with the distressed bank, whilst all other liabilities will be transferred in the sale or other winding up solution. The Act also regulates the valuation process regarding the sale price.

Restrictions on participating banks and branches: The Act should organize their business with respect to capital and liquidity, aiming to the strengthening of the banks' balance sheets, including a ban on dividend payments and share repurchases by banks participating in the scheme and new stock option programs for the management of a bank, replacing the expiring ones.

Appendix 2: Opinions of the European Central Bank

Member State	Opinion	Date of adoption
Austria	Opinion of the ECB at the request of the Austrian Ministry of Finance on draft legal measures to ensure the stability of the Austrian financial market (CON/2008/55)	20.10.2008
Belgium	Opinion of the ECB at the request of the Belgian Ministry of Finance on a preliminary draft law on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability (CON/2008/46)	8.10.2008
	Opinion of the ECB at the request of the Belgian Ministry of Finance on a draft royal decree adopted under Article 117*bis* of the Law of 2 August 2002 on the supervision of the financial sector and on financial services (CON/2008/50)	17.10.2008
	Opinion of the ECB at the request of the Belgian Minister for Finance on a draft royal decree implementing the Law of 15 October 2008 on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability, in relation to the protection of deposits and life insurance and amending the Law of 2 August 2002 on the supervision of the financial sector and on financial services (CON/2008/61)	28.10.2008
	Opinion of the ECB at the request of the Belgian Ministry of Finance on a draft royal decree on the guarantee for certain risks assumed by financial institutions (CON/2008/74)	21.11.2008
Denmark	Opinion of the ECB at the request of the Danish Ministry of Economic and Business Affairs on a proposed Law on financial stability (CON/2008/54)	17.10.2008
Finland	Opinion of the ECB at the request of the Finnish Ministry of Finance on a draft government proposal for laws amending the Law on the Government Guarantee Fund and the Law on credit institutions (CON/2008/68)	13.11.2008
	Opinion of the ECB at the request of the Finnish Ministry of Finance on a draft law on state capital investment in deposit banks (CON/2008/75)	24.11.2008
France	Opinion of the ECB at the request of the Banque de France on a draft amending finance law for the financing of the economy (CON/2008/56)	21.10.2008
Germany	Opinion of the ECB at the request of the German Ministry of Finance on a Law on the implementation of a package of measures to stabilise the financial market and an order on its implementation (CON/2008/57)	21.10.2008

Member State	Opinion	Date of adoption
Greece	Opinion of the ECB at the request of the Greek Ministry of Economy and Finance on a draft law on, inter alia, the establishment of the 'Depositors and Investors of Credit Institutions Compensation Fund' (CON/2008/51)	17.10.2008
	Opinion of the ECB at the request of the Greek Ministry of Economy and Finance on a draft law on enhancing liquidity of the economy to address the impact of the international financial crisis and on a draft decision on its implementation (CON/2008/79)	27.11.2008
Hungary	Opinion of the ECB at the request of the Hungarian Ministry of Finance on a draft law on strengthening the financial intermediary system (CON/2008/81)	1.12.2008
Ireland	Opinion of the ECB at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Bill 2008 (CON/2008/44)	3.10.2008
	Opinion of the ECB at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Scheme 2008 (CON/2008/48)	15.10.2008
	Opinion of the ECB at the request of the Irish Minister for Finance on a draft Financial Services (Deposit Guarantee Scheme) Bill 2008 (CON/2008/69)	17.10.2008
Italy	Opinion of the ECB at the request of the Banca d'Italia on behalf of the Italian Ministry for Economic Affairs and Finance on two Decree-Laws containing urgent measures to guarantee the stability of the banking system and the continuity of the provision of credit (CON/2008/58)	23.10.2008
	Opinion of the ECB at the request of the Banca d'Italia on behalf of the Italian Ministry for Economic Affairs and Finance on a draft ministerial decree containing provisions to implement Decree-Law No 157/2008 on further urgent measures to guarantee the stability of the credit system (CON/2008/65)	12.10.2008
Latvia	Opinion of the ECB at the request of the Latvian Ministry of Finance on a draft regulation establishing procedures for issue and supervision of bank loan guarantees (CON/2009/2)	7.1.2009
Poland	Opinion of the ECB at the request of the Polish Minister for Finance on a draft law on the provision of State Treasury support to financial institutions (CON/2008/80)	28.11.2008
Slovenia	Opinion of the ECB at the request of the Slovenian Ministry of Finance on a draft law amending the Law on public finance (CON/2008/76)	25.11.2008
	Opinion of the ECB at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting guarantees under Article 86.a of the Law on public finance (CON/2008/88)	19.12.2008
	Opinion of the ECB at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting loans under Article 81.a of the Law on public finance (CON/2008/92)	22.12.2008

Member State	Opinion	Date of adoption
Spain	Opinion of the ECB at the request of the Spanish State Secretary for Economic Affairs on a Royal Decree-Law creating a Fund for the acquisition of financial assets and on a Royal Decree-Law adopting urgent financial and economic measures in relation to the concerted European action plan of the euro area countries (CON/2008/52)	17.10.2008
	Opinion of the ECB at the request of the Spanish State Secretary for Economic Affairs on a draft Order implementing Royal Decree-Law 6/2008 creating the Fund for the acquisition of financial assets and on a draft Basic Agreement of the Fund's Executive Council (CON/2008/60)	27.10.2008
	Opinion of the ECB at the request of the Spanish Ministry for Economic Affairs and Finance on a draft order implementing Royal Decree-Law 7/2008 authorising State guarantees (CON/2008/67)	13.11.2008
Sweden	Opinion of the ECB at the request of the Swedish Ministry of Finance on a draft proposal on stabilising measures for the Swedish financial system (CON/2008/59)	24.10.2008
	Opinion of the ECB at the request of the Swedish Ministry of Finance on a draft ordinance on State guarantees for banks etc. (CON/2008/62)	2910.2008

Appendix 3: State aid cases

A. Decisions adopted by the Commission in 2008-2009 (as of 12 January 2009)

	Member State	Type of measure / Beneficiary	Type of Decision	Date of adoption	Number of Decision	Decision publication
1	Austria	Commission approves Austrian support scheme for financial institutions	Decision not to raise objections (IP/08/1933)	09 December 2008	N557/2008	Staatliche Beihilferegelung Nr. N 557/2008, Österreich Maßnahmen nach dem Finanzmarktstabilitäts- und dem Interbankmarktstärkungsgesetz für Kreditinstitute und Versicherungsunternehmen in Österreich - K(2008) 8408 endgültig
2	Belgium/France/ Luxembourg	Commission approves joint aid from Belgium, France and Luxembourg to rescue Dexia	Decision not to raise objections (IP/08/1745)	19 November 2008	NN45/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
3	Belgium/ Luxembourg/ Netherlands	Commission approves Belgian state guarantee for Fortis Bank	Decision not to raise objections (IP/08/1746)	19 November 2008	N574/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
4	Belgium/ Luxembourg/ Netherlands	Commission clears state aid to rescue and restructure Fortis Bank and Fortis Bank Luxembourg	Decision not to raise objections (IP/08/1884)	03 December 2008	NN42/2008, NN46/2008, NN53/2008A	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*

	Member State	Type of measure / Beneficiary	Type of Decision	Date of adoption	Number of Decision	Decision publication
5	Belgium	Commission approves recapitalisation of Belgian KBC Group	Decision not to raise objections (IP/08/2033)	18 December 2008	N602/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
6	Denmark	Commission approves Danish rescue package for Roskilde Bank	Decision not to raise objections (IP/08/1222)	31 July 2008	NN36/2008	State aid NN 36/2008 – Denmark - Roskilde Bank A/S - C(2008)4138
7	Denmark	Commission approves Danish liquidation aid for Roskilde Bank	Decision not to raise objections (IP/08/1633)	5 November 2008	NN39/2008	Statsstøttesag NN 39/2008 – Danmark - Støtte til afvikling af Roskilde Bank - K(2008) 6498
8	Denmark	Commission approves Danish state support scheme for banks	Decision not to raise objections (IP/08/1483)	10 October 2008	NN51/2008	State Aid NN51/2008 – Denmark - Guarantee scheme for banks in Denmark - C(2008)6034
9	Finland	Commission approves Finnish support scheme for financial institutions	Commission approves Finnish support scheme for financial institutions (IP/08/1705)	14 November 2008	N567/2008	State Aid N 567/2008 – Finland- Guarantee scheme for banks' funding in Finland - C(2008) 6986
10	France	Commission authorises French scheme for refinancing credit institutions (Refinancing)	Decision not to raise objections (IP/08/1609)	30 October 2008	N548/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
11	France	Commission authorises French scheme to inject capital into certain banks (Recapitalisation)	Decision not to raise objections (IP/08/1900)	08 December 2008	N618/2008	-

	Member State	Type of measure / Beneficiary	Type of Decision	Date of adoption	Number of Decision	Decision publication
12	Germany	Commission approves restructuring of Sachsen LB	Conditional decision (after formal investigation procedure) (IP/08/849)	4 June 2008	C9/2008	COMMISSION DECISION of 4 June 2008 on state aid implemented by Germany for Sachsen LB [Notified under No C 9/2008 (ex NN 8/2008, CP 244/2007)] - C(2008) 2269 final
13	Germany	Commission approves restructuring of German bank IKB	Conditional decision (after formal investigation procedure) (IP/08/1557)	21 October 2008		-
14	Germany	Commission approves German rescue bank aid package for Hypo Real Estate Holding AG	Decision not to raise objections (IP/08/1453)	2 October 2008		-
15	Germany	Commission approves modifications to German financial rescue scheme	IP/08/1966	12 December 2008	N625/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*

	Member State	Type of measure / Beneficiary	Type of Decision	Date of adoption	Number of Decision	Decision publication
15a	Germany	Commision approves German support scheme for financial institutions	Decision not to raise objections (IP/08/1589)	27 October 2008	N512/2008	State aid scheme No N 512/2008 – Germany - Rescue package for credit institutions in Germany - C(2008) 6422
		Amendment to the Decision	IP/08/1966	12 December 2008		
16	Germany	Commission approves state support for BayernLB	Decision not to raise objections (IP/08/2034)	18 December 2008	N615/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
17	Germany	Commission approves German banking rescue aid for LordLB	Decision not to raise objections (IP/08/2056)	22 December 2008	N655/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
18	Germany	Commission approves state support for IKB	Decision not to raise objections (IP/08/2055)	22 December 2008	N639/2008	*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
19	Greece	Commission authorises support package for Greek credit institutions	Decision not to raise objections (IP/08/1742)	19 November 2008	N560/2008	State Aid N 560 /2008 – GREECE - Support Measures for the Credit Institutions in Greece - C(2008) 7382
20	Ireland	Commission approves revised Irish support scheme for financial institutions	Decision not to raise objections (IP/08/1497)	13 October 2008	NN48/2008	State aid NN 48/2008 - Ireland - Guarantee scheme for banks in Ireland - C(2008)6059

	Member State	Type of measure / Beneficiary	Type of Decision	Date of adoption	Number of Decision	Decision publication
33	Sweden	Commission approves Swedish support schemes for financial institutions	Decision not to raise objections (IP/08/1600)	29 October 2008	N533/2008	State aid N 533/2008 – Support measures for the banking industry in Sweden - C(2008) 6538
34	Sweden	Commission approves Swedish rescue aid for Carnegie Bank	Decision not to raise objections (IP/08/1977)	15 December 2008	NN64/2008	State aid NN64/2008 – Sweden - Rescue aid to Carnegie Bank - C(2008) 8660
35	United Kingdom	Commission approves UK rescue aid package for Bradford and Bingley	Decision not to raise objections (IP/08/1437)	1st October 2008	-	-
36	United Kingdom	Commission approves modifications to UK financial rescue scheme	IP/08/2057	22 December 2008		*The public version of this decision is not yet available. It will be displayed as soon as it has been cleansed of any confidential information.*
36a	United Kingdom	Commission approves UK support scheme for financial support measures to the banking industry Amendment to the Decision	Decision not to raise objections (IP/08/1496) IP/08/2057	13 October 2008 22 December 2008	N507/2008	-

B. Cases currently under formal investigation procedure				
	Country	**Type of measure**	**Comments**	
1	Germany	Commission opens in-depth investigation into restructuring of WestLB	1 October 2008 (IP/08/1435)	*Case under assessment*
2	United Kingdom	Commission launches in-depth investication into UK restructuring aid package for Northern Rock	2 April 2008 (IP/08/489)	*Case under assessment*

C. Cases under assessment			
	Country	**Type of measure**	**Comments**
1	Belgium	Measures in favour of Ethias	Waiting for information from the Member State
2	Belgium/France/Luxembourg	Dexia recapitalisation and other measures	Waiting for information from the Member State
3	Finland	Kaupthing Bank Finland AB	Discussion with the Member State ongoing

C. Cases under assessment			
4	Hungary	Financial support measures to Hungarian financial industry in form of recapitalisation and guarantee scheme	Discussion with the Member State ongoing
5	Ireland	Recapitalisation of Anglo Irish Bank	Waiting for information from the Member State
6	Netherlands	Restructuring aid to Fortis Bank Nederland and ABN	Waiting for information from the Member State
7	Poland	Guarantee scheme for banks	Waiting for information from the Member State
8	Portugal	Nationalisation of BPN (Banco Portugués de Negócios)	Discussion with the Member State ongoing. Waiting for submission of restructuring plan.
9	Portugal	Recapitalisation scheme	Notified 5 November 2008. Waiting for additional information from Portugal.
10	Portugal	Banco Privado Portugues	Discussion with the Member State ongoing
11	Slovenia	Liquidity Scheme	Notification received.

Assessment and comparison of the banking rescue packages in two Member States, Austria and Hungary

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Hungarian Institute for Training of Bankers

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Executive summary

The crash of the American sub-prime credit market, followed by several other serious discrepancies in other segments of the financial world, has triggered, by now inevitably, a global financial and economic distress. After a short period of uncertainty it quickly turned out that the European banking system is also seriously affected by the crisis and steps must be taken in order to protect and enhance the European financial system. In an effort to restore confidence in banks, and interbank markets, and to avoid a serious drop in bank lending activities, the EU Commission has promoted Member States to design rescue packages to stabilize financial markets.

The Commission also formulated the standards to be followed by Member States to provide state aid (pursuant to Article 87.3 (b) of the EC Treaty). The guidance helps EU-Members to apply measures to restore confidence in the financial markets in accordance with the 12th October 2008 Eurogroup declaration. The guidance about the application of state aid was published on 13th October 2008 (often referred to as "The Banking Communication").

The Hungarian package is mainly aiming at saving financial institutions, whilst the goal of the Austrian package goes beyond that in the sense that it tries to enhance and strengthen its financial markets as well. A comparison between the Austrian and Hungarian packages shows that the former includes several more measures than the Hungarian one and an additional element of setting up an entity for improving inter-bank lending appears as well, thus bringing more liquidity in the market. Such an idea is fully absent in the Hungarian package.

