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"Bail-ins" in recent banking resolution and State aid cases

This briefing provides a list of recent banking resolution cases involving the use of State aid or other public interventions, and gives an overview the various legal issues linked to State aid rules and the BRRD.

Since 1 January 2016 it is mandatory under the Bank Recovery and Resolution Directive (BRRD) to bail-in shareholders and creditors for a minimum amount of 8% of total liabilities before any funds may be injected into a bank under resolution. The resolution of several weak banks was therefore triggered before the deadline of 31 December 2015. However, since 2013 EU State aid rules have imposed (the "2013 Banking Communication") that subordinated creditors contribute to the maximum extent (bail-in) to the restructuring of State-aided institutions. **All the resolution cases presented below and approved by the European Commission have complied with the State-aid requirement to bail-in subordinated creditors.** The list of cases presented in the first section includes all individual resolution cases involving the use of State aid in 2015 (see the Commission's overview of decisions and on-going in-depth investigations), as well as other examples of cases involving public intervention in Germany, Italy, Hungary and Denmark. The second section explores various legal issues related to the State aid framework or the implementation of the BRRD.

Section 1: Recent resolution cases and other restructuring measures

A. Recent resolution cases

Cyprus: Cooperative Central Bank

Cyprus' newly created resolution fund injected EUR 175 million in the Cypriot cooperative banks, after the equity, held at 99% by the Cypriot State, had been fully bailed-in (the Cypriot cooperative banks had no outstanding subordinated debt).

Denmark: Andelskassen JAK Slagelse

On 5 October 2015 Andelskassen JAK Slagelse was resolved and transferred to a bridge institution with all members fully bailed-in. Subordinated creditors as well as ordinary unsecured creditors were preliminarily written down to zero, while covered depositors remained fully protected by the Danish Guarantee Scheme for Depositors and Investors (*Garantiformuen*). On 21 January 2016 the Danish resolution authority launched the sale process for the remaining activities of the bank.

Greece: Panellinia Bank, Cooperative Bank of Peloponnese

On 17 April 2015 the Bank of Greece resolved Panellinia Bank by transferring selected assets and liabilities to Piraeus Bank, through a tender process. The equity (mostly held by Greek cooperative banks) and preference shares (held by the Hellenic Republic) remained in the entity in liquidation and were bailed-in. Panellinia Bank had no outstanding subordinated debt at that time.

On 18 December 2015 the Bank of Greece put the Cooperative Bank of Peloponnese in resolution, since it was not able to remedy its capital shortfall. The transfer of deposits to National Bank of Greece (following a tender process) was financed by the Greek resolution fund. All the assets and remaining liabilities, as well as shareholders, have been put into **liquidation** and therefore bailed-in.

Hungary:MKB

The Hungarian resolution fund financed the transfer of a portfolio of impaired assets to a special purpose vehicle in exchange for shares, while the Hungarian State, shareholder of MKB, was fully bailed-in (the bank had no outstanding subordinated debt).

Italy: Banca Marche, Banca Etruria, Carif, Carichieti, Banca Tercas

All the assets and liabilities (excluding equity and subordinated debts) of the four small Italian banks (aggregate total assets of EUR 47 billion) were transferred to four temporary bridge banks in November 2015. The Italian resolution fund, fully financed by contributions from the Italian banking sector, injected EUR 3.6 billion, in order (i) to absorb losses in the four banks (EUR 1.7 billion), (ii) to recapitalize the bad bank (EUR 0.1 billion) and (iii) to recapitalize the four bridge institutions (EUR 1.8 billion). The Italian resolution fund had to borrow funds from three Italian banks for that purpose, since the needed funds were not yet available in the resolution fund. Shareholders and subordinated bondholders were fully bailed-in, which turned highly controversial in Italy since many retail investors had subscribed subordinated instruments believing they were purchasing safe assets.

In addition, on 23 December 2015 the European Commission found Italy had provided **incompatible** State aid (hence to be recovered) for the resolution of Banca Tercas. One main objection was the absence of bail-in of subordinated debtholders. Italy had argued that the aid measure did not constitute State aid since it was granted by the Italian deposit guarantee scheme (see section 2.A).

Portugal: BANIF, Novo Banco

On 19 December 2015 BANIF was put into resolution which involved additional aid measures of up to EUR 3 billion, mostly to absorb past losses. The main business was sold to Banco Santander Totta, while equity (Portugal owns 60.5% of the bank) and subordinated debt were bailed in.

