Chaire de **DROIT EUROPÉEN**

The impact of the conditionality of bailout plans on credit institutions

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1. DEALING WITH THE FINANCIAL CRISIS: <u>THE EU FRAMEWORK</u>

- *National* bailout plans
  - ⇒ State guarantees and capital injections (and impaired assets relief programs)
  - *Economic policy remains a Member States' competence*
  - *No EU Treasury*

- *European* coordination
  - ⇒ EU State Aid policy enforcement (with strong support of ECB)
  - *Community Guidelines on State aid for rescuing and restructuring firms in difficulty (O.J. [2004] C 244/2)*
  - *Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (adopted Oct. 13, 2008 – O.J. [2008] C 270/8)*
  - *Communication from the Commission – The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (adopted Dec. 5, 2008 - O.J. [2009] C 10/2)*
  - *Communication on the treatment of impaired assets in the Community banking sector (adopted Feb. 25, 2009 - O.J. [2009] C 72/1)*

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2. EUROPEAN COORDINATION: OBJECTIVES AND MEANS

- Prevent distortions of the Internal Market
  - *Avoid discrimination based on "nationality"*
  - *Ensure proportionality in State support*

  ⇒ Eligibility (systemic relevance) and remuneration requirements

- Keep the incentives right
  - *Mitigate « moral hazard » issues*
  - *Level the playing-field for competitors*

  ⇒ Conditionality

NB: not a watertight distinction (e.g., remuneration requirements also contribute indirectly to keeping the incentives right)

3. CONDITIONALITY OF BAILOUT PLANS: LEGAL BASIS

- Phase I: up until mid-September '08
  - *Art. 87(3)**(c)** EC - Guidelines on rescue and restructuring aids*
  - *Conditions (risk of bankruptcy or loss of banking license):*
    - Restructuring aid (part of restructuring plan to restore viability): (i) compensatory measures to avoid undue distortions of competition (divestitures, reductions in capacity, etc.); (ii) significant contribution (50%) of beneficiaries to restructuring costs (sales of assets, external financing, etc.); (iii) any necessary conditions and obligations; (iv) regular reporting obligations.

- Phase II: since mid-September '08
  - *Art. 87(3)**(b)** EC – "to remedy a serious disturbance in the economy" – ad hoc Communications from the Commission in relation to the financial crisis*
  - *Conditions:*
    - Guarantees: (i) limitations as to the types of eligible securities; (ii) up to 2 years with 6 months review; (iii) adequate remuneration; (iv) behavioral constraints to keep incentives right; (v) restructuring if guarantee(s) called upon.
    - Recapitalization (sound *vs*. distressed banks): (i) high remuneration; (ii) corresponding rights; (iii) thigh behavioral safeguards against undue distortions of competition; (iv) conditions to sustain lending to the real economy; (v) restructuring plan for distressed banks assessed in line with restructuring aid guidelines (+ governance measures).

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4. CONDITIONS TO MITIGATE MORAL HAZARD ISSUES

- Towards shareholders – adequate burden sharing
  - *Limitations on the eligibility of debt instruments for State guarantees*
    - Exclude hybrid or subordinated debt considered as Tier 2 capital (*e.g.*, covered bonds)
  - *Adequate remuneration of State guarantees and capital (ECB guidelines)*
    - Guarantee fees set according to institution-specific risk and fixed mark-up
    - Annual return on capital btw. 8 (*e.g.*, French banks) and 12% (*e.g.*, originally, UK banks)
  - *Limitations on the distribution of dividends by recapitalized banks*
    - Outright prohibition pending redemption (*e.g.*, Germany and Denmark); or
    - Special dividend/coupon for State (*e.g.*, ING, Anglo Irish Bank).
  - *Limitations of share buyback programs*
    - Outright prohibition pending redemption (*e.g.*, Ireland); or
    - Subject to approval by State Board representatives (*e.g.*, ING)
  - *Transfer of power (rights) to State*
    - Issuance of preferred shares carrying extra rights (*e.g.*, Allied Irish Bank – 25%); and/or
    - Appointment of State Board representatives with special veto rights (*e.g.*, GR, IR, ND)