In the Austrian package conditions are set for participating in the initiatives, whilst the Hungarian package is less specific, setting only the framework of the bail-out and the topics to be discussed in an agreement between credit institutions and the State. The Austrian package is indirectly aiming at stimulating real economy, by obliging beneficiaries to provide funds to SME-s and design a business policy in favour of keeping workplaces, two aspects lacking from the Hungarian approach, partly as a result of high central budget deficit and necessary restrictions in fiscal policy.

Both the Austrian and the Hungarian legislations fail to answer the question of responsibility concerning the problems of subsidiaries of foreign parent banks. As EU legislation fails to appropriately address the question of sharing home-host responsibilities, common EU steps are recommended to clarify this question and resolve the problems and uncertainty subsidiaries face at present.

Background

Global financial crisis had a heavy impact on the EU financial markets, confidence in the inter-bank sector was eroded, and inter-bank lending dried up. Some of the financial institutions are facing problems because of their positions especially exposed to US mortgage market, and their particular business models, where a long-term viability of these institutions would need a far reaching restructuring. Other institutions are fundamentally sound and stable, their difficulties stem exclusively from the crisis, more specifically from restricted access to liquidity. However, the downfall of an institution, especially one, with key market position might lead to the collapse of a Member State's financial markets and have a dramatic effect on real economy. It has emerged, that state aid is a key part of the solution to current problems in the financial markets, and besides the focus on the systemically relevant financial institutions, general measures must also be taken to enhance soundness and stability of the banking system in order to restore confidence in the markets.

The EC Treaty rules allow state aids which are compatible with the common market, and do not distort or threaten to distort competition. In particular Article 87.3.b of the EC Treaty states an aid to remedy a serious disturbance in the economy of a Member State as an action which may be considered to be compatible with common market. The European Commission considered the circumstances as a legal basis for applying the quoted article of the EC Treaty, and has published a guidance on the 13th October 2008 (often referred to as "The Banking Communication") about the application of state aid rules and measures taken in relation to financial institutions in the context of the current global financial crisis. The rules formulated in the Communication apply to both general schemes and ad hoc interventions.

The Communication formulates some general principles which must be followed when designing a national aid scheme. These principles emphasize the compatibility of the schemes with the EC Treaty, for them having no or minimal impact on competition and being well targeted both in time and scope. These principles formulate the following specific conditions:

- Measures have to be clearly defined and well-targeted in order to achieve the expected stability effectively.
- Measures have to be proportionate to the objectives, providing aid to an extent which is needed to regain stability but not giving rise to an unduly market advantage of the beneficiary financial institution.
- The Member State must minimize negative spill-over effects on competitors and lay down behavioral rules that prevent expansion or aggressive market strategies of the beneficiaries due to state aid.
- General schemes must be based on the principle of non discrimination, meaning that access for application to these schemes has to be granted for all market participants, and eligibility should not be based on nationality.
- Measures have to be limited in time in a way that support should only be given as long as it is justified by the crisis situation, and it should be reviewed and adjusted or terminated as markets regain stability.
- The applied measures must be reviewed regularly in order to make sure they serve their objectives, and adjusted if necessary or terminated if market conditions so allow.

- There must be a distinction between fundamentally sound financial institutions, where the problems arise exclusively from the crisis, and financial institutions, who have endogenous problems beyond that.
- In case of a guarantee scheme the contribution of the private sector has to be ensured by adequate remuneration.

The Communication encompasses the possible measures taken for stabilizing financial markets, and translates the general principles into specific considerations for guarantees covering the liabilities of financial institutions, recapitalisation of financial institutions, controlled winding-up of financial institutions and provision of other forms of liquidity assistance.

The Hungarian banking rescue package

On the 6th November 2008 András Simor, the president of the National Bank of Hungary declared a banking rescue package in an extent of HUF 600 billion or EUR 2,39 billion[20] (which is 2,36% of the Hungarian GDP[21]) on a press conference in Budapest. As announced later, the package is financed by the IMF credit

After some weeks of debate the Parliament accepted the final version on the 15th December which was announced in the Hungarian Bulletin (Magyar Közlöny) on the 22nd December 2008, known as the **Law CIV of 2008** for strengthening the stability of the financial intermediary system (*2008. évi CIV. Törvény a pénzügyi közvetítőrendszer stabilitásának erősítéséről*). It formulates the rules and frames of the measures taken in relation with the market turmoil. The law is also designed to accommodate the previously mentioned sum, ultimately financed by the International Monetary Fund.

The Hungarian rescue package includes two measures for maintaining and insuring stability of the financial intermediary system:

- Guarantees covering the liabilities of financial institutions – to the extent of EUR 6 billion
- Increase of capital – to the extent of EUR 1,2 billion

Beyond these measures the law sets the rules of expropriation of financial institutions facing serious problems.

The law is effective as from the 23rd December 2008 until the 31st December 2009. The measures incorporated in this law are to be applied to credit institutions pursuant to the Act about credit institution and financial enterprises (Hitelintézetekről és pénzügyi vállalkozásokról szóló 1996. évi CXII törvény – **Hpt.**) resident in the Hungarian Republic, not including credit institutions operating as branches of foreign banks.

An amendment to the Hpt. was also announced on the 14th October 2008 (the amendment is the LVI law of 2008), which increases the deposit insurance limit from EUR 240'000 to EUR 500'000 by the National Deposit Insurance Fund of Hungary.

[20] Calculated at the average MNB exchange rates in 2008
[21] Hungarian GDP 2007 according to the Hungarian Central Statistical Office (Központi Statisztikai Hivatal): HUF 25'419 billion = EUR 101,27 billion

The Austrian banking rescue package

On the 13th October 2008 the Austrian government announced the banking rescue package, which was accepted by the parliament on the 21st October and published in the Federal Legal Gazette (Bundesgesetzblatt) on the 26th October 2008. An amendment was released on the 30th October 2008 where specific conditions on state aids are determined.

The 136. Federal Act of 2008 (136. Bundesgesetz 2008) aims at strengthening the inter-bank market and assuring stability in the financial market. The law incorporates the implementation of the Inter-Bank Market Enhancement Act (Interbankmarktstärkungsgesetz – **IBSG**) and the Financial Market Stabilization Act (Finanzmarktstablitätsgesetz - **FinStaG**) and some amendments to the ÖIAG-Act 2000 (ÖIAG-Gesetz 2000), the Banking Act (Bankwesengesetz - **BWG**), the Stock Exchange Act (Börsegesetz), the Financial Market Supervision Authority Act (Finanzmarktaufsichtsbehördengesetz) and the Federal Financial Act (Bundesfinanzgesetz). The 382. Enactment of 2008 (382. Verordnung 2008) regulates some specific conditions concerning the agreement set in relation with the state aid.

A total of EUR 100 billion (36,96% of the GDP[22]) are earmarked for supporting the financial system, which breaks down into EUR 75 billion for state guarantees and liquidity, EUR 15 billion for recapitalization measures and the remaining EUR 10 billion for supporting the Austrian deposit protection scheme.

The **Inter-Bank Market Enhancement Act** regulates the state guarantee, by setting up a separate entity responsible for borrowing and lending funds on the inter-bank market. The Federal Minister of Finance is entitled to

- guarantee liabilities issued by this entity,
- overtake a time limited liability for losses incurred by this entity,
- guarantee liabilities of credit institutions with a maturity of up to five years.

This guarantee scheme applies to credit institutions and Austrian insurance companies pursuant to the BWG and the Insurance Supervision Law (Versicherungsaufsichtsgesetz – **VAG)** respectively. The Act expires on the 31st December 2009.

The **Financial Market Stabilization Act** is dealing with recapitalization measures to be carried out by six different instruments:

1. guaranteeing liabilities
2. assuming liability vis-á-vis the financial institution
3. granting loans or providing own funds to financial institutions
4. acquiring shares or convertible bonds
5. buying existing shares
6. taking over the assets of the financial institution by merge (pursuant to the Stock Corporation Act (Aktiengesetz))

Beyond these instruments the Federal Minister of Finance, in accordance with the Federal Chancellor, is authorized to expropriate the bank if given conditions are met. There is no expiry of the Act, but once the objectives of the measures are achieved the state shall privatise its share holdings.

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[22] Austrian GDP 2007 according to the Hungarian Central Statistical Office (Központi Statisztikai Hivatal): EUR 270,8 billion

Agreements shall be signed with credit institution/insurance companies benefiting from these measures. These agreements have to take into consideration specific topics which are specified in a regulation issued on 30th October 2008.

The amendment of the Banking Act consists of authorizing the Financial Market Supervision (Finanzmarktaufsicht) to increase minimum capital requirement if reasonable and increasing the deposit protection limits per depositary per bank.

The amendment of the Stock Exchange Act allows the Financial Market Supervision to mark certain instruments and prohibit their short selling at the Vienna Stock Exchange for a period of not more than three months.

Similarities and differences in the two investigated packages

Size of the packages

The Hungarian package provides funds in a total amount of EUR 7,2 billion, whereas the Austrian totals EUR 100 billion. The difference is even larger if compared as ratios relative to the respective countries' GDP: 7,08% in Hungary, 34,09% in Austria. The difference can partly be explained by the difference in the ratios of total assets of credit institutions to GDP in the two countries, Austria having a far larger banking system (329% compared to 107% in Hungary) [23]. If the size of the packages are compared to total assets of credit institutions, the difference decreases significantly, Austrian ratio reaching 11,2%, while the Hungarian one is 6,61%. Another reason for the difference is owing to the fact that the Austrian package incorporates not only credit institutions but insurance companies in the rescue, unlike its Hungarian counterparty.

Scope of the packages

Both in Hungary and in Austria the scope of the rescue measures are credit institutions pursuant to the national banking act (the BWG in Austria and the Hpt. in Hungary), but as long as the Hungarian package excludes credit institutions operating foreign banks' branches, the Austrian includes them.

Another important issue is the incorporation of insurance companies, which are regulated in both countries under separate laws, in Hungary the law about insurance companies and insurance activities (Biztosítókról és a biztosítási tevékenységről szóló 2003. évi XL törvén), in Austria the VAG. The Austrian rescue package (that is the IBSG and the FinStaG) is available also for insurance companies pursuant to VAG, whereas the Hungarian rescue package is not extended to insurance companies.

Moreover, the Hungarian package is limited to credit institutions seated in Hungary and pursuant to Hpt.. Such a limitation does not exist in the Austrian provisions, but those credit institutions and insurance companies providing services in Austria that are using the EEA single passport regime are excluded from the lending facilities of the entity set up by IBSG.

Measures and instruments

The following table lists the measures proposed in the banking rescue packages:

[23] The amount of total assets according to EU Banking Structures 2008 (ECB) of the credit institutions in Hungary is EUR 108 billions and EUR 890 billions in Austria.

Measure	Incorporated in the Hungarian rescue package	Incorporated in the Austrian rescue package
Enhancement of inter-bank borrowing and lending		IBSG
Guaranteeing liabilities of financial institutions	Law CIV of 2008	FinStaG
Assuming liability vis-á-vis the financial institution		FinStaG
Granting loans to financial institutions		FinStaG
Increasing capital or acquiring convertible bonds	Law CIV of 2008[24]	FinStaG
Buy existing shares		FinStaG
Taking over the assets of the financial institution by merge		FinStaG
Protection of depositors	Law LVI of 2008 (Amendment to the Hpt.)	Amendment of the Financial Market Supervision Act
Raise of minimum capital requirements		Amendment of the Financial Market Supervision Act
Expropriation	Law CIV of 2008	FinStaG
Prohibition of short selling*		Amendment of the Stock Exchange Act

*The Financial Supervisory Authority of Hungary may require financial institutions to report short positions

The Austrian rescue package is thus a more complex set of applicable measures. Measures such as raising the minimum capital requirement in individual cases, the purchase of existing shares, assuming liability vis-á-vis the financial institution or especially the lending and borrowing on the inter-bank market are aiming not only at the stabilization of the current situation but also at the strengthening and enhancement of national financial markets. These measures are not included in the Hungarian banking rescue package, which doesn't mean that there is no possibility to carry out these measures assuming ordinary market conditions.

The lack of liquidity, the drying up of money and inter-bank markets is one of the central problems in this crisis, sometimes also referred to a "liquidity crisis" nowadays. In this sense it is of great importance to restore confidence in the markets and expand or simplify the access to funds. The Hungarian rescue package has two measures targeted at that, the protection of depositors (restoring public confidence in banks) and the guarantee of the liabilities. The first one will not expand access to funds, but stabilize current positions.

[24] Two types of shares are allowed: preferred shares and shares with veto.

The second one helps restoring confidence in the inter-bank market, but is not as effective as setting up an entity backed by state guarantees, responsible for both borrowing and lending on the inter bank market and providing extra liquidity as a result. The presence of this entity, also as a third party contractor, is aimed at increasing market confidence and, as a consequence, indirectly liquidity as well.

In this sense we think the Austrian rescue package is a stronger instrument to tackle the effects of the current crisis.

Conditions of the agreement about the state aid

In each type of measures applied in favour of a financial institution an agreement has to be signed, which contains the detailed conditions of the procedure of providing state aid.

The obligatory elements of these agreements can be found in the Law CIV of 2008:

- fees and other terms and conditions (ie. the fee for guarantees, or the issue price of shares),
- nominal value of shares acquired
- rights and obligations attached to the issued shares (supervision, sell or purchase),
- limitations to the remuneration of those holding a leading position in the credit institution during the time the guarantee is effective.

Specific conditions though are not regulated in the Law CIV of 2008, but will be treated in a separate enactment in case of state guarantees.

The content of these agreements is also defined in the FinStaG, but a separate enactment was released on 30th October 2008 in the Federal Legal Gazette about the specific conditions of the measures taken in relation with FinStaG or IBSG. The topics are:

- Sustainability
- Application of Funds
- Remunerations
- Facilities of Rescourses
- Divident policy
- Saving of workplaces
- Avoidance of competitive distortion
- Fees and credit spreads
- Reporting
- Letter of Commitment
- Completion

The specific conditions meet the EU requirements and determine the concrete process of drawing on state aid.

Dividends and remuneration

The Austrian and the Hungarian federal law sustain veto and restrictive rights to distribute profits. However, the packages do not contain themselves more specific details about regulation on dividend payments.

Both packages motivate beneficiaries of the measures to maintain the level of their current employment, and the Austrian framework explicitly indicates that banks and insurance companies should refrain from lay offs.

Although both countries' initiatives calls for a reduction in the bank management's remuneration, and the Austrian solution is somewhat more explicit and specific about this, none of them set actual rules for determining management remuneration and bonuses. Long-term motivation techniques are missing factors from the new regulations in this respect.