On 29 December 2015 the Bank of Portugal decided to retroactively modify the resolution actions related to the resolution of Banco Espirito Santo (BES). BES' good assets and senior/preferred creditors had been transferred to a new institution (Novo Banco), while the equity, subordinated debts and non-performing loans had been left in a bad bank (bail-in). Following the comprehensive assessment carried out in 2015 by the ECB (capital shortfalls of EUR 1.4 billion), and because Novo Banco was unable to attract investors, **the Bank of Portugal decided to transfer back to the bad bank 5 senior bonds (out of 52 senior bonds)** for a total amount of EUR 1.9 billion. Article 40.7 of the BRRD provides for such transfers under specific circumstances, in particular if the initial resolution scheme must explicitly provide for such transfers (see section 2.B).

Bank of Portugal claims the transfer is both legal and necessary to ensure that BES' losses are not absorbed by taxpayers nor the resolution fund. The transfer of the 5 bonds had a positive impact of about EUR 2.0 billion on the capital position of Novo Banco, enabling the latter to address its capital shortfall unveiled by the comprehensive assessment with no need for further State aid. Bank of Portugal also indicated that Novo Banco would resume its sale process in January 2016.

Investors impacted by the retroactive bail-in of those **senior** bonds complain that the pari-passu principle of equality among senior bondholders has been breached by the selection of 5 bonds (rather than a pro rata haircut of all senior bonds). Under the BRRD, creditors are protected by the "no creditor worse off principle" (see section 2.C) whereby creditors should not incur greater losses than what they would receive under normal insolvency proceedings.

It is reported in the Portuguese case that most senior bonds were excluded from the bail-in because they were **issued under foreign law**, or because they were mostly **held by retail investors**. Article 44.3 of the BRRD provides for a number of exceptions on various grounds ranging from the feasibility to the risk of widespread contagion or the destruction of value (see section 2.D). Bank of Portugal justifies this selective bail-in on the basis of public interest, arguing it was "*aimed to safeguard financial stability and ensure compliance with the purposes of the resolution measure applied to Banco Espírito Santo, S.A.*"

On 29 April it was reported[1] that a Portuguese court had provisionally suspended the decision to transfer one series of those senior bonds from Novo Banco to the bad bank. The final decision of the Portuguese courts will probably set the scene for future court cases.

[1] P. Wise, *Court blocks Novo Banco bond move*, Financial Times, 19 April 2016

B. Other restructuring measures

Germany: HSH Nordbank

In June 2013 the Commission had temporarily approved the provisional restoring to former level of a State guarantee granted to HSH Nordbank, pending an agreement on a restructuring plan. In its decision of 21 June 2013 the Commission expressed doubts as to the return to viability of HSH Nordbank. On 19 October 2015 Commissioner Vestager announced the Commission had "*reached an agreement in principle on the way forward to finally conclude the EC State aid procedure on HSH Nordbank*". The Bank indicated that it planned to settle the guarantee and split its activities between a holding company and an operational company to be privatized at a later stage. HSH Nordbank is publicly owned (85%), with the remaining equity held by private trusts (9%) and the Saving Banks Association of Schleswig-Holstein (5%).

On 2 May 2016 the Commission finally approved the increase in the guarantee granted to HSH Nordbank in June 2013. The Commission also indicated that the aid measure "*pre-dates the 2013 Banking Communication and the entry into force of the Bank Recovery and Resolution Directive (BRRD)*", and therefore it was assessed "*under the State aid rules applicable at the time of notification of the aid measure in May 2013, i.e. before the 2013 Banking Communication entered into force in August 2013*" (See section 2.E).

As to the new restructuring plan, the Commission concluded that it does not involve additional aid measures. The restructuring plan includes the split of the company into a holding company and an operational subsidiary to be sold to private investors, as well as the sale, at market terms, of a portfolio of non-performing loans to its current (public) shareholders and to private investors.