4. CONDITIONS TO MITIGATE MORAL HAZARD ISSUES

- Towards managers – prevent excessive risk taking
  - *Dismissal of executives*
    - Sachsen LB: dismissal of management team – “valuable signal against moral hazard”
    - Fortis: dismissal of management as a “good signal against moral hazard”
  - *Limitations on remunerations and severance packages*
    - UK: (i) no 2008 cash bonus; (ii) compliance with best practice codes; (iii) dismissal at reasonable and fair cost
    - Germany: (i) € 500 K remuneration cap; (ii) prohibition of contractual severance terms
    - France: (i) commitments to abide by ethics rules (also for traders); (ii) prohibition of severance package in case of “failure”
    - Ireland: control by newly established public oversight committee
    - Denmark: prohibition of new stock-options plans
  - *Obligations to sustain lending to the real economy/homeowners*
    - UK: maintain availability of lending to homeowners and small businesses at 2007 levels and support schemes to help people to stay in their homes
    - France: obligation to increase loans to individuals, SMEs and local authorities by 3 to 4%
    - Germany: take account of domestic industry’s borrowing requirements (particularly SMEs)

5. CONDITIONS TO PREVENT DISTORTIONS OF COMPETITION

- Behavioral conditions - duly monitored
  - ⇒ Impact on retail banking services – prevent "aggressive" conduct
  - *Prohibition to advertize the benefit of State guarantees/capital (e.g., Dexia)*
  - *Growth limitations*
    - GDP-related, market share or balance sheet growth ceilings (progressively abandoned for sound banks)
    - Outright prohibition of acquisitions (*e.g.*, Commerzbank, BNP, JSC Parex Bank)
    - Catch-all clause: "*refrain from expansion of business activities that would not have been pursued absent the capital injection*" (*e.g.*, ING, Aegon)
  - *Conditions on remuneration of services (outcome of complaints)*
    - Prohibition to undercut rivals
      - ✓ On specific services, *e.g.*, Fortis Bank for Internet accounts; or
      - ✓ All deposits, *e.g.*, Dexia; or
      - ✓ For "all" services, *e.g.*, Commerzbank when market share >5%
    - Cap on the openings of preferred savings accounts (*e.g.*, Dexia)
  - *Obligation to keep high solvency ratio* (*e.g.*, ING)

5. CONDITIONS TO PREVENT DISTORTIONS OF COMPETITION

- Structural conditions
  - *Reduction in activities*
    - Discontinue proprietary trading (Sachsen LB, West LB, etc.)
    - Close risky/loss-making activities
      - ⇒ Sachsen LB: *closure of Irish subsidiary involved in structured financial investments and international real estate business*
      - ⇒ *IKB Deutsche Industriebank AG: abandonment of IKB's main loss making activities, which were also its most important sources of revenues*
      - ⇒ *Northern Rock (orig.): closure of overseas operations, drastic reduction of the bank's lending operations, retail mortgage redemption program*
      - ⇒ *Commerzbank: reduction in investment banking operations*
  - *Divestitures*
    - Divestiture of non-core/loss-making businesses (often undisclosed)
      - ⇒ *Commerzbank: divestment of real estate activities (Eurohypo) and "other subsidiaries"*
      - ⇒ *Sachsen LB: "sale of assets"*

⇒ Outcome: balance sheet downsized by 45 to 50%

6. CONDITIONALITY OF BAILOUT PLANS: POLICY ISSUES

- Are structural compensations necessary/desirable?
  - *Systemic crisis? Interconnected financial institutions?*
  - *Sell to whom? At which price?*
  - *Consequences? Credit crunch? Need for flexibility in implementation?*

- Tensions with internal market policy?
  - Member States' focus on domestic economy
  - Controversy about possible divestiture of *Commerzbank*'s retail business in CEECs (not imposed at the end – intervention of BB's Chairman)

    ⇒ WestLB: "*In the context of its strategic reorientation, WestLB will* ***refocus on its home market****…and reduce its international activities*" (idem for Bayern LB)
  - Commission considers positively cross-border rescue mergers (*e.g.*, Santander/B&B, BNP/Fortis Belux; *contra* Fortis Netherlands/ABN Amro)

- Convergence between competition and regulatory objectives?