Treatment of subsidiaries of foreign parent banks

Both the Austrian and the Hungarian legislations fail to answer the question of responsibility concerning the problems of subsidiaries of foreign parent banks. In our reading, in the current national legislation it is those local governments' responsibility, where the subsidiaries are seated, however, the regulation is ambiguous. For example, one of the conditions in Hungary's IMF credit deal states that Hungarian parent banks are responsible for maintaining their CEE affiliates' sound liquidity and capital position. The question becomes especially crucial if a troubled subsidiary is important from the point of view of the host country's financial stability, but is small in the bank group. As EU Directives fail to appropriately address the question of sharing home-host responsibilities, common EU steps are recommended to clarify this question and resolve the problems and uncertainty subsidiaries face at present.

Do the rescue packages fulfill the requirements?

General requirements against rescue packages are twofold: those required by the current market situation and the EU.

Austrian and Hungarian banks are facing similar problems to a certain degree, both having exposures – through their subsidiaries – on the Eastern European markets. After the region has been downgraded in terms of its riskiness, funds became more expensive and difficult to obtain. Hungary is facing further difficulties as a result of its needs for high external financing, partly as a result of high amount of government debts and household indebtness. Thus, it is vital for both packages to restore confidence in financial markets in order to guarantee access to external liquidity.

The European Commission laid down the principles national bank rescue packages have to follow. Firstly, rescue packages are required to be relevant, that is they have to correspond to the specific financial problems Member State face, secondly, they have to be proportionate in terms of the countries' income (GDP) and the size of their financial systems. Both questions were answered earlier, stating that – in our judgment – both requirements are met by the packages. Further conditions are:

Behavioural rules

Hungary The Hungarian rescue package has minimal considerations on minimizing market distortions.

Austria The 382. Enactment of 2008 contains the details on the agreement in relation with the state aid, outlined in §2. (5) of FinStaG, which prescribes, that conditions must be set on the beneficiaries' business activity in order to avoid, or minimize market distortion.

Non discrimination

Hungary The Hungarian rescue package is compliant with the principle of non discrimination as it is open to all credit institutions resident in Hungary and pursuant to the Hpt.

Austria The Austrian rescue package is also incorporating all credit institutions and insurance companies holding a license pursuant to the BWG and VAG respectively.

Limitation in time

Hungary The Hungarian CIV law of 2008 is repealed on 31st December 2009. Apart from this, the duration of any credits guaranteed in the framework of the rescue package is limited to five years. In case of the recapitalization measures, the beneficiary has a right to repurchase its shares, otherwise the state has a right to sell these shares after a period of five years. Exact details of the repurchase agreement are not yet determined.

Austria The IBSG repeals on 31st December 2009 and issues securities of a duration of five years at maximum. The FinStaG has no expiry, but the duration of application of the measures is limited, so that after reaching the initially set goals the state must step out of the agreement.

Regular reviews

Hungary The Hungarian Financial Supervisory Authority (Pénzügyi Szervezetek Állami Felügyelete) and the National Bank of Hungary is continuously assessing the financial markets with a focus on stability and liquidity. Thus, the effects of the measures can and should be monitored.

Austria The Federal Minister of Finance has to report every quarter to the Headcommittee (Hauptausschuss) about the measures taken in relation with the FinStaG. The report must focus on the financial effects of the measures.

Distinction

Hungary Based on the continuous assessment of the financial institutions the Head of the Supervisory Board of the Supervision and the President of the National Bank can determine the group of fundamentally sound institutions and those facing endogenous problems. Their joint concordance is a precondition of granting state aid. In exceptional cases (clearly defined in the CIV. Law of 2008) the state has the right to expropriate the financial institution.

Austria According to 382. Enactment of 2008, measures under the IBSG and FinStaG can be executed in case of those institutions that meet the capital requirements, except if the purpose of the measure is to increase capital. This, together with the requirement that beneficiaries have to design their business policies aiming at long-term viability might distinct fundamentally sound institutions. The right for expropriation is incorporated in the FinStaG, but it includes no such specified conditions as the Hungarian rescue package.

Contribution of the private sector

Hungary The Hungarian banking rescue package prescribes, that the agreement set in relation with the state aid has to determine the fee of the state guarantee and the price of the purchased shares respectively. Specific conditions will be determined in each individual agreement.

Austria Interests on credits provided by the entity set up under the IBSG are by nature close to market rates. In case of other measures under FinStaG fees and other conditions must also be close to market conditions. Fees are specified in the 382. Enactment of 2008.

To sum it up, both rescue packages fulfill the most important criteria set by the Commission. Nonetheless, the Austrian package is often more detailed, and determines specific conditions more accurately, while the Hungarian package leaves some questions open. This is especially the case with state guarantees, where the procedure of granting the state aid will be regulated in a separate enactment.

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Member States' Banking Rescue Packages and Economic Recovery Plans: A Few Remarks

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive summary

The Committee requested an opinion on the Member States' banking rescue packages and economic recovery plans. It specified that this opinion could take into account a selection of the national measures or the general approach and that some remarks on the use of recapitalisation public money and on the remuneration of banks' top executives would be welcome. This briefing paper endeavours to offer a view on this complex issue focussing on a few selected, albeit relevant, institutional and legal aspects. Paragraph 1 provides a brief overview of the Member States' banking rescue packages. Paragraph 2 discusses in particular the need for a more centralised European institutional role in the implementation of such national measures affecting banks with relevant cross border activity. Paragraph 3 briefly discusses if additional measures are needed to ensure a proper safeguard of public funds and to prevent recapitalisation money from distorting competition in the European market. Paragraph 4 calls for renewed attention from European policy makers on rescued banks' top executives remuneration and disgorgement.

1.- Member States adopted a wide array of national measures to face the unprecedented banks' liquidity crisis which, deepening from last September, threatened to deliver in October the collapse of the international financial system. Although all the packages adopted are essentially directed at the same policy goals – and namely "to restore confidence and proper functioning of the financial system, aiming at restoring appropriate and efficient financing conditions for the economy" ([25]) - and, generally speaking, are organized around similar lines of action, the degree and magnitude of public intervention and some specific features of national measures differ also significantly.

The list of actions taken at national level to react to the banking crisis comprises at least the following.

[25] See point 4 of the Declaration on a concerted European Action Plan of the Euro Area Countries, Paris, 12 October 2008 (hereinafter "the Paris Declaration").

a) Emergency liquidity injections to liquidity constrained solvent banks.

In addition to the efforts made by the ECB and by other central banks in the area to ensure extraordinary additional liquidity to liquidity constrained solvent banks (cutting interest rates, providing more longer term funding and relaxing their collateral framework) ([26]), Member States acted in order to revive, through public intervention, the inter-bank longer term money market. To this aim, some MS have supported national banks through the purchase of "high quality" assets (as it was the scheme put in place in Spain) ([27]) and/or through the swap of banks securities with government securities (e.g. Italy; Greece) ([28]). For most MS the first measure has been, however, to make available to banks established in their territory, for a transitory period, a very relevant government guarantee.

Such a guarantee has been made available by a number of MS according to a similar scheme, at least in its very general terms (see for instance Denmark, France, Finland, Germany, Greece, Italy, Poland, Slovenia, Spain, UK): the guarantee could be granted, indeed, at market conditions in respect to a new medium term (up to 5 years) bank senior debt issuance by eligible banks.

However, details of the scheme and degree and magnitude of State involvement vary significantly. Counties like Italy and Spain seem to have followed quite strictly the standard broadly indicated by the Paris Declaration. In Italy the Minister of Economy is authorized by Article 1-bis of Law no. 190/2008 to grant the State guarantee, at market conditions, in respect to new medium term (up to 5 years) senior debt issued solely by banks after October 13, 2008. A very similar scheme is followed in Spain according to the Royal Decree no. 7/2008 ([29]).

In France, by contrast, the guarantee was made available, up to 320 billions and for a maximum duration of 5 years, in respect to the securities issued by the newly established *Société française de refinencement de l'economie* (SFRE), which in turns shall extend liquidity assistance and credit to liquidity constrained solvent banks in order to favour their "financement des particuliers, des enterprises et des collectivités territoriales". Article 6, paragraph II.A of Law no. 2008-1061 of October 16, 2008 is explicit in requiring that "seuls les établissements de crédit satisfaisant aux exigences de fonds propres prévues pourront bénéficier des prêts accordés par la société". In addition to that, in exceptional circumstances securities issued by solvent banks by 31 December 2009, carrying a maximum maturity of up to 5 years, can have access to a governmental guarantee upon delivery of adequate collateral (article 6, paragraph II.B).

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[26] Central banks' standing facilities for additional funding at the upper band of the interest rate corridor, as well as the recourse to emergency liquidity assistance or to the lender of last resort carry however a stigma of reputational risk and banks tend to postpone as long as possible the recourse to these facilities (with the related dangers of forbearance). For policy considerations on the reform of money market operations see C.A.E.Goodhart, *The Regulatory Response to the Financial Crisis*, CESifo Working Paper no. 2257, at p. 8-12; A.Chailloux, S.Gray, U.Klueh, S.Shimizu, P.Stella, *Central Bank Response to the 2007-08 Financial Market Turbolence: Experiences and Lessons Drawn*, IMF Working Paper, WP/08/210 (September 2008)

[27] Royal Decree no. 6 of October 10, 2008 ("por el que se crea el Fondo para la Adquisiciòn de Activos Financieros"). See also ECB, opinion 17 October 2008 (CON/2008/52).

[28] Article 1-bis, paragraph 2, Italian Law no. 190 of December 4, 2008. On the similar Greek provision, ECB, opinion 27 November 2008 (CON/2008/79).

[29] "Medidas Urgentes en Materia Economico-Financiera en relaciòn con el Plan de Acciòn Concertada de los Paises de la Zona Euro"

In Germany, in turn, it is the *Finanzmarktstabilisierungsanstalt* (FMSA) that is entitled to guarantee the issuance by financial sector entities of securities with a maximum maturity of 36 months up to the amount of 400 billions ([30]). It should be noted, however, that in Germany (but the same holds true also for Poland), the scope of coverage of the program is wider: not only banks, but also insurance companies, asset managers and brokers are eligible for support.

In other MS the governmental guarantee appears to be shaped even more differently. In Austria, for instance, banks and insurance companies set up a clearing house to revive the inter-bank money market: the State guarantee covers the clearing house activity ([31]). In Belgium the State guarantee was given directly to the Central Bank for the additional liquidity injected by the same in favour of eligible commercial banks ([32]). In Ireland the State guarantee has been extended to all outstanding retail and corporate deposits (to the extent not covered by existing deposit protection schemes), inter-bank deposits, senior unsecured debt, covered bonds and dated subordinated debts (Lower Tier 2) of the banks ("covered banks") admitted to the program ([33]).

b) Providing financial institutions with additional capital so as to continue to ensure the proper financing of the economy.

Providing fresh Tier 1 capital through public funds to solvent, albeit excessively leveraged, national banks has been a second line of action followed by many MS, so as to allow banks to continue to ensure the proper financing of the economy. This approach, strongly advocated by the UK, implies that "governments committed themselves to provide capital when needed in appropriate volume while favouring by all available means also the raising from banks of private capital" ([34]) and has been followed, especially through the underwriting of preference share or other hybrid securities, by many Member States.

In the UK this has been repeatedly done in favour of all its most important banks and through the underwriting of preference shares ([35]). In France *loi* 2008-1061 sets out, under article 6, paragraph III, that the State guarantee can also be granted "afin de garantir la stabilité du système financier français aux financements levés par une société dont l'Etat est l'unique actionnaire ayant pour objet de souscrire à des titres émis par des organismes financiers et qui constituent des fonds propres réglementaires". In Germany, in turn, the FMSA is now entitled to invest up to 80 billions in recapitalisation programs. In Greece the government is entitled to invest up to 5 billion in preference shares. In Italy Article 1 of Law no. 190/2008 authorises the Minister of Economy to underwrite or guarantee capital increases of undercapitalised banks. In turn, Article 12 of Italian Law Decree 29 November 2008 no. 185 authorises the same to underwrite hybrid securities convertible in common shares upon request of the issuer to provide banks with additional funds for the proper financing of the economy.

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[30] FinanzMarktStabilisierungsGesetz (FMStG) 17 October 2008; see also ECB, opinion 21 October 2008.
[31] ECB opinion 20 October 2008 (CON/2008/55)
[32] ECB opinion 8 October 2008 (CON/2008/46)
[33] ECB opinion 15 October 2008 (CON /2008/48)
[34] See point 9 of the Declaration on a concerted European Action Plan of the Euro Area Countries, Paris, 12 October 2008.
[35] See for instance Treasury statement on financial support to the banking industry, 13 October 2008. A different path was taken with purely distressed banks: see for instance the Bradford & Bingley plc Transfer of Securities and Property Order 2008, 2008 no. 2546. To be honest, in the face of recent events concerning other banks, the distinction between liquidity constrained banks and distressed banks appears to have significantly blurred.

In order to ensure that such new capital funds provided by the government are duly channelled by the recipient bank to the economy, the program can require banks to accept specific undertakings on this point. In France it is required, for instance, that "les établissements concernés passent une convention avec l'Etat qui fixe le contrepartie de la garantie, notamment en ce qui concerne le financement des particuliers, des entreprises et des collectivités territoriales. Cette convention précise également les engagements des établissements et de leur dirigeants sur des règles éthiques conformes à l'intérêts général ». In turn, in Italy, the issuer of hybrid securities acquired by the State shall sign a memorandum of understanding with the Ministry concerning both level and conditions of credit to be extended to SMEs and families, the future dividend policy so as to ensure the maintenance of adequate level of own funds and policies on the executives' remuneration (Article 12, paragraph 5, letters a) and b)

c) Restoring public confidence as regards the safety of banks' savings.

Many MS (e.g. Austria, Belgium, Greece, Latvia to mention only a few) have upgraded the level of protection being granted by their Deposit Guarantee Schemes well beyond the minimum set out according to the existing Directive of 2001 (spontaneously aligning the new threshold at around € 100.000, whereby anticipating in practice the outcome of a reform of the harmonized framework still under discussion). Some Member States, like Italy, provide a complementary government guarantee for all retail deposits. Similarly, in Austria the coverage has been made unlimited (the Deposit Guarantee Scheme being authorized, if and when needed, to issue debt notes backed by the State in order to meet its payment obligations).

In addition to that, and irrespective to the coverage of their Deposit Guarantee Schemes, MS like Ireland, as already mentioned, provide now a full and unlimited government coverage for retail deposits and certain additional covered banks' debts.

d) Specific interventions for distressed banks

A few MS empowered the government to act also in relation to distressed banks. In Austria, for instance, the Minister of Economy was empowered – in addition to provide guarantee, credit facilities, Tier 1 capital or to take over assets – to nationalise banks in distress should other measures prove insufficient.