Greece: National Bank of Greece, Piraeus Bank

Two of the four main Greek banks (National Bank of Greece and Piraeus Bank) were partially recapitalized with public funds at the end of 2015, following a comprehensive assessment carried out by the ECB. Piraeus Bank and National Bank of Greece managed to address the capital shortfalls stemming from the asset quality review and from the baseline scenario of the stress test with private solutions (through the conversion of creditors, new issue of equity or other capital actions)[2]. Since the capital injection by the HFSF was limited to the capital shortfall stemming from the adverse scenario of the stress test, those recapitalizations were considered *precautionary* as per article 32.4 of the BRRD (see section 2.F), and did not trigger resolution. **However, subordinated creditors (in compliance with State aid rules) as well as senior bondholders (as requested by the Eurogroup on 14 August 2014) were bailed-in through the conversion of their instruments into equity.**

It seems that Piraeus Bank managed to fully convert creditors on a voluntary basis through the activation of collective action clauses. While most NBG's bondholders accepted the voluntary offer, some of them had to be bailed-in on a mandatory basis. The provision of State aid also triggered the bail-in of preference shares held by the Hellenic Republic.

Hungary: MARK (Magyar Reorganizációs és Követeléskezelö)

On 10 February 2016 the Commission announced that Hungary's proposal for a Hungarian asset management company (MARK) did not involve State aid. The design of MARK ensures, according to the Commission, that **transfers of non-performing loans will be priced on market terms (see section 2.G)**. The scope is limited to non-performing loans collateralized by commercial real estate (hotels, offices, shopping centers...). The Commission assessed that granular valuation models developed for each asset category were based on prudent parameters, and that a number of safeguards (independent appraisal to be endorsed by a "qualified validator", cap on transfer prices, ex-post assessments of transactions) ensured the prices of such transactions would not entail State aid.

[2] For more details on the recapitalisation of Greek banks in 2015, see PE 574.389.

Italy: the Garanzia Cartolarizzazione Sofferenze (GACS) and the Atlante Fund

On 26 January 2016 Italy and the Commission agreed on the structure of a State guarantee on the securitisation of non-performing loans (*Garanzia Cartolarizzazione Sofferenze*, *"GACS"*), an impaired asset measure aimed at tackling the rising amount of non-performing loans (NPL) in Italy. Italian banks would be allowed to transfer NPL to special purpose vehicles, so that those loans can be repackaged and sold to investors. The Italian government will provide a guarantee on the senior tranche of those securitization transactions, and charge guarantee fees on market terms to the banks, provided that the senior tranche is awarded an investment-grade rating by an independent rating agency. Under the foreseen mechanism, the junior tranches (and mezzanine tranches, if any) shall not be repaid until the senior tranches guaranteed by the State have been fully repaid.

The Commission announced on 10 February 2016 that **the transaction would not involve State aid**: "*under the State guarantee scheme chosen by the Italian authorities, the State will be remunerated in line with market conditions for the risk it will assume by granting a guarantee on securitised non-performing loans. (...) If a Member State intervenes as a private investor would do and is remunerated for the risk assumed in a way a private investor would have accepted, then such interventions do not constitute State aid*."

Some observers questioned the assessment by the Commission that the measure involves no State aid, as "*there should be no need for government intervention if the guarantees for NPLs were to be priced at market terms*"[3]. The Commission's assessment is based on the *market economy investor principle*, which provides that a transaction at market price doesn't involve State aid (see section 2.G). No bail-in of shareholders or creditors is therefore needed under State aid rules, and the measure will not trigger the resolution of beneficiary banks.

In the case at hand, the price of the guarantee on the senior tranche will be benchmarked on single name CDS related to Italian issuers with a similar risk level. This assessment will be based on the rating granted to the senior tranche by an independent rating agency included in the list of credit rating agencies accepted by the Eurosystem[4]. The purpose of the mechanism is to kick-start the secondary market for NPLs in Italy, meaning it is expected that by offering State guarantees at market terms the GACS will enhance the liquidity on that market[5]. The Commission will monitor the implementation of the scheme with the help of a monitoring trustee, to ensure that guarantees are effectively priced on market terms.

In addition Italy unveiled on 11 April 2016 its plan to set up a rescue fund called Atlante, in order to shore up weak banks. The fund is mainly funded by private investors, albeit its establishment is the result of close coordination by the Italian Treasury. Its first mission was to deal with the failure of two cash calls (Banco Popolare di Vicenza and Veneto Banca) which were underwritten by Unicredit and Intesa Sanpaolo: the two largest Italian lenders, which will benefit the most from the fund, are the two main shareholders. The fund raised a total of EUR 4.25 billion from 67 institutional investors and may invest up to 30% of its ressources on junior and mezzanine tranches of securitized bad loans. The minority participation of Cassa Depositi e Prestiti (EUR 300 million) may not constitute State aid since Cassa Depositi e Prestiti invests pari passu with private investors and therefore the Commission could consider its minority participation does not provide any advantage to the fund.

