

PART VIII: TEMPORARY RULES REGARDING FINANCIAL CRISIS

The application, from 1 January 2012, of state aid rules to support measures in favour of banks in the context of the financial crisis

1 Introduction

1. Since the beginning of the global financial crisis in the autumn of 2008, the EFTA Surveillance Authority (“the Authority”) has issued four sets of Guidelines¹ which provided detailed guidance on the criteria for the compatibility of state support to financial institutions² with the requirements of Article 61(3)(b) of the Agreement on the European Economic Area (the “EEA Agreement”). The Chapters of the Guidelines in question are the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis³ (“the Banking Guidelines”); the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition⁴ (“the Recapitalisation Guidelines”); the treatment of impaired assets in the EEA banking sector⁵ (“the Impaired Assets Guidelines”) and the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules⁶ (“the Restructuring Guidelines”). Three of those four Guidelines, the Banking, Recapitalisation and Impaired Assets Guidelines, set out the prerequisites for the compatibility of the main types of assistance granted by EFTA States – guarantees on liabilities, recapitalisations and asset relief measures – while the Restructuring Guidelines detail the particular features that a restructuring plan (or a viability plan) has to display in the specific context of crisis-related state aid granted to banks on the basis of Article 61(3)(b) of the EEA Agreement.
2. On 2 March 2011, the Authority adopted a fifth set of Guidelines, on the application, from 1 January 2011, of state aid rules to support measures in favour of banks in the context of the financial crisis⁷ (“the Prolongation Guidelines”). The Prolongation Guidelines extended the Restructuring Guidelines – the only one of the four Guidelines with a specified expiry date – on amended terms until 31 December 2011. The Authority also indicated in the Prolongation Guidelines that it considered that the requirements for state aid to be approved pursuant to Article 61(3)(b) of the EEA Agreement, which exceptionally allows for aid to remedy a serious disturbance in the economy of an EU Member State or an EFTA State, were still fulfilled and that the Banking, Recapitalisation and Impaired

¹ Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement (“the State Aid Guidelines”), adopted and issued by the Authority on 19.1.1994, published in the Official Journal of the European Union (hereinafter referred to as OJ) L 231 of 03.09.1994, p.1 and EEA Supplement No 32, 03.09.1994, p.1. The Guidelines were last amended on 02.03.2011. The updated version of the State Aid Guidelines is published on the Authority’s website:

<http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

² For the convenience of the reader, financial institutions are referred to simply as ‘banks’ in this document.

³ Available at <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>

⁴ Available at <http://www.eftasurv.int/?1=1&showLinkID=16015&1=1>

⁵ Available at <http://www.eftasurv.int/?1=1&showLinkID=16585&1=1>

⁶ Available at <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII---Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>

⁷ Available at <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII---Financial-Crisis-Guidelines-2011.pdf>

Assets Guidelines would remain in place in order to provide guidance on the criteria for the compatibility of crisis-related aid to banks on the basis of Article 61(3)(b) of the EEA Agreement.

3. The exacerbation of tensions in sovereign debt markets that has taken place in 2011 has put the banking sector in the EEA under increasing pressure, particularly in terms of access to term funding markets. The "banking package" agreed by the Heads of State or Government at their meeting of 26 October 2011⁸ aims to restore confidence in the banking sector by way of guarantees on medium-term funding and the creation of a temporary capital buffer amounting to a capital ratio of 9 % of the highest quality capital after accounting for market valuation of sovereign debt exposures. Despite those measures, the Authority considers that the requirements for state aid to be approved pursuant to Article 61(3)(b) will continue to be fulfilled beyond the end of 2011.
4. Therefore, the Banking, Recapitalisation and Impaired Assets Guidelines will remain in place beyond 31 December 2011. In the same vein, the temporal scope of the Restructuring Guidelines is extended beyond 31 December 2011⁹. The Authority will keep the situation in the financial markets under review and will take steps towards more permanent rules for State aid for rescue and restructuring of banks, based on Article 61(3)(b) of the EEA Agreement, as soon as market conditions permit.
5. To facilitate the implementation of the banking package and to take into account developments in the risk profile of banks since the start of the crisis, it is desirable to further clarify and update the rules in certain respects. These Guidelines set out the necessary amendments to the parameters for the compatibility of crisis-related state aid to banks as from 1 January 2012. In particular, these Guidelines:
 - (a) supplement the Recapitalisation Guidelines, by providing more detailed guidance on ensuring adequate remuneration for capital instruments that do not bear a fixed return;
 - (b) explain how the Authority will undertake the proportionate assessment of the long-term viability of banks in the context of the banking package; and
 - (c) introduce a revised methodology for ensuring that the fees payable in return for guarantees on bank liabilities are sufficient to limit the aid involved to the minimum, with the aim of ensuring that the methodology takes into account the greater differentiation of bank credit default swap (CDS) spreads in recent times and impact of the CDS spreads on the EFTA State concerned.