2.- As noted, the national banking rescue packages, with few exceptions, substantially converge in their broad philosophy. This is due to the effectiveness of the political action concerted among MS as sponsored by European institutions and by the President of the Union then in charge. Indeed, the Paris Declaration of 12 October 2008 at the summit of the Euro area countries and the conclusions of the European Council of 15 and 16 October set the stage for such a broad alignment of national measures. The Commission and the ECB were, in turn, of significant guidance for MS during the process, the former especially with its communications ([36]) and practice under State aid rules, the latter with its opinions on draft legislation and its continuing efforts to warrant the independence of central banks and the prohibition for "monetary financing" (as set out under articles 101 and 237(d) of the Treaty).

[36] See in particular communication 2008/C 270/2 "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis" (so called "Banking Communication") and 2009/C 10/03 "The recapitalization of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortion of competition"

It is quite apparent, though, that the European institutional framework is still lagging behind events. Despite all these meritorious efforts, there has been no uniform pan-European response to the banking crisis. Some national first moves (e.g. in Ireland) delivered unintended dangerous consequences elsewhere (for instance in the U.K.); measures urgently adopted in the U.K. (the recapitalization of big UK banks) to react to such first moves - moves which, ironically, introduced an unprecedented type of regulatory competition, this time very costly for two countries which had benefited the most from regulatory competition over the last two decades - led to disturbances in the inter-bank market for continental banks and prompted in turn similar actions from many other MS to level again the playing field and to prevent banks assisted by their governments from taking competitive advantage from such governmental assistance. Once again regulatory competition plays a major role: and this is unfortunate. Many believe indeed (and I concur) that the current deplorable state of things largely depends on the perverse effects of unwarranted regulatory competition and oversight in the banking sector over the last two decades ([37]).

Fortunately, the European political response following the first national moves was effective enough to quickly deliver at least a common set of general principles to frame subsequent national packages, taking also into consideration – and rightly so – the need for international convergence with the US and the other G-20 countries ([38]). It has not been strong enough, though, to deliver a truly European response. Rescue packages, albeit coordinated, are and remain national; and this is pragmatically so, due to the current non federal status of the Union and its budgetary implications and because relevant banking groups are "too big to fail" first of all for their home Member States, although they operate cross border, often through systemically relevant branches or subsidiaries across Europe. In such a situation, the huge amount of public money urgently needed to subsidize them could only be made available by the home MS (the only one which is likely to have sufficient incentives to accept the negative effects of such intervention on its sovereign debt and its taxpayers). True: Spill over effects and the trans-national character of the operation of a few banking groups were deemed such as to require coordinated action in the emergency situation through appropriate multilateral standing committees and, in few cases, to justify even a joint assistance (with a very problematic burden sharing, though) from two or more MS; there has never been, however, a truly uniform pan-European response.

This is even more so with recapitalization packages and economic recovery plans. Despite the efforts of the Commission reflected in its recovery plan ([39]), intervention to date are principally national. The idea of a common European intervention through a specialized agency (as it was correctly advocated by some and more recently voiced again at the Davos summit) was considered politically not viable. And this epitomizes, to my mind, the failure of a true single market policy; it means that the ownership structure of big banks is, and will continue to be, still fragmented along national boundaries, with a strong, albeit implicit, involvement of national politics. The recourse to national measures, instead of European measures, confirms this course of action.

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[37] Bini Smaghi, *A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market*", paper presented at the CFM-IMF Conference in Frankfurt am Main, 26 September 2008, p. 2.

[38] Compare the Declaration of the G20 Leaders Summit on Financial Markets and the World Economy, Washington DC, November 14-15, 2008. See also Communiqué of IMF, Committee of the Board of Governors of the IMF, October 11, 2008.

[39] See Communication from the Commission "*From financial crisis to recovery: A European framework for action*", Brussels, October 29, 2008 (COM 2008 706 final) and Communication from the Commission to the European Council, "*A European Recovery Plan*", Brussels, November 26, 2008 (COM 2008 800 final)

True, as with the banking rescue packages, also the very substantial costs and governmental liabilities associated with economic recovery plans could not be transferred entirely to the European Union. But a more stringent European institutional role could have delivered, in my opinion, a more uniform response, a more accurate burden sharing among MS (well beyond that envisaged by the existing and non legally binding bilateral or multilateral Memoranda of Understanding, whose implementation on burden sharing is likely to prove very disappointing), more and better coordination with the European Central Bank, more level playing field.

Things having developed as they did, the question is whether or not now a more institutional role for the European institutions would be of help in the implementation of the national packages. I believe it would ([40]).

There is scope, in my opinion, to confer to CEBS a "Lamfalussy level 3 - like" authority concerning the proper implementation of national banking rescue packages at least with respect, due to the subsidiarity principle, to any bank having substantial cross border activity. In particular, CEBS should ensure that the framework principles agreed at Council level (albeit they do not amount formally to a legally binding directive) as well as those issued by the Commission under State aid rules be evenly implemented at national level. In doing so, CEBS should strictly coordinate with the ECB, ensuring for instance the strict application by all MS of its right recommendations on the pricing of government guarantees on bank debt ([41]). The reform of the 3L3 underway should also help in making CEBS more effective in delivering truly harmonized implementing rules and a real convergence among MS. Majority vote should apply.

Stretching the mandate of CEBS in this domain should represent, in my view, an important step forward towards a single European banking supervisory authority, closely linked to the ECB. And to me, it is difficult to see a better opportunity than this to take such a first step in the right direction. Indeed, path dependency has prevented up to now the adoption of a European centralized supervisory architecture for financial intermediaries traditionally regulated at the national level. The crisis clearly showed that the myopia of national regulatory and oversight competition in laxity had spill over effects and raised significant cross-border negative externalities which significantly contributed to undermine the financial stability of the area. To properly address such externalities supervisory decisions need to be taken, if not globally, at least at the European level. Thus, it does not make much sense, in my view, to acknowledge, on one hand, that the existing market failures have to be addressed through a concerted action based on common framework principles (as it has been at the European level), but, on the other hand, to avoid addressing the risk of a very likely competition in laxity in the implementation of such principles. In this domain, details are of essence (it is well known that "der Teufel liegt im Detail"). Why should we offer once again a leeway for regulatory and supervisory arbitrage?

[40] The following insights, if shared by the Committee, could therefore be directed also to the De Larosière Group currently considering, according to the mandate received by the Commission, the organization of European financial institutions to ensure the orderly functioning of markets and stronger European co-operation on financial stability oversight, early warning mechanisms and crisis management.

[41] ECB Opinion CON/2008/52 on the need for harmonizing pricing. Notice that the ECB CON/2008/67 requested Spain to delete any reference to such recommendation in its national legislation because "it is not a legal act and subject to revision". At the same time the ECB correctly reiterated that "it is crucial to ensure the harmonization and coordination of the price determination of State guarantees within the European Union, given that a level playing filed is of essence"

To conclude on this count, therefore, CEBS should be given a proper centralised role in the coordination and supervision of MS in their implementation of national rescue packages. This would not mean transferring all the power to the centre. Quite to the contrary. CEBS could and should exert most of its authority through delegation of tasks at the relevant national authorities, retaining at the centre core decisions, whilst delegating most of the work at the national level to the national supervisory authority sitting in the Committee.

However, in respect of State aid rules and their on going respect by national banking rescue packages CEBS and the Commission should in my view avail themselves quite extensively of one or more monitoring trustees appointed by the Commission. As a matter of fact, considered the relevance of the issue, this would hold true also in the event that the proposed conferral of a more comprehensive mandate to CEBS were not followed: indeed, the Commission is already vested under the State aids rules of the Treaty with the necessary powers to monitor compliance with State aid and competition rules through a monitoring trustee also without any institutional reform concerning CEBS's role.

The delegation of a thorough, on going and on the field monitoring task to an independent monitoring trustee proved indeed very effective in past competition and State aid cases and in the current situation (where EC and State interests may easily result at war) would certainly prove more appropriate than the simple delegation of monitoring functions concerning EU competition and State aid rules to the national banking supervisory authorities being part of the CEBS (which, on the contrary, shall monitor any other financial and/or technical aspect of the packages). As a matter of fact, the appointment by the Commission would have the advantage to avoid any risk of oversight capture at the national level in respect to cross border competition issues and would make the monitoring trustee directly accountable to European institutions.

Furthermore, in our case a strong legal basis can be derived from the Commission's Communication on "A temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis" (2009/C 16/01). There, in section 6 the Commission expressly emphasizes the need to monitor State aid and rescue activities carried out by MS: "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". This point is in line with a relevant statement at the beginning of the same Communication, at section 1.2, where it reads that "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" and that "competition policy is there to ensure this."

3.- Since it is crucial that, in the implementation of the national banking rescue packages and recovery plans, we ensure a proper level playing field, particular attention should also be paid, in my view, to the use made by recipient banks of public funds.

Although the matter is already partially covered, albeit a bit timidly, by the Commission's notices based on State aid rules (in particular paragraphs 35-39 of the Communication 2009/C 10/03), I believe that useful insights could also be drawn from the US experience (which showed also in recent times amazing examples of misuse of the public funds allocated for bank recapitalization to pay billions in bonuses to executives) ([42]). In particular I support the application also in Europe of at least the following principles, derived from the draft provisions currently part of the Bill to reform the Troubled Assets Relief Program pending before the US Congress ([43]):

a) Any assisted bank should publicly report to the national supervisory authority and to CEBS, not less than quarterly, on such bank's use of the assistance. To this purpose CEBS should issue guidelines concerning the manner in which the funds are to be used and benchmarks that the bank is required to meet in using the funding to strengthen the soundness of the bank and availability of credit to the economy: such guidelines should be incorporated in the agreement entered between the bank and the MS at the date of the provision of such funding and should be duly supervised, also through the appointment of a monitoring trustee by the European Commission.

b) No assisted bank may merge or consolidate with any bank or, either directly or indirectly, acquire the assets of or assume liability to pay any deposits made in another bank and no supervisory authority may approve any such action, while any such assistance is outstanding unless CEBS has determined, in consultation with the European Commission, that: (i) such action will reduce risk to taxpayer; or (ii) the transaction could have been consummated without funds provided by the MS according to its rescue package. CEBS should also issue, in consultation with the European Commission, guidelines on prohibited aggressive commercial practices from assisted banks. Such guidelines should be incorporated in the agreement entered between the bank and the MS at the date of the provision of such funding and should be duly supervised, also through the appointment of a monitoring trustee by the European Commission.

c) CEBS may require that an observer delegated by the national supervisory authority of the concerned bank attend the meetings of the board of directors of any assisted bank and any committee of such board of directors, while any assistance is outstanding.

d) CEBS should issue guidelines concerning harmonized economic and governance rights associated with Tier 1 securities issued by assisted bank in connection with national rescue packages; these rights should also comprise, in my opinion, provisions making the suspension of voting rights on preference shares conditional upon the regular payment by the bank of the specified dividends and provisions on the automatic conversion of Tier 1 hybrids into common shares upon occurrence of specified triggering events. Special rules aimed at protecting retail small investors from the dilution effect associated therewith, shifting such dilution effect only to large shareholders (other than UCITs and pension funds, which indirectly manage retail investors' money) should also be considered.

[42] On the payment by Merril Lynch of billions in bonuses soon after receiving $10 billion in taxpayer funds and on Citi orders for private jets see for instance FT, January 28, 2009, at page 1 ("Citi forced to cancel jet order as US clamps down on bank rescue")
[43] H.R. 384 (111th Congress, 1st Session), version 9 January 2009

4.- Finally an issue whose contemplation is required if European policy makers agree that it is right and morally necessary that those who determined the present course of action and in particular, due to their willful or negligent decisions, exposed their banks to the need for public assistance pay their bill. As the new elected US President recently said ([44]) "this crisis did not happen solely by accident of history or normal turn of the business cycle. We arrived at this point due to an era of profound irresponsibility that stretched from corporate boardrooms to the halls of power in Washington D.C. For years, too many Wall Street executives made imprudent and dangerous decisions seeking profit with too little regard for risk, too little regulatory scrutiny and too little accountability". If we believe that this holds true also for Europe and for the top executives of at least some of the assisted banks, there could be scope, drawing lessons from the current US experience, not only to issue new rules on the future remuneration of top executives (as it is contemplated by the Commission) but also on disgorgement of past earnings and profits.

Therefore, the following principles, currently part of the Bill to reform the Troubled Assets Relief Program ([45]) could be extended also to Europe:

a) a provision for the recovery by any assisted bank of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later found to be materially inaccurate;

b) a prohibition on any assisted bank making any golden parachute payment to a senior executive officer during the period that the assistance is outstanding;

c) a prohibition on any assisted bank paying or accruing any bonus or incentive compensation during the period that the assistance is outstanding to the 25 most highly compensated employees;

d) a prohibition on any assisted bank to own, use or lease any private passenger aircraft during the period that the assistance is outstanding to the 25 most highly compensated employees.

[44] American Recovery and Reinvestment, Transcript of President Elect's speech on the economy, January 8, 2009.

[45] H.R. 384 (111th Congress, 1st Session), version 9 January 2009

EU Member States'Banking Rescue Plans

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Richard Pratt

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Executive Summary

Global trade imbalances in the 1990s and early 2000s led to substantial financial flows from developing economies, such as China, to Western economies. The result was cheap and easily available credit whose inflationary impact was masked by the influx of cheap goods from China and India and the flow of cheap labour from transitional neighbouring economies.

The cheap credit led to an expansion of lending both to individuals (many of whom might not normally have been regarded as creditworthy) and to financial institutions, which sought to secure additional returns on investment by borrowing. Lending to individuals was facilitated by the development of new financial instruments designed to transfer risk from banks, who made the lending decisions, to other investors. The new instruments also satisfied the demand from investors for better returns.

Although this process should have reduced systemic risk by taking credit risk away from banks, in fact it increased it. This was partly because many of the new instruments remained on the balance sheets of banks and partly because the new instruments, being less transparent than traditional means of credit transfer, were not well understood and were probably mispriced.

When the process began to unwind in 2007 and 2008, banks made substantial losses that severely depleted their capital. In order to preserve their prudential capital ratios, they were forced to sell assets, causing prices to fall, particularly of the new instruments, whose markets were relatively illiquid. Other investors, seeing prices fall, also began to sell and this created a downward spiral of lower asset prices, bank losses, depleted capital and further asset sales. Some banks failed, others suffered a shortage of liquidity and the cumulative effect was a severe restriction of credit flows to individuals and companies.

Authorities have sought to overcome this by offering additional Government capital to banks, supplying liquidity through asset swaps and other means and limiting the losses arising from the banks' assets. Many Member States introduced packages on these lines between October and December 2008. The result was some easing of the position. However, discussion of further measures is continuing, including bank nationalisation or the purchase of poor quality assets by Governments.

In addition, international regulatory authorities have been calling for strengthened bank supervision in future. More importantly, there is a call for a new approach that defines clear responsibility for assessing the systemic risk arising from new instruments and the emergence of new institutions within the financial sector. There will, moreover, be a need for additional tools to address the systemic risks that continued financial innovation may create in the future.