On 26 June 2016 the Commission also approved a guarantee scheme aiming at facilitating the funding of solvent Italian banks. Such liquidity support has been widely used in the EU since the start of the crisis, and does not entail any bail-in of subordinated creditors nor any restructuring of beneficiary banks. However a number of safeguards ensure such schemes do not end bailing-out zombie banks (see section 2.H). Under article 32.4 BRRD, banks benefitting from such guarantee schemes on newly issued liabilities are not considered failing or likely to fail (see section 2.F).

[3] http://www.ft.com/intl/cms/s/0/597c7cf0-c4f7-11e5-b3b1-7b2481276e45.html?siteedition=intl#axzz40XnlsSNo.
[4] See press release of the Italian Treasury.
[5] S. Merler, 2016: "*This should allow demand and supply of NPLs to intersect*".

Section 2: BRRD, State aid rules and failing banks: selected issues

A. Does the use of Deposit Guarantee Schemes constitute State aid?

Deposit guarantee schemes (DGS) can fulfil different missions. Their primary objective is to cover depositors against the failure of their bank, up to a given threshold: this is the "paybox" function (Article 11.1 DGS Directive "DGSD"). The DGSD provides that EU deposits must be covered up to 100 000 euros. However DGS shall also participate in bank resolutions (Article 11.2 DGSD), in line with BRRD provisions, and may finance some pre-crisis interventions (article 11.3 DGSD).

Article 11 DGSD: Use of funds

1. The financial means referred to in Article 10 shall be primarily used (...) to repay depositors (...)

2. The financial means of a DGS shall be used in order to finance the resolution of credit institutions in accordance with Article 109 of Directive 2014/59/EU. (...)

3. Member States may allow a DGS to use the available financial means for alternative measures in order to prevent the failure of a credit institution provided that (...) the resolution authority has not taken any resolution action under Article 32 of Directive 2014/59/EU (...) and the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS (...);

4. Alternative measures as referred to in paragraph 3 of this Article shall not be applied where the competent authority, after consulting the resolution authority, considers the conditions for resolution action under Article 27(1) of Directive 2014/59/EU to be met. (...)

6. Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, (...) provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned.

While the paybox function and the absorption of losses up to the EUR 100 000 ceiling is not considered State aid by the Commission, alternative measures may constitute State aid if they rely on State resources and are imputable to the State. The notion of State aid is indeed an *objective* and *legal* concept defined in article 107.1 of the Treaty, as interpreted by the case-law of Union courts.

Point 63 2013 Banking Communication

Interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes (21) do not constitute State aid (22). However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State (23). (...)

Article 109 BRRD provides that DGS shall be made liable only for losses that covered depositors should have suffered if the failing institution had been put into normal insolvency proceedings. The DGSD benefits from the No Creditor Worse Off principle enshrined in article 34 BRRD.

Banca Tercas is not the only case where the Commission concluded that the use of the DGS is imputable to the State. In Denmark (The Danish winding-up scheme N 407/2010), Poland (The Polish orderly liquidation scheme SA.37425) and Spain (Caja Castilla La Mancha NN 61/2009, Caja de Ahorros del Mediterraneo SA.34255), the Commission also concluded that albeit DGS were funded by banks, their use was imputable to the State. The Commission notably argued that contributions were compulsory and that governments had crucial influence on the decisions of those DGS.

Conversely, the use of a private IPS in Denmark (Roskilde Bank NN 36/2008) was considered State aid free by the Commission on the ground that membership was fully voluntary, and that any decision could be vetoed by any member, with no interference from the Ministry of Finances.

B. What are the conditions for transferring assets back from the bridge institution to the entity in liquidation?

As discussed in section 1.A, the Bank of Portugal decided on 29 December 2015, 16 months after the resolution of BES and the transfer of certain assets and liabilities to Novo Banco, to transfer back some of the liabilities from Novo Banco to the entity in liquidation.

Article 40.7 of the BRRD provides for such transfers under specific circumstances, in particular if the possibility that assets and liabilities be transferred back is explicitly stated in the initial resolution scheme. In addition, the BRRD does not impose any time limit for transferring some assets and liabilities back to the failing entity.