2 Pricing and conditions for state recapitalisations

6. The Recapitalisation Guidelines provide general guidance on the pricing of capital injections. That guidance is geared mainly towards capital instruments bearing a fixed remuneration.

⁸ Statement of EU Heads of State or Government of 26 October 2011, (http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/125621.pdf).

⁹ In line with the Authority's previous practice, existing or new bank support schemes (irrespective of the support instruments they contain: guarantee, recapitalisation, liquidity, asset relief, other) will only be prolonged or approved for a duration of six months to allow for further adjustments, if necessary, in mid-2012.

7. In view of the regulatory changes and the changing market environment, the Authority anticipates that State capital injections may in the future more commonly take the form of shares bearing a variable remuneration. Clarification of the rules on pricing of capital injections is desirable given that such shares are remunerated in the form of (uncertain) dividends and capital gains, making it difficult to assess directly *ex ante* the remuneration on such instruments.
8. The Authority will therefore assess the remuneration of such capital injections on the basis of the issue price of the shares. Capital injections should be subscribed at a sufficient discount to the share price (after adjustment for the "dilution effect"¹⁰) immediately prior to the announcement of the capital injection to give a reasonable assurance of an adequate remuneration for the State¹¹.
9. For listed banks, the benchmark share price should be the quoted market price of shares with equivalent rights to those attaching to the shares being issued. For non listed banks, there is no such market price and EFTA States should use an appropriate market-based valuation approach (including a peer group P/E approach or other generally accepted valuation methodologies). Shares should be subscribed at an appropriate discount to that market (or market-based) value.
10. If EFTA States subscribe for shares without voting rights, a higher discount may be required, the size of which should reflect the pricing differential between voting and non-voting shares in the prevailing market conditions.
11. Recapitalisation measures must contain appropriate incentives for banks to exit from state support as soon as possible. In relation to shares with variable remuneration, if exit incentives are designed in a way that limits the upside potential for the EFTA State, for example by issuing warrants to the incumbent shareholders to allow them to buy back the newly issued shares from the State at a price that implies a reasonable annual return for the State, a higher discount will be required to reflect the capped upside potential.
12. In all cases, the size of the discount must reflect the size of the capital injection in relation to the existing Core Tier 1 capital. A higher capital shortage in relation to existing capital is indicative of greater risk to the State, and therefore requires a higher discount.
13. Hybrid instruments should in principle contain an "alternative coupon satisfaction mechanism" whereby coupons which cannot be paid out in cash would be paid to the State in the form of newly issued shares.
14. The Authority will continue to require EFTA States to submit a restructuring plan (or an update of the existing restructuring plan) within six months of the date of the Authority's decision authorising rescue aid for any bank that receives public support in the form of recapitalisation or impaired asset measures. Where a bank has been the subject of a previous rescue aid decision under the rules governing the compatibility of aid to banks with Article 61(3)(b) of the EEA Agreement, whether as part of the same restructuring operation or not, the Authority may require the submission of the restructuring plan within a period shorter than six months. The Authority will undertake a proportionate assessment of the long-

¹⁰ The "dilution effect" can be quantified using generally accepted market techniques (for instance, the theoretical ex-rights price (TERP)).

¹¹ If EFTA States underwrite the issue of shares, an adequate underwriting fee should be payable by the issuing institution.

term viability of banks, taking full account of elements indicating that banks can be viable in the long-term without the need for significant restructuring, in particular where the capital shortage is essentially linked to a confidence crisis on sovereign debt, the public capital injection is limited to the amount necessary to offset losses stemming from marking sovereign bonds of the Contracting Parties to the EEA Agreement to market in banks which are otherwise viable, and the analysis shows that the banks in question did not take excessive risk in acquiring sovereign debt.

