PART VIII: TEMPORARY RULES REGARDING FINANCIAL CRISIS

The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition

1 Introduction

(1) The EFTA Surveillance Authority’s (hereinafter “the Authority”) Guidelines of 29 January 2009 on The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (“the Guidelines on financial institutions”) recognize that recapitalisation schemes are one of the key measures that EFTA States can take to preserve the stability and proper functioning of financial markets.

(2) The ECOFIN Council of 7 October 2008 and the Eurogroup meeting of 12 October 2008 addressed recapitalisation in a similar spirit by concluding that "Governments commit themselves to provide capital when needed in appropriate volume while favouring by all available means the raising of private capital. Financial institutions should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non beneficiaries", and “legitimate interest of competitors must be protected, in particular through the state aid rules.”

(3) Until December 2008, the Commission approved recapitalisation schemes in three Member States, as well as individual recapitalisation measures, in line with the principles laid down in the so-called Banking Communication. Recapitalisation, notably in the form of ordinary and preferred shares, has been authorized, subject in particular to the introduction of market-oriented remuneration rates, appropriate behavioural safeguards and regular review. However, as the nature, scope and conditions of recapitalisation schemes currently being envisaged vary considerably, both Member States and potential beneficiary institutions have called for more detailed guidance as to whether specific forms of recapitalisation would be acceptable under state aid rules. In particular, some States envisage the recapitalisation of banks, not primarily to rescue them but rather to ensure lending to the real economy. The present Guidelines provide guidance for new recapitalisation schemes and opens the possibility for adjustment of existing recapitalisation schemes.

Common objectives: Restoring financial stability, ensuring lending to the real economy and dealing with the systemic risk of possible insolvency

1 For the convenience of the reader, financial institutions are referred to simply as ‘banks’ in this document.
2 These Guidelines correspond to the Commission’s Communication “The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition.”, issued on 5 December 2008 (C(2008) 8259 final), hereinafter “the Recapitalisation Communication”.
4 In these Guidelines the EFTA States refers to Norway, Iceland and Liechtenstein.
In the context of the current situation in the financial markets, the recapitalisation of banks can serve a number of objectives. First, recapitalisations contribute to the restoration of financial stability and help restore the confidence needed for the recovery of inter-bank lending. Moreover, additional capital provides a cushion in recessionary times to absorb losses and limits the risk of banks becoming insolvent. Under current conditions, triggered in particular by the collapse of Lehman Brothers, fundamentally sound banks may require capital injections to respond to a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk and the increased cost of funding.

Second, recapitalisations can have as objective to ensure lending to the real economy. Fundamentally sound banks may prefer to restrict lending in order to avoid risk and maintain higher capital ratios. State capital injection may prevent credit supply restrictions and limit the pass-on of the financial markets' difficulties to other businesses.

Third, State recapitalisation may also be an appropriate response to the problems of financial institutions facing insolvency as a result of their particular business model or investment strategy. A capital injection from public sources providing emergency support to an individual bank may also help to avoid short term systemic effects of its possible insolvency. In the longer term, recapitalisation could support efforts to prepare the return of the bank in question to long term viability or its orderly winding-up.

Possible competition concerns

With these common objectives in mind, the assessment of any recapitalisation scheme or measure must take into account possible distortions of competition at three different levels.

First, recapitalisation by one EFTA State of its own banks should not give those banks an undue competitive advantage over banks in other EEA Member States. Access to capital at considerably lower rates than competitors from other EEA Member States, in the absence of an appropriate risk-based justification, may have a substantial impact on the competitive position of a bank in the wider single European market. Excessive aid in one EFTA State could also prompt a subsidy race among EEA Member States and create difficulties for the economies of other States in the EEA which have not introduced recapitalisation schemes. A coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalisation, is indispensable to the preservation of a level playing field. Unilateral and uncoordinated action in this area may also undermine efforts to restore financial stability. ('Ensuring fair competition within the EEA')

Secondly, recapitalisation schemes which are open to all banks within an EFTA State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles may give an undue advantage to distressed or less-performing banks compared to banks which are fundamentally sound and better-performing. This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of European banks ('Ensuring fair competition between banks')
Thirdly, public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position. A public scheme which crowds out market-based operations will frustrate the return to normal market functioning. ('Ensuring a return to normal market functioning')

Any proposed recapitalisation has cumulative competitive effects at each of these three levels. However, a balance must be struck between these competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the one hand, banks must have sufficiently favourable terms of access to capital in order to make the recapitalisation as effective as necessary. On the other hand, the conditions tied to any recapitalisation measure should ensure a level playing field and, in the longer-term, a return to normal market conditions. State interventions should therefore be proportionate and temporary and should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances permit, in order for a competitive and efficient European banking sector to emerge from the crisis. Market-oriented pricing of capital injections would be the best safeguard against unjustified disparities in the level of capitalisation and improper use of such capital. In all cases, EFTA States should ensure that any recapitalisation of a bank is based on genuine need.