1. Introduction

1.1. This briefing paper discusses the bank rescue packages that are currently being implemented in European Union Member States. It covers the underlying reasons for the difficulties banks face, the problems the rescue packages are seeking to address, the nature of the packages and the options available to the authorities. The paper then considers some of the options for regulatory changes to avoid similar problems in the future.

1.2. It is apparent that the scale and nature of the difficulties faced by EU banks (and indeed banks in all developed countries) are not yet fully known. The response of the banks and the markets to the bank rescue packages has not yet been played out and is affected by general market developments and other matters, not all directly the result of the nature of the packages themselves. At the time of submission of this paper (January 2009), it is therefore not possible to attempt a full analysis of the effects of the rescue packages.

1.3. The measures taken by EU Member States have been coordinated not only with each other but also with the actions of other countries, particularly the United States. The options available and discussed have been subject to consideration by international bodies, in addition to the EU, and this paper draws upon such discussions as well as the debates within the EU itself.

2. Background to the Problem

1.4. The underlying causes of the global banking crisis lie in the global macroeconomic imbalances that emerged during the 1990s and early part of the 21st century. China, India and other developing countries began to run current account surpluses. Such surpluses could only be offset by capital flows in the opposite direction to the deficit countries – particularly the US and Western economies. The authorities of the emerging economies, particularly in China, took a policy decision to restrict the appreciation of their exchange rates that would otherwise have followed from their trade surpluses and, as a result, acquired substantial holdings of US Government debt. It has been noted [1] that in China the national savings rate peaked at 50 per cent of GDP. In effect, excess savings flowed from developing countries to the deficit countries. Moreover, because the outward flow of savings was dominated by the actions of the Government, much of the savings were invested in US Government debt. Because of the scale of the savings flow, the rate of return on US and other Western Government debt was driven to very low levels. For example, Lord Turner (Chairman of the UK Financial Services Authority) has noted that the rate of return on risk-free Government debt, having been 3 per cent in 1990, fell to 2 per cent and sometimes as low as 1 per cent in more recent years [2].

1.5. The consequences of this flow of savings were two-fold. Firstly, credit in the US and other Western developed economies became cheap and easily available. This did not have an immediate effect on inflation, because of the offsetting effect of cheap imports from China and elsewhere, combined with the inflow of low cost immigrant labour in the EU from new accession countries and in the US from Mexico. However, the cheap and easily availability of credit fuelled an asset price boom (for example in housing and equities) and resulted in the extension of credit to individuals and households who might otherwise have been regarded as posing too high a credit risk [2].

1.6. Secondly, investors who needed to hold low risk investments looked for instruments other than Government debt in order to obtain higher returns[3].

1.7. The demand for such instruments was supplied through innovation in the financial markets which created increasingly sophisticated structured products that reallocated risk and returns in a way that apparently provided higher returns for relatively modest increases in risk. These structured products also enabled the banks that were extending credit on a larger scale than hitherto to securitise the loans and mortgages they created and sell them to investors eager for the higher yields these securities produced. Banks, which had traditionally relied largely on deposits to fund their lending, were able to gain funding from alternative sources – the wholesale money markets – that were channelled through these new financial instruments [4]. The gap between loans and deposits for UK banks, for example, rose from nil in 2000 to £700 billion by 2008 [3]. The banks assumed that their continuing need for liquidity could be met, if necessary, by selling the new instruments and realising the cash [2].

1.8. While this process was developing, the conventional analysis was that the transfer of risk to end investors outside the banking sector was increasing the resilience of the financial sector. Banks traditionally perform the role of maturity transformation – that is, they borrow short term (from deposits) and lend long term (on mortgages, corporate loans and so on). This creates a risk that more depositors may ask for their money back than the bank can meet through selling assets, because many longer term loans cannot be quickly called in. A regulatory infrastructure of minimum capital requirements and supervision with central bank facilities is put in place by public authorities to mitigate this risk. However, if the banks are able to transfer loans to other investors, the risks in the banking sector should be reduced. The IMF Global Financial Stability report of 2006 made precisely this claim [5].

1.9. However, this reduction in risk was not, in fact, happening because the risks arising from the rapid credit extension were not being sold solely, or even primarily, to investors outside the banking system. Banks themselves bought the new instruments. Banks also took part in the creation of the vehicles and retained part of the risk at that time. Furthermore, banks lent money to investors to buy the new instruments and hence retained an indirect exposure to the risks [2], [4].

1.10. Moreover, the profits from these activities and the increase in the prices of assets resulting from cheap and easily available credit apparently enhanced the banks' capital, thus encouraging the increased use of the new instruments. The Governor of the Bank of England noted that the balance sheets of many of the world's major banks doubled between 2004 and 2009 [6]. The Governor of the Banque de France noted that the ability to take full value in the profit and loss account of discounted future profits may well have increased incentives for additional risk taking [7].

1.11. The new instruments were, in effect, performing part of the maturity transformation function traditionally performed by banks (as noted above). However, the new instruments and structured vehicles were not always subject to the capital requirements and supervision of regulators. Nor were their accounts subject to the disclosure rules applicable to banks [2]. Consequently, the nature of the risks and hence their true value were not always understood by those who bought them. Reliance was placed on mathematical models and credit rating agencies, which were not able properly to assess the likely performance of these instruments in adverse market conditions (there having been no experience of performance of the new instruments in such conditions). Risk was, as a result, underpriced [4] [7].

1.12. In 2007, doubts about the quality of the loans underlying the new instruments rapidly spread amongst investors. Credit rating agencies downgraded the ratings of the securities [8]. The extent of the risk retained by banks started to become apparent.

1.13. The market for the new instruments, which had never been very liquid, dried up and banks were not able to sell the assets (for the value they had been assumed to have) [2]. New funding from the wholesale markets also ceased to be available to banks [1]. Accounting rules demanded that banks recognised the losses arising from the reduction in asset values and their capital was reduced. In order to avoid falling below regulatory capital minima, banks were forced to sell assets in a thin and falling market. At the same time, other investors who had bought these assets (often through borrowing) were in danger of breaching their loan covenants and were also forced to sell. Hedge funds were facing increasing calls for redemptions from their investors and they, too were obliged to sell. The forced selling pushed the prices down still further and intensified the downward spiral of falling asset prices and depleted bank capital.

1.14. The situation facing the authorities by the spring of 2008 was that some banks were dependent on funding sources that were no longer available and were close to being unable to fund their operations altogether. Many banks were also facing severe losses that were depleting their capital. Similar effects were being felt by hedge funds and investment banks. Without a response from the authorities, there was a real danger of bank failure. Even banks that were able to survive were likely to do so by preserving their cash (for liquidity purposes) and maintaining their capital ratios (by reducing new lending). In either case, there was a danger of a severely restricted flow of credit on which any economy must depend [5].

1.15. The initial response of the authorities was to supply additional liquidity to the banking system. The European System of Central Banks agreed to accept a wider range of securities as collateral for lending by central banks and, in practice, increased the amount of liquidity available to banks from €450 billion before the crisis to €960 billion by October 2008 [9]. In other cases, such as the UK Special Liquidity Scheme, announced on 21 April 2008, banks were allowed to swap illiquid assets, including mortgage backed securities, for Treasury Bills supplied by the Bank of England. Since there remained a liquid market for Treasury Bills, such bills could be sold or pledged as security for loans.

1.16. These measures alleviated banks' liquidity problems for a while. However, the failure in the US of major institutions, including Fannie Mae, Freddie Mac, Lehman Brothers and Washington Mutual, caused a further crisis of confidence. The collapse of Lehman brothers upset the previous widely held assumption that large investment banks would not be allowed to fail. Lehman Brothers had been the creator of a vast quantity of the new and complex instruments and the realisation that they could not meet their obligations undermined further the value of the products and caused deep concern about the viability of institutions holding such instruments – including commercial banks. The failure of Washington Mutual was the first time that holders of so-called "senior debt" (securities that were supposed to be less risky) suffered losses. These events caused banks and other investors to cease to trust any institutions, even the previously most trustworthy counterparties.

3. The Situation Facing the Authorities in October 2008

1.17. The situation facing the authorities in October 2008 was that some banks were unable to meet their obligations. Others were close to breaching their minimum regulatory capital ratios (with little realistic chance of being able to raise more capital from private investors). Banks, even if solvent, were unable to obtain funding to continue their obligations (except on the basis of overnight loans, a highly risky and unstable source). There was also widespread uncertainty about the true value of many of the asset backed securities held by banks.

1.18. Based, as these securities were, on the willingness of borrowers to repay loans in the future, there was little confidence in the ability of traditional models or default ratios to give guidance on the true value of the securitised instruments. Even if long term historical default ratios did continue to hold and, on maturity, the asset backed securities proved to have a substantial value, the immediate price of the assets was heavily discounted by the unwillingness of investors to buy them. Many banks did not have alternative sources of liquidity to allow them to hold the assets until maturity.

1.19. Banks were aggressively “deleveraging” - reducing their levels of debt by selling assets and reducing lending [6]. The supply of lending to many developed economies was further reduced by the withdrawal of foreign sources of credit. For example, about one third of UK mortgages were being funded from foreign sources in 2006-2007, whereas by 2008 these sources were no longer available.

1.20. Within the developed economies, confidence in bank deposits was also being reduced since deposit insurance schemes were not well understood.

4. The Authorities' Response

1.21. In October 2008, a series of measures were taken by authorities in many Member States. The measures have been designed to restore the banks to a position whereby they can continue their traditional role of deposit taking, maturity transformation and credit extension, while continuing to operate the national and international payments systems. Authorities have been acutely aware of the popular anger within Member States about the behaviour of banks and their apparent responsibility for the current severe economic downturn. The measures have therefore sought to avoid protecting the owners and controllers of banks.

1.22. When framing the measures, Member States' Governments have noted the irony that problems arose in the first place because of excess use of cheap credit and yet the objective of their current policy is to maintain credit flows [6]. However, the problem faced in late 2008 was too little credit rather than too much. Too little credit can result in depression and the underutilisation of the capacity in Member States' economies. It is important to add that most of the excess credit in the years to 2007 resulted in increased debt within the financial sector – banks lending to and borrowing from other financial institutions. In the UK, for example, lending within the financial sector amounted to two thirds of the total increase in debt and the position was similar in other economies in Europe [5]. Credit growth in the real economy was not necessarily excessive. The objective of policy in the developed economies should therefore be to achieve an orderly wind down of credit and debt by focussing on reducing the debts owed within the financial sector while allowing lending to the real economy to continue.

1.23. The authorities undertook specific rescue packages for individual banks, such as Hypo Real Estate in Germany, Dexia in France, Belgium and Netherlands, ING in Netherlands, Glitnir in Norway and the Royal Bank of Scotland, Lloyds TSB, HBOS and other banks in the UK. In addition, the authorities established broader rescue packages for the banking system as a whole. The main elements of the rescue packages announced by Member States since October 2008 are set out at Appendix A. In summary, they include the following:

1.23.1. Liquidity schemes have been designed to allow banks to use their current assets to borrow cash either directly from the central banks or by swapping illiquid assets for more liquid instruments, which themselves could be used to raise cash. The purpose of these measures was to allow banks to gain ready access to funds to continue their operations.

1.23.2. Government guarantees have been given to support bank borrowing. This was intended to provide a basis for the resumption of normal interbank borrowing and also to provide banks with the opportunity to raise funds by issuing their own bonds.

1.23.3. Governments have invested directly in banks, providing them with capital by purchasing ordinary or preference shares in the bank. This was designed to maintain the solvency of banks, in the first place, provide a cushion against future losses and thereby halt the banks' deleveraging process that was restricting lending.

1.23.4. There have also been insurance schemes designed to cap the losses arising from particular assets. Many of the banks' assets have an uncertain value and banks' investors or counterparties were concerned less the assets would deteriorate further in value and erode a bank's capital to the point where it would be unable to continue as a going concern.

1.23.5. In some cases, guarantees have been offered to certain assets, in an attempt to restore liquidity in the markets for those instruments, on the basis that the current uncertainty was leading to their being undervalued with an unnecessary cost in terms of depleted bank capital.

1.24. The October round of rescue packages had a positive effect in that liquidity pressures eased and the cost of insuring against bank defaults reduced substantially. However, confidence in the banks remained fragile and further banks sought additional capital from EU Governments.

1.25. Within the EU, support for banks was conducted within the context of the provisions regarding state aids that are included in the European Union Treaty. The Commission, in its Communication on state aids stated that, in its view, measures could be justified in accordance with Article 87(3)(b) of the Treaty where there is serious disturbance in a Member State's economy. However, each measure by each country had to be assessed and approved by the European Commission on a case by case basis [10].

1.26. The European Council (ECOFIN) at its meeting on 7th October 2008 set out the principles that should govern the bank rescue packages. These are set out in full at Appendix B. In summary, they required Member States to ensure that the measures were temporary, protected taxpayers but not shareholders or management and avoided undue damage to competitors and other negative spillover effects [11].

1.27. As a consequence, most Member States have, as a quid pro quo for the measures, insisted on payments for the guarantees and insurance at commercial rates. Some have invested in preference rather than ordinary shares (although the UK retracted from this position in January 2009) Member States have. In some cases, restricted the payment of bonuses, salaries and dividends and have required banks to continue lending to solvent businesses.

5. Options for Future Measures

1.28. There remains concern that the measures may be insufficient to enable the banks to remain in business and provide traditional bank services. The key concern is the scale of future losses that may be revealed as a result of further analysis of the quality of the assets of each bank, or market developments which may reduce the price of such assets, further deplete bank capital and result in insolvency.

1.29. In some cases, there have been concerns that the total liabilities of the banks may be too great, even for the Government to absorb. Such concerns have been expressed in respect of Iceland, where bank liabilities peaked at 10 times GDP and were approximately 7 times GDP at the time of the collapse of the major banks. Similar concerns have been expressed in the case of Ireland and the UK (in the latter case, where the total assets of UK owned banks are about equivalent to the UK's annual GDP).

1.30. In the absence of specific information about the nature of the assets remaining on banks' balance sheets, it is difficult to evaluate such concerns. However, the key issue is not so much the total liabilities, but the value of the assets that support those liabilities. On the basis of the latest balance sheets of the banks, the assets at least match the liabilities (or the banks would be forced to cease trading). There remains a real possibility that the value may fall in the future but it is highly improbable that they would fall to zero. Moreover, as noted above, in the longer run, the traditional default rate of mortgages should reassert itself and the assets based on mortgages and other loans will, by the time they reach maturity, have substantial value. One of the principles underlying government action is that, unlike private sector banks, Governments can afford to be in a position of holding the assets until maturity and hence realise their full value.

1.31. Governments can use this comparative advantage to underpin the assets in a number of ways. There are currently three main options that have been discussed. The first is the insurance scheme that some Governments have already announced. The second is to sell the assets whose value is uncertain to a separate institution, owned by the government (a "bad bank") on the basis that the assets would be held or sold when an appropriate price could be obtained. The third would be to nationalise the banks.