Article 40.7 BRRD: transfer back of selected assets or liabilities

Resolution authorities may transfer shares or other instruments of ownership, or assets, rights or liabilities back from the bridge institution in one of the following circumstances:
(a) the possibility that the specific shares or other instruments of ownership, assets, rights or liabilities might be transferred back is stated expressly in the instrument by which the transfer was made;
(b) the specific shares or other instruments of ownership, assets, rights or liabilities do not in fact fall within the classes of, or meet the conditions for transfer of shares or other instruments of ownership, assets, rights or liabilities specified in the instrument by which the transfer was made.
Such a transfer back may be made within any period, and shall comply with any other conditions, stated in that instrument for the relevant purpose.

Bank of Portugal indeed justified the transfer on the basis of article 40.7(a): "***The original resolution decision expressly provides that Banco de Portugal, as the Resolution Authority, in use of its powers, may at any time re-transfer assets and liabilities between Banco Espírito Santo, S.A. and Novo Banco, S.A.".***

However as highlighted by the provisional suspension decided by Portuguese courts at the end of April, the delay in transferring back assets or liabilities from the good bank to the bad bank entails additional legal risks for all stakeholders.

C. The no creditor worse-off principle (NCWO)

The implementation of the bail-in tool must comply with the fundamental rights of shareholders and creditors. In particular, shareholders and creditors shall not receive a lesser compensation in resolution than what they would have received if the bank had been put into liquidation. This is the *no creditor worse off (NCWO)* principle, enshrined in Article 34.1(g) of the BRRD[6]. If such principle was infringed, shareholders or creditors would be entitled to compensations[7] from the resolution fund. Under State aid rules, a similar safeguard protecting the rights of subordinated creditors is enshrined in point 46 of the 2013 Banking Communication[8].

The assessment of the NCWO principle under BRRD relies on the comparison between the proceeds received by shareholders and creditors according to the resolution decision (based on an independent valuation of the bank), and the theoretical proceeds those shareholders and creditors would have received under liquidation. Therefore a second valuation, based on a different set of assumptions (liquidation), is necessary.

The EBA has published a draft regulatory technical standard (RTS) on valuation to determine difference in treatment following resolution. Such valuation shall take into account, in particular:
- the expected recovery on all assets;
- the timeline for such recovery;
- the relevant discount rates for discounting expected cash flows;
- the cost associated with the liquidation procedure (administration, maintenance, transaction costs), including any potential restriction on the administrator's ability to negotiate transaction terms;
- the actual treatment of such creditors.

It is to be noted that the expected recovery under liquidation differs widely from the book value of assets on the balance sheet of the bank. Some assets may lose value under liquidation, as for example deferred tax asset which are not transferable nor guaranteed by the State, or some intangible assets such as licences. In addition, administrating large portfolios of loans until their disposal entails costs which will be ultimately borne by the creditors of the entity under liquidation. This explains why the valuation of a bank under a liquidation scenario (article 74 BRRD) is different from the valuation used to design the resolution scheme (article 36 BRRD), and often way below book value.

In any case, the NCWO assessment is complex and requires a careful analysis of the counterfactual scenario, including the time needed for creditors to receive the proceeds from the liquidation. This time parameter explains why expected liquidation proceeds must be discounted, as provided in the EBA draft RTS, before any comparison with the actual proceeds to be received by shareholders and creditors in resolution, if any.

Article 101 BRRD provides that resolution funds may be used to pay compensations to shareholders and creditors in accordance with article 75 BRRD (NCWO principle). In addition, article 85 BRRD foresees that "*the annulment of a decision of a resolution authority shall not affect any subsequent administrative acts or transactions*" and that "*remedies for a wrongful decision or action by the resolution authorities shall be limited to compensation for the loss suffered by the applicant as a result of the decision or act*" (article 85 BRRD). Therefore under specific circumstances, bailed-in creditors may be entitled to compensation by the resolution authority while the subsequent use of the resolution fund could not be cancelled out.

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[6] Article 34.1 (g) BRRD: "*No creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75*".

[7] Article 75 BRRD: "*Member States shall ensure that if the valuation carried out under Article 74 determines that any shareholder or creditor referred to in Article 73, or the deposit guarantee scheme in accordance with Article 109(1), has incurred greater losses than it would have incurred in a winding up under normal insolvency proceedings, it is entitled to the payment of the difference from the resolution financing arrangements*".

[8] Communication from the Commission, OJ C 216, 30.07.2013, point 46: " *(...) Thus subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted*".