The balance to be achieved between financial stability and competition objectives underlines the importance of the distinction between fundamentally sound, well-performing banks on one hand and distressed, less-performing banks on the other.

In its assessment of recapitalisation measures, whether in the form of schemes or support to individual banks, the Authority will therefore pay particular attention to the risk profile of the beneficiaries. In principle, banks with a higher risk profile should pay more. In designing recapitalisation schemes open to a set of different banks, EFTA States should carefully consider the entry criteria and the treatment of banks with different risk profiles and differentiate in their treatment accordingly (see Annex 1). Account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis.

In addition to indicators such as compliance with regulatory solvency requirements and prospective capital adequacy as certified by the national supervisory authorities, pre-crisis CDS spreads and ratings should, for example, be a good basis for differentiation of remuneration rates for different banks. Current spreads may also reflect inherent risks which will weaken the competitive situation of some banks as they come out of the general crisis conditions. Pre-crisis and current spreads should in any event reflect the burden, if any, of toxic assets and/or the weakness of the bank's business model due to factors such as overdependence on short-term financing or abnormal leverage.

It may be necessary, in duly justified cases, to accept lower remuneration in the short term for distressed banks, on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures. Financially sound banks may be entitled to relatively low rates of entry to any recapitalisation, and correspondingly significantly reduced conditions on public support in the longer term, provided that

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6 See Annex 1 for more details.
they accept terms on the redemption or conversion of the instruments so as to retain the temporary nature of the State's involvement, and its objective of restoring financial stability/lending to the economy, and the need to avoid abuse of the funds for wider strategic purposes.

Recommendations of the Governing Council of the European Central Bank (ECB)

(16) In the Recommendations of its Governing Council of 20 November 2008, the European Central Bank proposed a methodology for benchmarking the pricing of State recapitalisation measures for fundamentally sound institutions in the Euro area. The guiding considerations underlying these Recommendations fully reflect the principles set out in this introduction. In line with its specific tasks and responsibilities, the ECB placed particular emphasis on the effectiveness of recapitalisation measures with a view to strengthening financial stability and fostering the undisturbed flow of credit to the real economy. At the same time, it underlined the need for market-oriented pricing, including the specific risk of the individual beneficiary banks and the need to preserve a level playing field between competing banks.

(17) Although the EFTA States are not members of the ECB, the Authority welcomes its Recommendations which propose a pricing scheme for capital injections based on a corridor for rates of return for beneficiary banks which, notwithstanding variations in their risk profile, are fundamentally sound financial institutions. This document aims to extend guidance to conditions other than remuneration rates and to the terms under which banks which are not fundamentally sound may have access to public capital.

(18) In addition, while acknowledging that the current exceptional market rates do not constitute a reasonable benchmark for determining the correct level of remuneration of capital, the Authority is of the view that recapitalisation measures by EFTA States should take into account the underestimation of risk in the pre-crisis period. Without this, public remuneration rates could give undue competitive advantages to beneficiaries and eventually lead to the crowding out of private recapitalisation.

2 Principles governing different types of recapitalisation

(19) Closeness of pricing to market prices is the best guarantee to limit competition distortions. It follows that the design of recapitalisation should be determined in a way that takes the market situation of each institution into account, including its current risk profile and level of solvency, and maintains a level playing field by not providing too large a subsidy in comparison to current market alternatives. In addition, pricing conditions should provide an incentive for the bank to redeem the State as soon as the crisis is over.

(20) These principles translate into the assessment of the following elements of the overall design of recapitalisation measures: objective of recapitalisation, soundness of the beneficiary bank, remuneration, exit incentives, in particular with a view to the replacement of state capital by private investors, to ensure the temporary nature of the State's presence in banks' capital, safeguards against abuse of aid and competition.