1.32. Each of these options has advantages and disadvantages. Full nationalisation would increase Government control over the banks and allow the Government to insist on an appropriate level of lending. However, this could also result in political motivation for bank lending, resulting in greater losses in the future. There would also be difficulties in determining an appropriate level of compensation for shareholders. Too much compensation would be unreasonable and contribute to excessive risk taking in future. Too little compensation might prompt shareholders of other banks to sell their shares for fear of having their value reduced by a future nationalisation. The selling of assets to a "bad bank" would permit a bank to start again, with a clean balance sheet, operating on normal commercial terms with a traditional degree of risk taking. However, much would depend on the price paid for the assets taken off the balance sheet, which could either represent a poor deal for taxpayers, or severely cripple the bank moving forward. Similar concerns arise in respect of the Government guarantees for low quality assets, where, again, much depends on the price paid for the insurance offered by the Government.

1.33. These measures are still under discussion as banks and markets digest the effect of the action taken so far.

6. Longer Term Regulatory Reform

1.34. The immediate priority for Governments has been to prevent banks from failing and to put them in a position where they can continue to support the economy. However, much thought has been given as to the regulatory action necessary to ensure that banks do not create similar problems in the future.

1.35. There is little doubt that the recent problems were exacerbated by weaknesses in supervision practices, perverse incentives within banks and weak risk management in a wide range of financial institutions. Moreover, there is also a case for arguing that credit rating agencies were subject to conflicts of interest and weak methodologies, while at the same time given too much credence by investors. Accounting rules allowed banks to assume that asset price inflation represented a real addition to profits that could be used to pay dividends and bonuses, while increasing the capital available for increased lending.

1.36. The regulatory system focussed on the maintenance of minimum capital ratios and paid insufficient attention to the need for reliable sources of liquidity. In the case of capital levels, the international standards tended to allow the banks to take advantage of increased capital in good times (thus increasing the upswing in lending) and carried the danger of forcing banks to contribute to the downswing in economic activity by deleveraging at a time of economic downturn. This was, in effect exacerbating the economic cycle.

1.37. Moreover, once the difficulties began to emerge, concerns have been raised about whether the depositor compensation schemes, the tools available for winding down insolvent banks and the arrangements for cross border cooperation in such insolvency cases, were adequate.

1.38. Action has already been taken to address some of these issues. On 18 December 2008, the European Parliament agreed to a proposal to amend the Deposit Insurance Directive to increase the minimum amount of compensation to €50,000 by June 2009 and to €100,000 by June 2010 [12]. Many Member States have increased the level of protection already.

1.39. The European Parliament has adopted a report calling for a restructuring of supervision, an enhancement of the legal status of Lamfalussy Level 3 Committees and mandatory supervisory colleges for cross border institutions [13].

1.40. The European Commission has introduced proposals to strengthen the regulation of credit rating agencies [14]. The International Accounting Standards Board has also issued guidance increasing the flexibility of the mark–to–market accounting rules [15].

1.41. The Basel Committee for banking supervision has published proposed revisions to the capital accord (Basel II) which will have the effect of bolstering capital standards and reducing the reliance on credit rating agencies [16].

1.42. On January 15th, the Group of 30 (a group of senior international regulators and financial experts) published recommendations for regulatory reform that summarise current thinking by regulatory authorities [17]. The recommendations cover substantial ground but include:

1.42.1. A greater focus by regulatory authorities on liquidity (bearing in mind that depositors are no longer, in an age of on-line banking, as reliable a source of funding as they once were and transparent liquid markets should not necessarily be discounted as a source of liquidity);

1.42.2. Capital rules that increase the amount of capital held by banks in times of growth and allow that capital to be run down in difficult times in a counter cyclical rather than pro cyclical manner;

1.42.3. Restrictions on and capital requirements for the proprietary trading activity of large systemically important banking institutions;

1.42.4. Consolidated supervision of non bank institutions and the regulation of money market funds that offer bank-like services, systemically important hedge funds and of credit rating agencies;

1.42.5. Enhancements to the national regulatory structures and to international cooperation to eliminate gaps and ensure better information sharing;

1.42.6. Enhanced arrangements for governance and risk management by banks;

1.42.7. Re-evaluation of accounting standards, to deal with illiquid instruments and distressed markets, to remove incentives to take full account of future profits in current accounts and to ensure adequate provision is taken for credit loss over the life of assets regardless of the tax consequences;

1.42.8. More transparency in the credit securities markets and the retention of risk by institutions that originate loans for distribution to investors;

1.42.9. Enhanced resolution regimes for banks that can be allowed to fail.

7. Conclusion

1.43. Proposals for regulatory reform on the lines of those summarised in Section 0 are being considered by international standard setting bodies. However, there was a more fundamental cause of the current financial turmoil that will also need to be considered. It is now widely understood that the developments in the financial markets in the early part of this century created a new kind of systemic risk that was not appreciated by the authorities at the time. Central banks had a focus on financial stability at a macroeconomic level and banking supervisors examined the position of individual banks. However, the effect of a newly developed form of financial intermediation on the financial sector as a whole did not appear to be within the responsibility of any of the authorities. Nor, indeed, were there any appropriate tools to deal with it.

1.44. There will be proposals for changes to the structure of financial institutions to address some of the specific causes of the current crisis. One current debate is whether to restrict systemically important banks to the traditional banking functions of deposit taking, maturity transformation, credit extension and payments – forbidding them from engaging in proprietary trading. Many have argued that such restrictions will not only restrict innovation and efficiency but may also drive some banking activity out of the regulated sector altogether. There are difficult balances to be struck here.

1.45. As a number of senior officials have argued there is a need to ensure that the financial sector infrastructure allocates clear responsibility for assessing the operation of the financial sector as a whole so as to determine future developments that may have systemically important consequences or may be building up systemic risks – better international co-operation on macroprudential regulation [7]. The entity with such responsibility will need to have appropriate tools for dealing with the problem. For, while it is important to learn the lessons of the current crisis and to avoid repeating the same mistakes, the real danger is that the authorities may miss the next development capable of creating a new set of systemic risks, not necessarily the same as those the world economy is suffering from now but equally potent nonetheless.

Appendix A: Member States' Rescue Packages

Descriptions based on announcements since October 2008 by Member States authorities forwarded to Committee of European Banking Supervisors:
http://www.c-ebs.org/News--Communications/News-from-CEBS-members.aspx
Exchange rates valid on 27 January 2009

Excludes increases in deposit protection schemes.
Italy: announced October 10 2008

Facility for subscription by the Government for capital issued by banks incorporated in Italy to be held in the form of preferred shares.

Facility for a state guarantee for new liabilities of Italian banks.

Accompanying measures: requirement for a 3 years stabilisation plan.

Denmark: announced October 5 2008

Special liquidity facility whereby banks can get liquidity at a high interest rate.

Accompanying measures include enhanced supervision.

Sweden: announced October 6 2008

Liquidity facility for banks provided by the Riksbank and the National Debt Office creating total availability of SEK 500 billion (€47 billion) to Swedish banks.

Announced October 20

SEK 1500 billion (€143 billion) guarantee fund for new debt issued by banks based and operating in Sweden.

Facility for acquiring preference shares in banks.

Accompanying measures include restrictions on board and executive pay, bonuses and severance payments, the right of the state to buy out other shareholders.

Spain: announced October 7 2008

€30 billion - €50 billion_ fund to acquire high quality Spanish assets from financial institutions (although the Government announced that it did not consider the acquisition to be necessary at the time of the announcement).

€100 billion guarantee for senior debt issuance by banks.

United Kingdom: announced October 8 2008

Bank of England's Special Liquidity Scheme (announced in April 2008) to be increased by £200 billion (€428 billion) available against extended forms of collateral.

Facility for providing £25 billion (€27 billion) to specified banks to raise tier 1 capital, in the form of preference shares and ordinary shares Banks also committed to raising an additional £25 billion (€27 billion) privately or on the market.
Facility for £250 billion (€268 billion) guarantee of new loans issued by banks to refinance maturing funding obligations as they fall due.

Announced on January 19 2009

New guarantee scheme for new issues of AAA rated asset backed securities.

£50 billion (€53 billion) fund to allow Bank of England to buy a wide range of assets from banks (including corporate bonds, commercial paper, syndicated loans and some asset backed securities)

Asset protection (insurance) scheme for existing assets held by banks. Government provides insurance for losses on specified assets after an initial predetermined level of loss.

Accompanying measures include examination of dividend policies and executive pay. Banks must meet specified capital levels after stress tests but may draw down on capital to cover losses.

The Netherlands: announced October 9 2008

Facility for capital injection to banks. Total amount flexible but initially €20 billion is available.

The central bank (DNB) to lend to individual financial enterprises against adequate collateral

Accompanying measures include examination of executive pay.

Portugal: announced October 12 2008

Up to €20 billion borrowed under state guarantee to be available for the financing of banks.

Accompanying measures include enhanced supervision.

Germany: Measures announced October 13 2008

€80 billion fund for capital injection into banks in the form of shares, preference shares or hybrid instruments – to be allocated at the request of banks (for example, Commerzbank sought capital injection under the scheme on January 8 2009).

€400 billion in loan guarantees to be implemented at the request of banks

€5 - €20 billion for accompanying measures including the purchase of troubled assets from banks

Accompanying measures included salary caps for senior bank officials, restrictions on dividend payments and requirements for lending to SMEs and restriction.

France: announced October 13 2008

€40 billion to be available for capital injection in banks in the form of ordinary shares, preference shares or subordinated debt (for example, Dexia received €1 billion from the capital fund).

€320 billion fund borrowed under state guarantee to be available to lend to banks.

Czech Republic: announced October 14 2008

Liquidity supplied by the Czech National Bank through repo operations.

Austria: announced October 15 2008

Establishment of a clearing house for interbank lending, to be guaranteed by the government. Clearing house itself to issue bonds for lending to banks.

Facility for providing equity capital in all forms for banks as required.

Accompanying measures include restrictions on short selling.

Greece: announced October 15 2008

€15 billion for new medium term loans and notes issued by banks.

€8 billion facility for swapping bank assets for Greek Treasury bills.

€5 billion available for acquiring preference shares in banks – to be applied for on a voluntary basis.

Slovenia: announced October 22 2008

€8 billion for refinancing operations by banks incorporated in Slovenia.

Facility for direct lending to banks, insurance and pension companies.

Facility for capital investment in banks.

Hungary: included in Letter of Intent to IMF November 4 2008

HUF 300 billion (€105 billion) facility for bank recapitalisation designed to bring capital adequacy ratio up to 14%.

HUF 300 billion (€105 billion) guarantee fund for interbank lending

Accompanying measures include strengthened bank supervision.

Ireland: announced December 14 2008

€10 billion for recapitalisation of banks in Ireland in the form of ordinary or preference shares

Accompanying measures include requirements for transparency and commercial conduct.

Appendix B: Extract from Conclusions of the European Council (ECOFIN)

October 7 2008

The Council adopted the following conclusions:

"In the current troubled situation in the financial sector, and building on our Heads of State and Governments' declaration of 6 October, we agree that the priority is to restore confidence and proper functioning of the financial sector.

We have agreed to support systemic financial institutions. We all commit to take all necessary measures to enhance the soundness and stability of our banking system and to protect the deposits of individual savers. EU authorities and Member States will remain in daily contact through the EFC in order to share information and ensure a comprehensive and coordinated response to the current situation and our continued effort to work on our common principles, ahead of the European Council.

We welcome the actions taken by the ECB and the national central banks since the beginning of the turmoil. The liquidity of the financial system shall be ensured by all authorities in order to preserve confidence and stability.

We reaffirm our call on financial institutions in Europe to achieve full transparency and we will closely monitor the progress achieved in this regard.

We agree to coordinate closely in our actions and to take into consideration potential cross-border effects of national decisions. We agree that public intervention has to be decided at national level in a coordinated framework.

To protect the depositors' interests and the stability of the system, we stress the appropriateness of an approach including, among other means, recapitalisation of vulnerable systemically relevant financial institutions. We are prepared to act accordingly in this context.

We agree on EU common principles so as to guide our action:

– interventions should be timely and the support should in principle be temporary;

– we will be watchful regarding the interests of taxpayers;

– existing shareholders should bear the due consequences of the intervention;

– the government 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 aids rules;

– negative spillover effects should be avoided.

We will ensure rapid cooperation within the EU, with reference to the Memorandum of Understanding, in particular as regards cross-border financial institutions.

We underline the necessity of avoiding any distortion of treatment between US and European banks due to differences in accounting rules. We take note of the flexibility in the application of mark to market valuation under IFRS as outlined in recent guidance from the IASB. Ecofin strongly recommends that supervisors and auditors in the EU apply this new guidance immediately. We also consider that the issue of asset reclassification must be resolved quickly.

To this end, we urge the IASB and the FASB to work together on this issue and welcome the readiness of the Commission to bring forward appropriate measures as soon as possible. We expect this issue to be solved by the end of the month, with the objective to implement as of the third quarter, in accordance with the relevant procedures.

We welcome the Commission's continued commitment to act quickly and apply flexibility in state aid decisions, within the framework of the single market and state aid regime. The Council welcomes the Commission's commitment to shortly issue guidance setting out 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.

The application of the Stability and Growth Pact should also reflect the current exceptional circumstances, in accordance with the provisions of the Pact.

Several Member States have recently increased the level of coverage of national deposit guarantee schemes. We agreed that all Member States would, for an initial period of at least one year, provide deposit guarantee protection for individuals for an amount of at least EUR 50 000, acknowledging that many Member States determine to raise their minimum to EUR 100 000. We welcome the intention of the Commission to bring forward urgently an appropriate proposal to promote convergence of deposit guarantee schemes.

This short term strategy is fully consistent with the framework established by the Ecofin since October 2007, which aims at fostering transparency and responsibility within the financial sector, in coordination with our partners, notably within the FSF."

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Assessment of the Banking Rescue Packages of the Member States: The Case of the United Kingdom[46]

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

- There is wide agreement that a good bank rescue package should do three things. First, impaired assets should be written down on or taken off banks' balance sheets. Second, banks that are insolvent and too big to fail should be recapitalised. Third, adequate liquidity should be provided.
- The United Kingdom was in a relatively poor position at the start of the financial crisis, compared to the euro area and the United States. It had a deposit insurance system and a central bank collateral policy that invited runs by bank depositors and wholesale creditors.
- The United Kingdom's first attempt at rescuing a bank was flawed: it encouraged a bank run, the bank was of no systemic importance, it gave the appearance that the government was pandering.
- The United Kingdom's current scheme is intended to recapitalise banks and to provide liquidity. But, unlike schemes elsewhere it does not remove toxic assets from banks' balance sheets.
- The United Kingom's bank rescue policy has an element of financial protectionism.