D. Exclusions from bail-in

The BRRD confers upon the resolution authority the right to exclude, under exceptional circumstances, some liabilities from the scope of bail-in. Such an exclusion must not lead other creditors to suffer greater losses than what they would have suffered under normal insolvency proceedings.

Article 44.3 BRRD: exclusions from bail-in

In exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers where:

(a) it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority;

(b) the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions;

(c) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union; or

(d) the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

Where a resolution authority decides to exclude or partially exclude an eligible liability or class of eligible liabilities under this paragraph, the level of write down or conversion applied to other eligible liabilities may be increased to take account of such exclusions, provided that the level of write down and conversion applied to other eligible liabilities complies with the principle in point (g) of Article 34(1).

E. Entry into force of the 2013 Banking Communication

The 2013 Banking Communication, which introduced the mandatory bail-in of subordinated creditors, was adopted in July 2013, and entered into force on 1 August 2013. However point 90 of the Communication states that "*notifications registered by the Commission prior to 1 August 2013 will be examined in the light of the criteria in force at the time of notification*". Therefore the mandatory bail-in of subordinated creditors **only applies to those cases which were notified after 1 August 2013**.

The following table lists a number of cases which were assessed on the basis of the former set of State aid rules, although the decision was formally taken after 1 August 2013.

Table 1: State aid decisions taken after 1 August 2013, on the basis of the former set of rules

Member State	Bank	Date of the decision	Date of the notification	Aid measure	Case number
Austria	HGAA	03/09/2013	03/12/2012	recap./guarantees	32554
Italy	MPS	27/11/2013	07/02/2012	recapitalisation	35137
Slovenia	NKBM	20/12/2013	05/12/2012	recapitalisation	35709
Denmark	FIH	11/03/2014	06/03/2012	impaired assets	34445
Greece	Eurobank	29/04/2014	27/12/2012	recapitalisation	34825
Greece	NBG	23/07/2014	27/12/2012	recapitalisation	34824
Greece	Alpha Bank	09/07/2014	27/12/2012	recapitalisation	34823
Greece	Piraeus Bank	23/07/2014	20/12/2012	recapitalisation	34826
Ireland	AIB/EBS	07/05/2014	05/07/2011	recapitalisation	33296
Germany	HSH Nordbank	02/05/2016	22/05/2013	Impaired assets	29338

Source: European Commission

It is to be noted that beside the mandatory bail-in of subordinated creditors, the 2013 Banking Communication also introduced an amended procedure whereby the restructuring plan of the failing institution must be approved *before* the capital support is granted to the bank, unless exceptional circumstances apply. This amendment aimed at preventing such cases where the beneficiary bank would enjoy capital support for months or years while the restructuring measures were not yet finally approved by the Commission.

Point 50 of the 2013 Banking Communication

Once the Commission begins to apply the principles set out in this Communication, a Member State will have to notify a restructuring plan to the Commission and obtain State aid approval before any recapitalisation or impaired asset measures are taken. However, such measures can exceptionally be authorised by the Commission to be granted by the Member State on a temporary basis as rescue aid before a restructuring plan is approved, if such measures are required to preserve financial stability. If a Member State invokes this financial stability clause, the Commission will request an ex ante *analysis from the competent supervisory authority confirming that a current (not prospective) capital shortfall exists, which would force the supervisor to withdraw the institution's banking license immediately if no such measures were taken. Moreover, any such analysis will have to demonstrate that the exceptional risk to financial stability cannot be averted with private capital within a sufficiently short period of time or by any other less distorting temporary measure such as a State guarantee.*

F. How does the Commission assess precautionary recapitalisations?

To reduce the cost of bank failures for taxpayers, the BRRD provides (i) that resolution costs should be first and foremost borne by banks' shareholders and creditors and (ii) that State aid would trigger resolution and bail-in. However some flexibility was introduced to allow for targeted measures aiming at promoting financial stability, such as State guarantees on central-bank refinancing or newly-issued liabilities, or capital support benefitting solvent institutions facing capital shortage in the aftermaths of a stress test.