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7 See point 39 of the Guidelines on financial institutions.
8 All the references to exit incentives or incentives to redeem the State in this document have to be understood as aiming at the replacement of State capital by private capital to the extent necessary and appropriate in the context of a return to normal market conditions.
distortions, and the review of the effects of the recapitalisation scheme and the beneficiaries’ situation through regular reports or restructuring plans where appropriate.

2.1 Recapitalisations at current market rates

(21) Where state capital injections are on equal terms with significant participation (30% or more) of private investors, the Authority will accept the remuneration set in the deal\(^9\). In view of the limited competition concerns raised by such an operation, unless the terms of the deal are such as to significantly alter the incentives of private investors, in principle there does not appear to be any need for \textit{ex ante} competition safeguards or exit incentives.

2.2 Temporary recapitalisations of fundamentally sound banks in order to foster financial stability and lending to the real economy

(22) In evaluating the treatment of banks in this category, the Authority will place considerable weight on the distinction between fundamentally sound and other banks which has been discussed in paragraphs 12 to 15.

(23) An overall remuneration needs to adequately factor in the following elements:

  a) Current risk profile of each beneficiary\(^10\);
  b) Characteristics of the instrument chosen, including its level of subordination; risk and all modalities of payment\(^11\);
  c) Built-in incentives for exit (such as step-up and redemption clauses);
  d) Appropriate benchmark risk-free rate of interest.

(24) The \textit{remuneration} for state recapitalisations cannot be as high as current market levels (about 15\%)\(^12\) since these may not necessarily reflect what could be considered as normal market conditions\(^13\). Consequently, the Authority is prepared to accept the price for recapitalisations of fundamentally sound banks at rates below current market rates, in order to facilitate banks to avail themselves of such instruments and to thereby favour the restoration of financial stability and ensuring lending to the real economy.

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\(^9\) See for example Commission decision of 27.10.2008 in case N512/2008 \textit{Support measures for financial institutions in Germany}, point 54.
\(^10\) See Annex 1 for more details.
\(^11\) For example, a number of parameters increase or decrease the value of preferred shares, depending on their exact definition, such as: convertibility into ordinary shares or other instruments, cumulative or non-cumulative dividends, fixed or adjustable dividend rate, liquidation preference before ordinary shares, participation or not in earnings above dividend rate paid to ordinary shares, put option, redemption clauses, voting rights. The Authority will use the general classification of capital instrument among the different regulatory categories as a benchmark (e.g. core/non core, Tier 1/Tier 2).
\(^12\) Reference is made to Commission Communication on the recapitalisation of financial institutions in the current financial crisis, footnote 10.
\(^13\) Current levels of remuneration may also reflect present relatively high demand for Tier 1 capital, as banks move away from what is now perceived as the undercapitalised business model of the past, combined with relatively small supply and high market volatility.
At the same time, the total expected return on recapitalisation to the State should not be too distant from current market prices because (i) it should avoid the pre-crisis under-pricing of risk, (ii) it needs to reflect the uncertainty about the timing and level of a new price equilibrium, (iii) it needs to provide incentives for exiting the scheme and (iv) it needs to minimise the risk of competition distortions between EEA States, as well as between those banks which raise capital on the market today without any State aid. A remuneration rate not too distant from current market prices is essential to avoid crowding out recapitalisation via the private sector and facilitating the return to normal market conditions.

**Entry level price for recapitalisations**

In the “Recapitalisation Communication”\(^{14}\), the Commission described methods to determine the entry level price for recapitalisations. The Authority will apply the methods described below in a similar manner, taking into account that the EFTA States are outside the Eurosystem. The Commission considers that an adequate method to determine the price of recapitalisations is provided by the Eurosystem recommendations of 20 November 2008. The remunerations calculated using this methodology represent in the view of the Eurosystem an appropriate basis (entry level) for the required nominal rate of return for the recapitalisation of fundamentally sound banks. This price may be adjusted upwards to account for the need to encourage the redemption of state capital\(^{15}\). The Commission considers that such adjustments will also serve the objective of protecting undistorted competition.