3 Pricing and conditions for state guarantees

15. Banks may benefit from a state guarantee for the issuance of new debt instruments, whether secured or unsecured, with the exception of instruments that qualify as capital. Since pressure on the funding of banks is concentrated in the term funding markets, state guarantees should in general only cover debt with a maturity of between one and five years (seven years in the case of covered bonds).
16. Since the start of the crisis, the pricing of state guarantees has been linked to the median CDS spread of the beneficiary over the period from 1 January 2007 to 31 August 2008. That pricing was increased with effect from 1 July 2010 to better reflect the risk profile of individual beneficiaries¹².
17. To take into account the greater differentiation by risk of bank CDS spreads in recent times, that pricing formula should be updated to refer to median CDS spreads over a three-year period ending one month before the grant of guarantees. Since increases in CDS spreads in recent years are partially due to influences that are not specific to individual banks, in particular the growing tensions in sovereign debt markets and an overall increase in the perception of risk in the banking sector, that formula should isolate the intrinsic risk of individual banks from changes in CDS spreads of EEA States and of the market as a whole. That formula should also reflect the fact that guarantees on covered bonds expose the guarantor to substantially lower risk than guarantees on unsecured debt.
18. In line with the principles mentioned in paragraph 17, the revised pricing formula set out in the Annex establishes the minimum guarantee fees that should apply where state guarantees are granted on a national basis, without any pooling of guarantees among EFTA States. The Authority will apply that formula to all state guarantees on bank liabilities with a maturity of one year or more issued on or after 1 January 2012.
19. Where guarantees cover liabilities that are not denominated in the domestic currency of the guarantor, an additional fee should apply to cover the foreign-exchange risk taken by the guarantor.
20. Where it is necessary for guarantees to cover debt with a maturity of less than one year, the Authority will continue to apply the existing pricing formula, which is set out for reference in the Annex. The Authority will not authorise guarantees covering debt with a maturity of less than three months except in exceptional cases where such guarantees are necessary for financial stability. In such cases,

¹² See Directorate-General for Competition Staff Working Document of 30 April 2010 on the application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010 (http://ec.europa.eu/competition/state_aid/studies_reports/phase_out_bank_guarantees.pdf).

the Authority will assess the appropriate remuneration taking into account the need for appropriate incentives to exit from state support as soon as possible.

21. If EFTA States decide to establish pooling arrangements for guarantees on bank liabilities, the Authority will review its guidance accordingly, to ensure in particular that weight is given to CDS spreads of EFTA States only to the extent that they remain relevant.
22. To enable the Authority to assess the application in practice of the revised pricing formula, EFTA States should indicate, when notifying new or prolonged guarantee schemes, an indicative fee for each bank eligible to benefit from those guarantees, based on an application of the formula using recent market data. EFTA States should also communicate to the Authority, within three months following each issue of guaranteed bonds, the actual guarantee fee charged in relation to each issue of guaranteed bonds.

ANNEX

Guarantees covering debt with a maturity of one year or more

The guarantee fee should as a minimum be the sum of:

- (1) a basic fee of 40 basis points (bp); and
- (2) a risk-based fee equal to the product of 40 basis points and a risk metric composed of (i) one-half of the ratio of the beneficiary's median five-year senior CDS spread over the three years ending one month before the date of issue of the guaranteed bond to the median level of the iTraxx Europe Senior Financials five-year index over the same three-year period, plus (ii) one-half of the ratio of the median five-year senior CDS spread of all EEA States to the median five-year senior CDS spread of the EFTA State granting the guarantee over the same three-year period.

The formula for the guarantee fee can be written as:

$$Fee = 40bp \times (1 + (1/2 \times A/B) + (1/2 \times C/D))$$

where A is the beneficiary's median five-year senior CDS spread, B is the median iTraxx Europe Senior Financials five-year index, C is the median five-year senior CDS spread of all EEA States and D is the median five-year senior CDS spread of the EFTA State granting the guarantee.

The medians are calculated over the three years ending one month before the date of issue of the guaranteed bond.

In the case of guarantees for covered bonds, the guarantee fee may take into account only one-half of the risk-based fee calculated in accordance with point (2) above.

Banks without representative CDS data

For banks without CDS data, or without representative CDS data, but with a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of large banks in the EEA States. The supervisory authority will assess whether the CDS data of a bank are representative.

For banks without CDS data and without a credit rating, an equivalent CDS spread should be derived from the median value of five-year CDS spreads during the same sample period for the lowest rating category¹³, based on a representative sample of large banks in the EEA States. The calculated CDS spread, for this category of banks, may be adapted on the basis of a supervisory assessment.

The Authority will determine the representative samples of large banks in the EEA States.

Guarantees covering debt with a maturity of less than one year

¹³ The lowest rating category to be considered is A, as there is not sufficient data available for the rating category BBB.

As CDS spreads may not provide an adequate measure of credit risk for debt with a maturity of less than one year, the guarantee fee for such debt should as a minimum be the sum of:

- (1) a basic fee of 50 basis points; and
- (2) a risk-based fee equal to 20 basis points for banks with a rating of A+ or A, 30 basis points for banks with a rating of A-, or 40 basis points for banks rated below A- or without a rating.