Lax regulation, poor corporate governance and a compensation system that favours excessive risk taking led many EU member financial institutions (hereafter, "banks") to be excessively leveraged. At the start of 2008, the leverage ratio (Tier 1 capital as proportion of assets) was about three percent in the United Kingdom and slightly lower in the rest of Europe. This meant that for a typical European bank, only a small decline in the average value of its assets or a sharp decline in the value of just a small fraction of its assets was enough to wipe out its equity and make it insolvent. With great uncertainty about both the value of banks' impaired assets and the importance of these assets in different banks' balance sheets it became unclear which banks were on the verge of insolvency and all banks became distrusted as counterparties. The market for interbank lending became dysfunctional and banks that have liquidity are now hoarding it. When banks are unable or unwilling to make loans to businesses and households, the consequence is recession and unemployment.

[46] Briefing paper for the Committee on Economic and Monetary Affair's annual meeting with national parliaments.

There is widespread agreement about the general features of an appropriate policy response to this or any other banking crisis. First, impaired assets must be written down or written off banks' balance sheets and banks must be classified as solvent, insolvent and systemically unimportant or insolvent and systemically important. Second, banks that are insolvent and systemically unimportant should be allowed to fail and banks that are insolvent and too systemically important to be allowed to fail should be recapitalised. Third, central banks should ensure that the interbank market remains functional so that banks that are solvent and those that have been recapitalised have access to liquidity.

In this note I describe the United Kingdom's plan to rescue its troubled banks and loan markets. I assess the merits of the plan and compare it to plans implemented elsewhere.

1. The Initial Reaction to the Crisis

Both the liquidity crisis that began in August 2007 and the credit crisis that began with the failure of Lehman Brothers in September 2008 caught policy makers, as well as researchers and market participants, by surprise. Thus, policy makers in the United Kingdom and elsewhere initially reacted to events in an ad hoc fashion.

In some important respects, policy makers in the United Kingdom were less prepared than policy makers elsewhere for a crisis. In the United States, the Federal Deposit Insurance Corporation guarantees that all depositors in insured banks are fully covered up to $100,000 and that payouts are made within days. In August 2007 the United Kingdom's deposit insurance scheme covered up to £35,000 but required a ten percent deductable after the first £2,000 and payouts could be delayed for over six months. Such a large deductable and length of time before a payment would be made was an invitation to a bank run. In addition, while the ECB accepted a range of public and private securities rated at least A- in its lending and repurchase operations, the Bank of England accepted only the highest grade collateral, effectively only UK sovereign debt or better. This made the Bank of England an inadequate lender of last resort and did little to forestall wholesale creditor runs. The tripartite arrangement, wherein the Bank of England, the Financial Services Authority and the Treasury shared responsibility for the financial system had probably hampered reform; it may have later hindered the ability of the authorities to respond effectively to a crisis.

The first serious test of the crisis for UK policy makers arose in late summer 2007. On 12 September, the UK's fifth largest mortgage lender, Northern Rock, was unable to refinance its maturing loans.[47] If Northern Rock had been located in the euro area, it could have borrowed from the ECB using its good quality mortgages as collateral. But, as it was located in the United Kingdom it was forced to ask for a government bailout. On 14 September, insisting that Northern Rock was solvent, the Chancellor authorised the Bank of England (as its agent) to make a loan to Northern Rock against appropriate collateral and at a penalty rate; the Bank of England announced that similar emergency funding would also be available to other institutions in similar circumstances. Their attention clearly focused by this usual action, Northern Rock depositors fled en masse on 17 September. Undoubtedly shaken by the widely televised spectacle of a 1930s-style bank run, on 17 September the government announced that *all* deposits held at Northern Rock would be guaranteed by the government. The government's initial pronouncement of Northern Rock's health later proved sanguine; on 17 February 2008 the government nationalised the bank.

The government's first attempt at a bank rescue was flawed. Lending to a solvent but illiquid institution at a penalty rate is widely accepted good practice. However, the government's initial support of Northern Rock appeared to go beyond short-term liquidity provision and – as it turned out – Northern Rock was more than merely illiquid. Once this became obvious, Northern Rock should have been allowed to fail; as the institution was of no systemic importance there was no justification for recapitalising it.[48] In addition, while *ex ante* deposit insurance promotes efficiency by preventing depositor runs, providing it *ex post* merely redistributes money from tax payers to depositors who chose to hold large sums in uninsured accounts and looks suspiciously like politically motivated pandering.

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[47] Some might think the Finanical Services Authority indolent or ingenuous for standing by while Northern Rock introduced its "Together" mortgage range, which let first-time buyers borrow nearly six times their income and 125 percent of a property's value.

[48] This was not a one-off error due to haste: on 29 September 2008 the government sold part of the even smaller Bradford & Bingley to Santander and nationalised the rest.

While flawed, the rescue was swift and audacious. Financial crises can be or can contain elements that are bad outcomes associated with self-fulfilling expectations. To quell the fear in financial markets and restore confidence quickly and move away from these bad outcomes, it is often beneficial for a government to act boldly and decisively to signal its commitment. Thus, for the United States it was probably better that the imperfect Emergency Economic Stabilization Act of 2008 was passed with great celerity and bipartisan support than that a more perfect act had been passed after much dithering.[49] Unfortunately, in the case of Northern Rock, the drama of a special loan for the troubled institution had the unfortunate effect of focusing market attention on the likelihood that the bank might fail thus provoking, rather than preventing, a bad outcome based on self-fulfilling expections.

2. Later measures to rescue the banks and restore lending

The more recent UK bank rescue policies fall into two categories: those designed to recapitalise banks and those designed to restore bank lending. I examine both of these types of measures.

2.1 *The United Kingdom's Bank Recapitalisation Scheme*

On 8 October 2008 – five days after the US bank rescue plan was signed into law by President Bush -- the UK government announced its own plan for recapitalising its banks. Under the plan, Abbey, Barclays, HBOS, HSBC, Lloyds TSB, Nationwide, the Royal Bank of Scotland and Standard Chartered agreed that – in aggregate – they would increase their Tier 1 capital by £25 billion, giving each a Tier 1 capital ratio in excess of nine percent.[50] The banks could raise needed capital in the market or the government would make £25 billion available to this group of banks in return for preference shares or permanent interest bearing shares. In addition, the government made an additional £25 billion available to other UK incorporated banks or building societies which do substantial business in the United Kingdom. Participation in the recapitalisation scheme allows banks to participate in the government's liquidity schemes – detailed in the next subsection. Receiving government funding requires concessions from the banks on executive compensation, dividend policies and lending to small businesses and home buyers. The government also has the right to agree with boards on the appointment of new independent non-executive directors. On 3 November a special body, UK Financial Investments Ltd, was set up to manage at arm's length the government's stake in banks which accepted funds.

Terms for the recapitalisation were negotiable between banks and the government. The offer was taken up by HBOS, Lloyds TSB and RBS. In the case of Lloyds TSB and HBOS, it was planned that the government would own around 44 per cent of the proposed merged bank; in the case of RBS the government took a 57 percent share (which has since increased to over 70 percent). No cash bonuses were to be paid to any board member in 2008. Directors in HBOS were asked to relinquish their bonuses and directors in Lloyds TSB were to receive restricted stock instead of cash. Bonuses to RBS board members in 2009 were to be in stock and linked to long-term growth. The availability of lending to homeowners and small businesses was to be maintained at least 2007 levels, and greater support was to be given to people with difficulties making mortgage payments.

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[49] The act was initially rejected on 29 September; an amended version was signed by President Bush on 3 October.

[50] There is a tradeoff: increased Tier 1 ratios lower risk but can lead to curtailed lending. Nine percent does not seem unreasonable.

The government's recapitalisation scheme suffers from two main problems. The most severe is that it does not do the first thing that any good bank rescue package should do: write down or write off the toxic assets. From this point of view, the Swiss approach to UBS is more appealing. In November, UBS had an estimated $60 billion in bad assets. The Swiss government split UBS into a relatively healthy bank and a "bad" bank, unloading $60 billion of bad assets onto the bad bank. The bad bank had to raise $60 billion to pay for the impaired assets. To do this, UBS raised new capital of $6 billion by selling shares to the Swiss government and it invested these shares in the "bad" bank. The Swiss government then loaned the bad bank $54 billion. From the point of UBS, they have invested $6 billion that they are likely to lose, their shareholders were diluted by nine percent and they have gotten rid of $60 billion in toxic assets. From the point of view of Swiss tax payers, they have made a not-very-promising investment of $54 billion, they own a small part of UBS and UBS is now known to be a healthier bank – stripped of $60 billion its bad assets. Other banks should be more willing to lend to it and it can get back in the business of lending to households and firms.[51] This contrasts with the UK banks that have increased capital, but still hold their toxic assets, and may not be viewed as uniformly healthy banks. [52]

A second problem with the UK's bank recapitalisation plan is the concessions banks must make. Banks may be discouraged from participating because of the conditions on salaries. If a board member knows that it is in the interest of shareholders for his bank to join, but that he will lose his otherwise hefty bonus by agreeing, he may act in his own self interest by voting against participation. In addition, it has been argued that the government ought to want the best managers possible for troubled banks. Thus, it must take care to pay them a competitive compensation. Finally, market efficiency dictates that economic considerations should determine who gets loans. Especially in difficult times, the government should not introduce further distortions by meddling in the lending decisions of banks. If the government wants to redistribute money from taxpayers, many of whom do not own homes, to homeowners who struggle to pay their mortgages, it is better to just do so than to order banks to allocate their lending inefficiently.

2.2 The United Kingdom's plans to get banks lending again

If a bank anticipates that is will be unable to borrow in the interbank market then it is likely to hoard the liquidity that it has, rather than make loans to households and firms. To restore bank lending the government has three options. First, it can ensure that toxic assets are removed from banks' balance sheets so that banks again trust each other as counterparties. Second, it can lend directly to banks and, third, it can insure counterparty risk so that banks become willing to lend to each other. As the UK government has not pursued the first policy, it is actively pursuing the second and third.[53] The government has attempted to ensure adequate provision of liquidity by acting directly as the counterparty of banks and by encouraging banks to trade with each other by guaranteeing bank debt. In addition to making it easier for banks to borrow, the United Kingdom has instituted a scheme that makes it easier to lend to its customers by guaranteeing certain asset-backed securities.

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[51] The problem with the "bad" bank solution is determining which assets are bad. Willem Buiter suggests an alternative: the government should create a "good" bank out of the (clearly) good assets and the deposits of the impaired bank. (Maverecon blog, *Financial Times*, 29 Jan 2009.)

[52] The description of the rescue draws on Simon Johnson and James Kwak, "Bad Banks for Beginners," *Baseline Scenario*, 21 Jan 2009.

[53] This is politically easier: it does not involve up-front expenditure.

2.2.1 *The government's schemes to act as counterparty*

On 21 Apr 2008 the Treasury and the Bank of England announced a temporary Special Liquidity Scheme that was to last for only six months. Under the scheme, banks could swap high-quality, but illiquid assets for Treasury bills. Each swap could last for a year and be renewed for up to three years. The Bank was to charge a fee based on three-month Libor and the value of the assets was to be significantly greater than the value of the Treasury bills received. If the assets were down rated, the banks would have to replace them with high-rated assets or return some of the Treasury bills. The scheme did not cover securities backed by loans originated after the end of 2007 and was backed by the Treasury. On 6 October it was announced that the government had made over £100 billion available for the scheme. A wide range of securities would be accepted and the scheme would continue until November. On 8 October it was announced that the Treasury would make at least £200 billion available.

On 19 January it was announced that the Special Liquidity Scheme would cease as planned at the end of the month. It would be replaced by new Discount Window Facility, allowing borrowing for a year instead of a month for an extra fee of 25 basis points.

In addition, the government announced a qualitative easing policy, under which the government will exchange the government securities that it holds for high-quality private sector assets such as corporate bonds, commercial paper and even some asset-backed securities. The Bank of England (on its own account or on the account of the Treasury) will sell Treasury bills for money. The operation will then be sterilised (so that the monetary base is unchanged) by using the proceeds of the sale to purchase private sector assets.

2.2.2 *The government's scheme to act as guarantor of bank debt*

On 8 Oct 2008 the government announced a measure that it hopes will reduce the counterparty risk associated with longer term lending to banks. Under this measure, a borrowing bank pays a premium and the government guarantees its issuance of new debt. The fee any bank pays is related to the market's perception of its riskiness: the premium is a per annum fee of 50 basis points plus the bank's median five year Credit Default Swap spread during the previous year. This scheme is open to institutions participating in the bank's recapitalisation scheme, described in the last section. Thus, it is open to incorporated UK deposit takers or building societies, including subsidiaries of foreign banks, that do substantial business in the UK and which have sufficient Tier 1 capital relative to their assets. The government announced that it provisionally anticipated providing an amount equal to £250 billion. Given that the toxic assets remain on the banks' books, this is an appealing policy.

2.2.3 *The government's scheme to make lending to customers easier*

If a bank makes a loan to a customer it exchanges its own liquidity for a long-term asset. The bank can undo some of this change in its asset-maturity structure if it can securitize its loans. Unfortunately for banks, asset-backed securities are not especially popular at the moment, limiting banks' ability to do this. Thus, on 19 January 2009 the government announced that, beginning in April, it would provide full or partial guarantees to be attached to eligible AAA-rated asset-backed securities, including mortgages and corporate and consumer debt. Participants would be subject to following best practices and the securities would have to be transparent and backed by high-quality assets.

It is not obvious that this is an unambiguously great idea; it should be recalled that securitization by US banks was a major cause of the financial crisis. The point of banks is to act as an intermediary between borrowers and savers by collecting information about and monitoring the behaviour of borrowers. If banks are going to securitize their loans, this reduces or even eliminates the incentives of banks to act information gatherers and to make loans only to good quality borrowers. Administrators of the scheme need to ensure that the securities are not mixed, bundled and repackaged, but instead associated with a single primary lender so that lender has an incentive to maintain a reputation for selling good quality securities. In addition, it would be a good idea to further strengthen the banks' incentives to screen borrowers by requiring the banks to hold on to some or all of the worst quality or equity tranche of any security.

2.3 *The United Kingdom's plan and the rest of the world*

It is a widely held view that beggar-thy-neighbour policies such as tariff wars contributed the Great Depression of the 1930s. Thus, in evaluating the actions taken by policy makers it is important to ask not only what the effect is on the domestic banking system, but what the effect is on the rest of the world. In this area, the UK government does not score high marks.

Asking taxpayers to contribute vast amounts of money to the banks that caused the crisis is not a naturally popular idea; hence, as a sop to the voters, it is tempting for governments to attach populist conditionality to funding. Under the UK bank recapitalisation programme, for example, banks are supposed to maintain lending to homeowners and to small businesses and to provide support for "people struggling with mortgage payments to stay in their homes". Presumably, the government is talking about domestic homeowners and businesses. Thus, the government is asking banks to curtail cross-border lending: a beggar-thy-neighbour policy. The United Kingdom is not alone in pursuing financial protectionism, suggesting the need for more global regulatory coordination.