In line with the Eurosystem recommendations, the required rate of return by the government on recapitalisation instruments for *fundamentally sound banks* – preferred shares and other hybrid instruments - could be determined on the basis of a “price corridor” defined by: (i) the required rate of return on subordinated debt representing a lower bound, and (ii) the required rate of return on ordinary shares representing an upper bound. This methodology involves the calculation of a price corridor on the basis of different components, which should also reflect the specific features of individual institutions (or sets of similar institutions) and of EFTA States. The Commission has established that the application of the methodology by using average (mean or median) values of the relevant parameters (government bond yields, CDS spreads, equity risk premium) determines a corridor with an average required rate of return of 7% on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9,3% on ordinary shares relating to Euro area banks. As such, this average price corridor represents an indicative range.

The Authority will accept a minimum remuneration based on the above methodology for fundamentally sound banks. This remuneration is differentiated at the level of an individual bank on the basis of different parameters:

a) the type of capital chosen\(^{16}\): the lower the subordination, the lower the required remuneration in the price corridor;

b) appropriate benchmark risk-free interest rate;

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\(^{14}\) See footnote 2, paragraphs 26 and following.

\(^{15}\) See points 5 to 7 of the ECB Governing Council recommendations on the pricing of recapitalisations of 20 November 2008.

\(^{16}\) Such as ordinary shares, non-core Tier 1 capital, or Tier 2 capital.
c) the individual risk profile at national level of all eligible financial institutions, (including both financially sound and distressed banks).

(29) EFTA States may choose a pricing formula that in addition includes step-up or payback clauses. Such features should be appropriately chosen so that, while encouraging an early end to the State's capital support of banks, they should not result in an excessive increase in the cost of capital.

(30) The Authority will also accept alternative pricing methodologies, provided they lead to remunerations that are higher than the above methodology.

Incentives for State capital redemption

(31) Recapitalisation measures need to contain appropriate incentives for state capital to be redeemed when the market so allows\(^\text{17}\). The simplest way to provide an incentive for banks to look for alternative capital is for EFTA States to require an adequately high remuneration for the state recapitalisation. For that reason, the Authority considers it useful that an add-on be generally added to the entry price determined\(^\text{18}\) to incentivise exit. A pricing structure including increase over time and step-up clauses will reinforce this mechanism to incentivise exit.

(32) If an EFTA State prefers not to increase the nominal rate of remuneration, it may consider increasing the global remuneration through call options or other redemption clauses, or mechanisms that encourage private capital raising, for instance by linking the payment of dividends to an obligatory remuneration of the State which increases over time.

(33) EFTA States may also consider using a restrictive dividend policy to ensure the temporary character of state intervention. A restrictive dividend policy would be coherent with the objective of safeguarding lending to the real economy and strengthening the capital basis of beneficiary banks. At the same time, it would be important to allow for dividend payment where this represents an incentive to provide new private equity to fundamentally sound banks\(^\text{19}\).

(34) The Authority will assess proposed exit mechanisms on a case-by-case basis. In general, the higher the size of the recapitalization and the higher the risk profile of the beneficiary bank, the more necessary it becomes to set out a clear exit mechanism. The combination of the level and type of remuneration and, where and to the extent appropriate, a restrictive dividend policy, needs to represent, in its entirety, a sufficient exit incentive for the beneficiary banks. The Authority considers, in particular, that restrictions on payment of dividends are not needed where the level of pricing correctly reflects the banks’ risk profile, and step-up clauses or comparable elements provide sufficient incentives for exit and the recapitalisation is limited in size.

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\(^{17}\) Taking into account the type of recapitalisation instrument and its classification by supervisory authorities.

\(^{18}\) This is all the more important as the method presented above may be affected by underpricing of risk before the crisis.

\(^{19}\) Taking into account these considerations, restrictions on the payment of dividends could for example be limited in time or to a percentage of the generated profits, or linked to the contribution of new capital, (for example by paying out dividends in the form of new shares). Where the redemption of the State is likely to occur in several steps, it could also be envisaged to foresee the gradual relaxation on any restriction on dividends in tune with the progress of redemption.
Prevention of undue distortions of competition

(35) The Guidelines on financial institutions stresses, in point 35, the need for safeguards against possible abuses and distortions of competition in recapitalisation schemes. Point 38 of the Guidelines on financial institutions requires capital injections to be limited to the minimum necessary and not to allow the beneficiary to engage in aggressive commercial strategies which would be incompatible with the underlying objectives of recapitalisation.20

(36) As a general principle, the higher the remuneration the less there is a need for safeguards, as the level of price will limit distortions of competition. Banks receiving state recapitalisation should also avoid advertising it for commercial purposes.