Article 32.4 BRRD: precautionary recapitalisation

(...) an institution shall be deemed to be failing or likely to fail in (...) the following circumstances:
(a) the institution infringes (...) the requirements for continuing authorisation (...);
(b) the assets of the institution are (...) less than its liabilities;
(c) the institution is (...) unable to pay its debts or other liabilities as they fall due;
(d) extraordinary public financial support is required except (...) any of the following forms:
(i) a State guarantee to back liquidity facilities provided by central banks (...);
(ii) a State guarantee of newly issued liabilities; or
(iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution (...).
(...) The guarantee or equivalent measures referred to therein shall be confined to solvent institutions and shall be conditional on final approval under the Union State aid framework. Those measures shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and shall ***not be used to offset losses that the institution has incurred or is likely to incur*** *in the near future.*
Support measures (...) shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests *(...).*

Article 32.4.d(iii) BRRD therefore lists a number of conditions which must be fulfilled for such a *precautionary* capital support. In particular, the Commission considers that capital needs stemming from an asset quality review of from the baseline scenario of a stress test would cover losses that the institution *has incurred* (asset quality review) or is *likely to incur in the near future* (baseline scenario), and would therefore trigger resolution should they be covered through public support. As a consequence, the correct design of a comprehensive assessment, and the respective methodology and assumptions for the asset quality review, the baseline and adverse scenario of the stress test, become all the more important.

In its decision on National Bank of Greece, the Commission justifies its assessment as follows:

- "*The Commission notes that* ***the aid measures do not confer an undue advantage*** *to the Bank, i.e. an advantage incompatible with the internal market under State aid rules(...)*" (recital 173); however in recital 103 the Commission had also noted "*that the HFSF is recapitalising the Bank in circumstances and under terms that no private investor would accept*";
- "*The aid is confined to a* ***solvent institution*** *as the Bank complied with the capital requirements*" (recital 174);
- "*The aid injected into the Bank is of a* ***precautionary and temporary nature*** *as [it] will result in the creation of prudential buffers in the Bank. (...) The temporary nature of the aid is ensured by the fact that a high proportion of the aid (75%) is granted in the form of a repayable capital instrument, i.e. CoCos, as well as by the overall objective of the Greek State to exit the capital of the Bank through privatisation (...)*" (recital 177);
- "*The HFSF will recapitalise the Bank only* ***after the State aid decision is adopted***" (recital 175);
- "*The Commission has already concluded in the present Decision that the aid is* ***proportionate*** *to remedy the consequences of the serious disturbance in the Greek economy*" (recital 178);
- "*The aid measures (...) are limited to the injections necessary to cover the capital shortfall arising under the* ***adverse scenario of the stress test*** *(...), after the capital shortfall arising under the AQR and the baseline scenario of the stress test has been covered by private means*" (recital 180);

G. The market economy investor principle (MEIP)

The Treaty on the Functioning of the European Union prohibits the discrimination between public and private undertakings: article 345 TFUE provides that "*The Treaties shall in no way prejudice the rules in Member States governing the system of property ownership*". Therefore the Commission is bound by a **principle of neutrality** when assessing State aid, and cannot find a transaction constitutes State aid if a private undertaking, under similar circumstances, would have signed the transaction on the same terms. To that end, the Commission developed the ***market economy investor principle*** **(MEIP)** in its assessment of State aid cases, and the European Court of Justice endorsed this practice[9].

The consequence of such an approach is that, if it can be demonstrated that a transaction is signed on terms which are equivalent to normal market conditions, then it does not grant the counterpart any advantage, which constitutes a key criteria in the definition of State aid under article 107.1 TFUE[10]. Certain guarantees, for example, do not constitute State aid if they are adequately remunerated[11].The Commission enjoys ample discretion as to the methodology used for assessing the MEIP. In most obvious cases, the State invests *pari passu* with private investors, meaning those private investors and the State share the same risks and rewards. In less obvious cases, the Commission has to determine, on the basis of relevant benchmarks, whether the terms of the transaction are acceptable to private investors. More guidance on the MEIP is provided in the Commission Notice on the notion of State aid as referred to in article 107(1) TFUE.

However, the mere intervention by the State, either on the supply side or on the demand side, can potentially shift the market price upward or downward, especially when markets are illiquid. This means that under specific circumstances a purchase of capital instruments by the State may drive prices up, while the state intervention may continue to comply with the MEIP test if market investors continue to invest alongside the State on the same terms.