Any assessment of the response of the British government to the banking crisis should include something about the United Kingdom's treatment of Iceland. In late September, Glitnir – one of Iceland's three large banks – had a sizable amount of debt set to mature in mid October. Glitnir was unable to raise the money to pay the debt and the Icelandic authorities lacked the foreign exchange to make Glitnir a sizable enough loan. On 29 September it was announced that Glitnir would be nationalised. On 3 October British depositors staged a run on their Icesave accounts in a second Icelandic bank: Landsbanki. Landsbanki was placed in receivership on 7 October and, nationalisation plans abandoned, Glitnir followed on 8 October. This left one large Icelandic bank standing: Kaupthing. It is probable, but by no means certain, that Kaupthing would have failed. It had not experienced a run and the Icelandic government was working on refinancing plans. After a discussion with the Icelandic authorities who supposedly said that they would fully guarantee deposits in Iceland and would attempt to pay the minimum required deposit insurance to holders of accounts outside Iceland, the British authorities used their anti-terrorism laws to freeze the UK assets of Landsbanki. In addition, they seized the assets of Kaupthing's UK subsidiary and transferred them to the Dutch bank, ING. This ensured the collapse of Kaupthing on 9 October: a devastating blow for Iceland.

Bank rescues in the UK, Ireland and Finland

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Jane Welch

Executive Summary

1. The main measures used to rescue failing banks are :

- Liquidity assistance , either in the form of general measures or emergency liquidity assistance to an individual institution
- Enhanced guarantee schemes for deposits and guarantees for bank debt instruments
- Recapitalisation schemes
- The acquisition of banks' toxic assets by the State.

2. All forms of state support have to compatible with the EU rules on state aid, which are monitored and enforced by the European Commission. The Commission has adjusted its policy to deal with the unprecedented financial crisis and published guidance to Member States on how best to support banks , while avoid excessive distortions of competition.

3. The UK has provided liquidity support, coupled with injections of capital into many of the major banks. Two banks have been nationalised. It has also extended the guarantee on bank deposits and is now working on the introduction of an asset protection scheme .

4. Ireland has provided guarantees on deposits and debt to eligible banks active on the Irish market. It has now nationalised one of the major Irish banks.

5. Finland has also provided a guarantee to eligible institutions , covering the issue of new short and medium term subordinated debt. The collapse of the Icelandic Bank Kaupthing resulted in a Finnish state guarantee for the banks who offered to compensate depositors in full.

Bank rescues

This paper is divided into three sections:

- Section 1 outlines the various measures used by Member States to support and rescue ailing banks
- Section 2 covers the EU rules on state aid , against which the rescue measures must be assessed
- Section 3 describes the specific rescue measures taken to date by the UK, Ireland and Finland.

1. State Rescue Measures

1.1 Deposit guarantees Faced with a run on deposits , Member States may decide to extend the guarantee provided on retail deposits to cover 100% of retail deposits with no monetary limit. At present the EU Deposit Guarantee Directive requires compensation of retail depositors up to 20,000 euro per depositor. There are proposals to amend the directive to raise the compensation available, initially to 50,000 euro and subsequently to 100,000 euro. Apart from the minimum requirements of the Directive , Member States may wish in some cases to guarantee wholesale deposits as well.

1.2 Guarantee of bank debt instruments The paralysis in the inter-bank lending market may lead Member States to consider the guaranteeing of short and medium term debt instruments.

1.3 Recapitalisation Recapitalisation schemes have been adopted in several Member States , as well as individual recapitalisation measures . Injections of capital may be made to strengthen the capital base of the bank or to facilitate injections of private capital. The state may end up with a minority, majority or total ownership of the shares of the bank.

1.4 Assisted bank mergers Sale of a failing bank or part of the bank to another bank may require an element of state funding to the buyer or seller .

1.5 Controlled winding up of banks Where it appears that restructuring of an individual institution is impossible , a Member State may decide to carry out a controlled winding – up of the institution, in conjunction with a state injection of funds.

1.6 Liquidity assistance Member States have sought to deal with the acute liquidity crisis by providing liquidity assistance , either in the form of general support to all market participants or in the form of dedicated support to an individual institution.

1.7 Acquisition of "toxic assets" Following the successful precedent set by Sweden in the early 1990s , Member States may consider the acquisition of all toxic assets from banks . There are two main options: either the creation of a "bad bank" or other agency to buy up toxic securities from the banks – or the provision of insurance by the State for toxic assets. Under the latter option, the Government could, for a fee, insure the value of a bank's toxic assets, making up the difference if they fall below an agreed floor price. The advantage of this model is that it does not involve the huge up-front costs of the "bad bank" model.

2. EU State aid rules

2.1 Commission Banking Communication

Following the ECOFIN Council meeting on 7 October, 2008, the Commission set out its views on the application of the EU state aid rules to the various support measures introduced by Member States as a result of the global financial crisis in its **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 .**[54] Although the Communication is based on the principles underpinning the existing Rescue and Restructuring Guidelines of 2004(R&R guidelines),[55] it was clear that Member States were now facing an unprecedented financial crisis, which threatened not only the overall functioning of their financial markets, but their entire economy. For the first time the Commission is prepared to use Art.87.3.b of the EU Treaty which allows state aid "to remedy a serious disturbance in the economy of a Member State". This provision had not been made available in the case of Credit Lyonnais in the 1990s, nor more recently in the bail out of Northern Rock in the UK.

2.2 Art 87.3.b.In the Commission's view Art 87.3.b can apply to aid granted by way of a general scheme available to several or all financial institutions in a particular MS and to ad hoc interventions. While aid should follow the general principles laid down in the R&R guidelines ,the current crisis may allow for exceptional measures going beyond 6 months or structural emergency interventions. The aid can only be maintained while justified by the crisis, necessitating a review every six months by the Member State followed up by a report to the Commission. The Communication distinguishes between fundamentally sound but illiquid banks and unsound institutions – the former needing more limited restructuring , while the latter would fit within the normal framework of rescue aid , needing more fundamental restructuring , as well as compensatory measures to limit distortions of competition.

2.3Guarantees The Communication stresses that the eligibility criteria for a guarantee scheme must be objective and non-discriminatory – so should cover all locally incorporated institutions, including subsidiaries of foreign institutions with significant activities in that MS. General guarantees protecting all retail deposits are likely to be legitimate. Guarantees going beyond this must be targeted at the particular problem, eg paralysis in the inter-bank lending market might justify guaranteeing some types of wholesale deposits, but not subordinated debt (tier 2 capital) or all liabilities. Again a regular 6 month review is required and the Member State in question must take appropriate steps to ensure a significant contribution from the beneficiary and/or the sector in question. It is important to minimise distortions of competition. Restrictions should be imposed on advertising , expansion , size of balance sheet, while maintaining availability of credit. There should be no new stock options for management. Member States must have sufficient powers to monitor the situation and , if necessary, to withdraw the guarantee.

2.4 Restructuring follow-up. Guarantee schemes are not sufficient in themselves and must be accompanied by restructuring or liquidation of beneficiary institutions.

2.5Application of guarantee scheme to individual institutions **.** Aid to institutions that are not fundamentally sound is likely to raise greater concerns.

[54] OJ C270,25.10.2008,p.8.
[55] OJ C 244,1.10.2004, p.2.

The Commission sees it as essential that , as soon as the financial position improves , steps are taken to restructure or liquidate the beneficiary. The notification of a restructuring or liquidation plan is required for recipients of payments under the guarantee, which will be separately assessed for compatibility with the state aid rules.

2.6 ***Recapitalisation***. Where an injection of public funds is necessary, the same principles apply under the state aid rules - the eligibility criteria should be objective , non-discriminatory, temporary and proportionate. Recapitalisation should be provided on basis that the Member State receives rights , the value of which corresponds to their contribution to the recapitalisation . So preference shares with adequate remuneration “will be regarded positively”.

2.7 Liquidity support General liquidity assistance to all comparable market players will probably be outside state aid rules. According to the Northern Rock decision,[56] emergency liquidity assistance (ELA) to a specific bank is not state aid if certain conditions are met:

- The institution is solvent at the time of liquidity provision
- The facility is fully secured by collateral to which haircuts are applied
- A penal interest rate is charged by the Central Bank
- The measure is taken at the initiative of the Central Bank and is not backed by any counter-guarantee of the State.

The ELA could extend beyond 6 months to 2 years , and provided that there is a regular review every 6 months of such a liquidity scheme , approval of the scheme could extend beyond two years, if justified by the continuing financial crisis.

2.8 Controlled winding up. If involves sale of assets to other banks , sales process should be open and non-discriminatory , sale should take place on market terms , and if aid granted to purchaser or seller will lead to scrutiny under R&R guidelines.

2.9 Commission procedures and Governing Principles Support schemes can be cleared rapidly by the Commission if they comply with certain specified conditions aimed at ensuring the measures are well-targeted, proportionate and contain safeguards against unduly negative effects on competition. The conditions largely endorse the following conclusions of the ECOFIN Council on 7 October 2008 :

- Interventions should be timely and the support should in principle be temporary
- Member States should have regard to the interests of taxpayers
- Existing shareholders should bear the due consequences of the intervention
- Member States should be able to bring about a change of management
- The management should not retain undue benefits – governments should be able to intervene in remuneration
- The legitimate interests of competitors must be protected, in particular through the state aid rules and
- Negative spill-over effects should be avoided.

[56] OJ C 43, 16.2.2008,p.1.

3. National rescue measures

3.1.United Kingdom

3.1.1 Northern Rock Rescue . State aid rules do not apply to Central Banks' emergency liquidity assistance (ELA) to an illiquid financial institution . Thus the ELA provided by the Bank of England on 14 September 2007 to **Northern Rock**, which was secured by high quality collateral and was interest-bearing(at a penal interest rate) , did not constitute state aid. But the guarantee on deposits granted by the Treasury on 17 September 2007, as well as the additional measures on 9 October 2007 , did constitute state aid. These aid measures were cleared by the Commission on 5 December 2007 [57]as rescue aid in line with the **Commission's guidelines on state aid for rescuing and restructuring firms in difficulty.** Under these rules , rescue aid must be given in the form of loans or guarantees lasting no longer than six months, although there are certain exceptions to these rules in the banking sector to cater for prudential requirements. Further rescue measures were authorised by the Commission on 2 April 2008.

3.1.2 Northern Rock restructuring The UK Government subsequently delivered a restructuring plan for Northern Rock on 17 March 2008 , dealing with the medium and long term. This converted the temporary rescue assistance into restructuring assistance , which is currently under investigation by the Commission. During the investigation, and pending a decision from the Commission, the rescue package can continue.

The plan submitted by the UK Government in March 2008 provides for a reduction in Northern Rock's lending operations and in the size of its balance sheet. Over the period of the restructuring , the bank would repay the loans made by the Bank of the England , while the UK Government guarantees on its funding operations in the deposit and wholesale funding markets would gradually be phased out. The bank would need to build up its retail deposit funding base and reduce severely its reliance on wholesale funding.

3.1.3 Bradford &Bingley B&B was a specialised UK bank providing mortgages and savings products. Its market share of net new mortgage lending at the end of 2007 was 7.7%. At that time it had a balance sheet total of approximately 65.7 billion euro. By September 2008, the bank was experiencing acute liquidity problems. It was downgraded by the credit rating agencies , which in turn made it more difficult for the bank to refinance. On 27 September 2008, the UK Financial Services Authority decided to withdraw its banking authorisation because it was no longer able to meet the statutory conditions . The Government decided to nationalise the bank. Its retail deposit book , along with a matching cash amount provided by the UK deposit insurance fund- the Financial Services Compensation Scheme and HM Treasury, was sold to Abbey National after a competitive bidding process. The remainder of the bank is in liquidation , with the Treasury providing working capital and a guarantee. These measures were formally notified to the Commission on 30 September 2008 and the Commission concluded within 24 hours that the state aid provided (i.e., the state funding to enable the sale of the deposit book and the working capital facility and the guarantee arrangements) complied with EU rules on rescue aid.[58] The UK is committed to submitting a restructuring plan for B&B by 29 March 2009.

3.1.4 Introduction of further support measures for Banking Industry.A further package of intervention measures was announced by the UK in October 2008 and notified to the Commission on 11 October. The package consisted of :

[57] IP/07/1859.
[58] IP/08/1437.

- A **recapitalisation** scheme, making available new capital to banks and building societies in exchange for preference or ordinary shares, to strengthen their balance sheets against possible losses

- A **guarantee** scheme covering the new issuance of short and medium term debt , in return for market –oriented remuneration, to support fundamentally sound banks which are unable to access funding; and

- An extension of the **short-term liquidity assistance** provided by the Bank of England.

3.1.5 The Commission decided that the package was an appropriate way to restore confidence in the creditworthiness of UK financial institutions and to stimulate bank lending.[59] The package is limited in time and scope – it is open to all financial institutions with substantial business in the UK. It caps the future lending activity of participating institutions with regard to their past balance sheets in order to avoid abusive expansion. At company level, it limits managers' remuneration and requires the beneficiaries to respect good governance practices. The UK is committed to reporting to the Commission every six months on the operation of the scheme. Companies which intend to maintain the state's shareholding beyond a certain timeframe have to submit a restructuring plan to the Commission. So far the only banks fully nationalised are Northern Rock (where the restructuring package has been under investigation since April 2008) and Bradford & Bingley . The Government currently owns 70% of the Royal Bank of Scotland and 43% of Lloyds HBOS. Lloyds currently pays £480 million annual interest (a rate of 12%) to the Government on £4 billion preference shares .

3.1.6 Modifications to this scheme notified by the UK on 18 December were approved by the Commission on 23 December 2008.[60] The amendments were designed to bring the package into line with the **Commission Communication on recapitalisation** [61] and to bring it into line with schemes in other Member States.

3.1.7 The Commission has accepted that fundamentally sound banks do not need to submit a restructuring plan, but may instead provide a report indicating how they intend to repay the state capital. Moreover, the imposition of a balance sheet growth limitation in line with certain thresholds in the Guarantee and Recapitalisation Scheme will no longer apply to those banks that can be considered as fundamentally sound.

3.1.8 Other amendments mean that the state guarantee is extended to debt instruments issued in Japanese yen, Australian dollars, Canadian dollars and Swiss francs (previously only instruments denominated in sterling, US dollars or euros were eligible)

3.1.9 Although the initial term of the guaranteed instruments will remain no longer than three years , participating institutions will now be able to roll over the guarantee on some individual instruments for an additional two years , ending in April 2014. The proportion of guaranteed liabilities that can be roiled over shall not exceed one third of the guaranteed liabilities.

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[59] IP/08/1496.
[60] IP/08/2057.
[61] IP/08/1901.