(37) Safeguards may be necessary to prevent aggressive commercial expansion financed by state aid. In principle, mergers and acquisitions can constitute a valuable contribution to the consolidation of the banking industry with a view to achieving the objectives of stabilising financial markets and ensuring a steady flow of credit to the real economy. In order not to privilege those institutions with public support to the detriment of competitors without such support, mergers and acquisitions should generally be organised on the basis of a competitive tendering process.

(38) The extent of behavioural safeguards will be based on a proportionality assessment, taking into account all relevant factors and, in particular, the risk profile of the beneficiary bank. While banks with a very low risk profile may require only very limited behavioural safeguards, the need for such safeguards increases with a higher risk profile. The proportionality assessment is further influenced by the relative size of the capital injection by the State and the reached level of capital endowment.

(39) When EFTA States use recapitalisation with the objective of financing the real economy, they have to ensure that the aid effectively contributes to this. To that end, in accordance with national regulation, they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy.

Review

(40) In addition, as indicated in the Guidelines on financial institutions21, recapitalisations should be subject to regular review. Six months after their introduction, EFTA States should submit a report to the Authority on the implementation of the measures taken. The report needs to provide complete information on:

a) the banks that have been recapitalised, including in relation to the elements identified in point 12 to 15, Annex 1, and an assessment of the bank' business model, with a view to appreciating the banks' risk profile and viability;

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20 Given the objectives of ensuring lending to the real economy, balance sheet growth restrictions are not necessary in recapitalisation schemes of fundamentally sound banks. This should in principle apply also to guarantee schemes, unless there is a serious risk of displacement of capital flows between EEA Member States.

21 See points 34 to 42 of the Guidelines on financial institutions. In line with the Guidelines on financial institutions, individual recapitalisation measures taken in conformity with a recapitalisation scheme approved by the Authority do not require notification and will be assessed by the EFTA Surveillance Authority in the context of the review and the presentation of a viability plan.
b) the amounts received by those banks and the terms on which recapitalisation has taken place;

c) the use of the capital received, including in relation to (i) the sustained lending to the real economy and (ii) external growth and (iii) the dividend policy of beneficiary banks;

d) the compliance with the commitments made by EFTA States in relation to exit incentives and other conditions and safeguards; and

e) the path towards exit from reliance on State capital\(^{22}\).

(41) In the context of the review, the Authority will assess, amongst others, the need for the continuation of behavioural safeguards. Depending on the evolution of market conditions, it may also request a revision of the safeguards accompanying the measures in order to ensure that aid is limited to the minimum amount and minimum duration necessary to weather the current crisis.

(42) The Authority recalls that where a bank that was initially considered fundamentally sound falls into difficulties after recapitalisation has taken place, a restructuring plan for that bank must be notified.

### 2.3 Rescue recapitalisations of other banks

(43) The recapitalisation of banks which are not fundamentally sound should be subject to stricter requirements.

(44) As far as remuneration is concerned, as set out above, it should in principle reflect the risk profile of the beneficiary and be higher than for fundamentally sound banks\(^{23}\). This is without prejudice to the possibility for supervisory authorities to take urgent action where necessary in cases of restructuring. Where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. Notwithstanding the need to ensure financial stability, the use of State capital for these banks can only be accepted on the condition of either a bank's winding-up or a thorough and far-reaching restructuring, including a change in management and corporate governance where appropriate. Therefore, either a comprehensive restructuring plan or a liquidation plan will have to be presented for these banks within six months of recapitalisation. As indicated in the Guidelines on financial institutions, such a plan will be assessed according to the principles of the rescue and restructuring guidelines for firms in difficulties, and will have to include compensatory measures.

(45) Until redemption of the State, behavioural safeguards for distressed banks in the rescue and restructuring phases should, in principle, include: a restrictive policy on dividends (including a ban on dividends at least during the restructuring period), limitation of executive remuneration or the distribution of bonuses, an obligation to restore and maintain an increased level of the solvency ratio compatible with the objective of financial stability, and a timetable for redemption of state participation.

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\(^{22}\) Taking into account the characteristics of the recapitalisation instrument.