Conversely, the Commission has developed since the start of the financial crisis the notion of real economic value (REV), which is not a market price but a price which reflects the expected long term economic value of an asset, "*on the basis of underlying cash flows and broader time horizons*" (Point 40 of the Impaired Assets Communication). When a specific market is illiquid, meaning there is a wide imbalance between supply and demand, market prices can deviate in the short term from the long term intrinsic value of the instrument. Therefore the Commission defined the REV as the maximum value at which a distressed portfolio of assets could be transferred from a beneficiary bank to a state-owned structure. The REV is typically the net present value of expected cash flows under reasonable assumptions as to the future losses until maturity, and is generally above market prices but below book value[12]. **Contrary to a transfer at market value, a transfer at REV entails the existence of State aid and therefore must comply with the conditionality imposed under the Commission's crisis communications**. The difference between the market value and the REV is thus used as a benchmark to quantify the amount of aid in the Commission's State aid decisions.

While most impaired assets measures implemented during the financial crisis involved State aid with transfers at REV, recent measures in Italy and Hungary were considered State aid free by the Commission which concluded transfers would take place at market price.

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[9] K. Rezaul, The EU Market Economy Investor Principle: A Good Paradigm?, p6.

[10] Article 107.1 TFEU: *Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.*

[11] See, for example, B. Slocock: The Market Economy Investor Principle, Competition Policy Newsletter, Number 2, June 2002.

[12] Y. Boudghene, S. Maes, *Empirical review of EU asset relief measures in the period 2008-2012*, European State Aid Law Quarterly, 4/2012.

H. What is the conditionality attached to State guarantee schemes?

Point 58 of the 2013 Banking Communication provides that guarantee schemes shall be limited to banks which have no capital shortfall. For those banks which report capital shortfalls and need urgent liquidity needs, an individual notification is required and processed like other restructuring measures.

Point 59 of the 2013 Banking Communication: conditions for guarantee and liquidity support

In order to be approved by the Commission, guarantees and liquidity support must meet the following requirements:
(a) guarantees may only be granted for ***new issues*** *of credit institutions'* ***senior debt*** *(subordinated debt is excluded);*
(b) guarantees may only be granted on debt instruments with ***maturities from three months to five years*** *(or a maximum of seven years in the case of covered bonds). (...);*
(c) the ***minimum remuneration level*** *of the State guarantees must be in line with the formula set out in the 2011 Prolongation Communication;*
(d) a restructuring plan must be submitted (...) for any credit institution granted guarantees (...) for which, at the time of the granting of the new guarantee, the total outstanding guaranteed liabilities (...) exceed both a ratio of 5 % of total liabilities and a total amount of EUR 500 million;
(e) for any credit institution which causes the guarantee to be called upon, an individual restructuring or wind-down plan must be submitted within two months after the guarantee has been activated;
(f) the recipients of guarantees and liquidity support must ***refrain from advertising*** *referring to State support and from employing any aggressive commercial strategies (...).*

Point 60 of the 2013 Banking Communication: conditions for guarantee and liquidity schemes

For guarantee and liquidity support schemes, the following additional criteria must be met:
(a) the scheme must be restricted to ***banks without a capital shortfall*** *(...);*
(b) guarantees with a maturity of more than three years must be limited to ***one-third*** *of the total guarantees granted to the individual bank;*
(c) Member States ***must report to the Commission on a three-monthly basis*** *on: (i) the operation of the scheme; (ii) the guaranteed debt issues; and (iii) the actual fees charged;*
(d) Member States must supplement their reports on the operation of the scheme with available ***updated information on the cost of comparable non-guaranteed debt issuances*** *(...).*

The requirement to bail-in subordinated debt, as per points 43 and 44 of the 2013 Banking Communication, only applies to **capital support** granted through State resources. On the contrary, guarantees on newly issued liabilities[13] constitute **liquidity support**. Since guarantee schemes (i) are limited to solvent institutions and newly issued liabilities, and (ii) cannot cover subordinated debt, it is assumed that such measures don't aim at absorbing losses. If it were the case (if the guarantee is activated), then the institution shall submit an individual restructuring or wind-down plan (Point 59(e) of the 2013 Banking Communication). Similarly, such guarantees on newly issued liabilities are also included in the exemptions of Article 32.4 BRRD, meaning the provision of such aid doesn't make the beneficiary bank failing or likely to fail (see section 2.F).

As to the pricing of such guarantees, it is closely monitored by the Commission. The [2011 Prolongation Communication] set a precise formula for the calculation of the fee, and Point 60(c) and (d) above impose strict reporting obligations to the Member State on the use of the scheme.

Guarantee schemes have been approved by the Commission in **19 Member States** since the start of the crisis. A full list of decisions is available on the [Commission's website].

[13] Guarantees on assets constitute capital support since they aim at absorbing losses and therefore provide capital relief to the beneficiary bank.