\(^{23}\) See paragraph 28 on the extended price corridor implying increased rates of remuneration for distressed banks.
2.4 Final remarks

(46) Finally, the Authority takes into account the possibility that banks' participation in recapitalisation operations is open to all or a good portion of banks in a given EFTA State, also on a less differentiated basis, and aimed at achieving an appropriate overall return over time. Some EFTA States may prefer, for reasons of administrative convenience for instance, to use less elaborated methods. Without prejudice to the possibility for EFTA States to base their pricing on the methodology above, the Authority will accept pricing mechanisms leading to a level of a total expected annualised return for all banks participating in a scheme sufficiently high to cater for the variety of banks and the incentive to exit. This level should normally be set above the upper bound referred to in paragraph 27 for Tier 1 capital instruments. This can include a lower entry price and an appropriate step-up, as well as other differentiation elements and safeguards as described above.

24 The Commission has so far accepted recapitalisation measures with a total expected annualised return of at least 10% for Tier 1 instruments for all banks participating in a scheme. For EEA States with risk-free rates of return significantly divergent from the Eurozone average such a level may need to be adapted accordingly. Adjustments will also be necessary in function of developments of the risk-free rates.

25 See, as an example of a combination of a low entry price with such differentiation elements, the Commission decision of 12.11.2008 in case N528/2008 the Netherlands, Aid to ING Groep N.V where for the remuneration of a sui generis capital instrument categorized as core Tier 1 capital a fixed coupon (8.5%) is coupled with over-proportionate and increasing coupon payments and a possible upside, which results in an expected annualised return in excess of 10%.
ANNEX 1

Pricing of equity

Equity (ordinary shares, common shares) is the best known form of core Tier 1 capital. Ordinary shares are remunerated by uncertain future dividend payments and the increase of the share price (capital gain/loss), both of which ultimately depend on the expectations of future cash flows/profits. In the current situation, a forecast of future cash flows is even more difficult than under normal conditions. The most noticeable factor, therefore, is the quoted market price of ordinary shares. For non-quoted banks, as there is no quoted share price, EFTA States should come to an appropriate market-based approach, such as full valuation.

If assistance is given in the issuance of ordinary shares (underwriting), any shares not taken up by existing or new investors will be taken up by the EFTA State as underwriter at the lowest possible price compared to the share price immediately prior to the announcement of placing an open offer. An adequate underwriting fee should also be payable by the issuing institution. The Authority will take into account the influence that previously received State aid may have on the share price of the beneficiary.

Indicators for the assessment of a bank's risk profile

In evaluating a bank's risk profile for the purpose of the appreciation of a recapitalisation measure under State aid rules, the Authority will take into account the bank's position in particular with respect to the following indicators:

(a) Capital adequacy: The Authority will value positively the assessment of the bank's solvency and its prospective capital adequacy as a result of a review by the national supervisory authority; such a review will evaluate the bank’s exposure to various risks (such as credit risk, liquidity risk, market risk, interest rate and exchange rate risks), the quality of the asset portfolio (within the national market and in comparison with available international standards), the sustainability of its business model in the long term and other pertinent elements;

(b) Size of the recapitalisation: The Authority will value positively a recapitalisation limited in size, such as for instance no more than 2% of the bank's risk weighted assets;

(c) Current CDS spreads: The Authority will consider a spread equal or inferior to the average as an indicator of a lower risk profile;

(d) Current rating of the bank and its outlook: The Authority will consider a rating of A or above and a stable or positive outlook as an indicator of a lower risk profile.

In the evaluation of these indicators, account needs to be taken of the situation of banks which face difficulties due to the current exceptional circumstances, although they would have been regarded as fundamentally sound before the crisis, as shown, for instance, by the evolution of market indicators such as CDS spreads and share prices.

Table 1: Types of capital

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<tr>
<th>Equity</th>
<th>Tier 2</th>
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<td>Tier 1</td>
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<td>Greater loss absorbency</td>
<td>Non-cumulative preference shares or other similar instruments</td>
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<td>Greater return required</td>
<td>Other high quality hybrids</td>
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<td>Greater loss absorbency</td>
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<td>Greater return required</td>
<td>Ordinary shares</td>
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- **Debt**
  - Tier 2
    - Fixed term debt instruments
    - Perpetual Subordinated Debt instruments
  - Tier 1
    - Cumulative preference shares or other similar instruments
    - Non-cumulative preference shares or other similar instruments
    - Other high quality hybrids
    - Reserves /Retained earnings
    - Ordinary shares