



# State aid to financial institutions

EUROPEAN COMMISSION GUIDANCE IN THE CONTEXT OF THE GLOBAL FINANCIAL CRISIS

The European Commission has issued guidance on how it will assess State aid to financial institutions in the context of the current international global financial crisis. While the general principles for assessing aid such as guarantees or recapitalisation are familiar, the Commission has introduced more flexibility and more rapid decision-making.

The European Commission has issued a Communication on the application of State aid rules to measures taken in relation to financial institutions and the banking industry in the context of the current global financial crisis.

The Communication outlines the more flexible approach that the Commission has demonstrated on an ad hoc basis for some of the measures recently taken by Member States to protect particular institutions or the banking system as a whole. The purpose of the Communication is to ensure a level playing field across the EU so that national rescue measures do not distort competition between banks. The Commission's more flexible approach has also been demonstrated by its willingness to grant derogations authorising banks to merge without first obtaining full formal approval under the EC Merger Regulation.

## Background

The turmoil in the international financial system has led Member State governments to intervene rapidly in the banking system to protect depositors and to prevent fundamentally sound institutions from being fatally undermined by the lack of liquidity. The Commission has responded by speeding up its State aid decision-making process (some decisions have been issued within 24 hours) and by authorising aid under the little used, but more flexible, provisions of the EC Treaty which permit aid to remedy a 'serious disturbance in the economy'.

Member States' interventions have included nationalisation of specific financial institutions, State-sponsored recapitalisation, deposit guarantees, extended liquidity facilities, interbank lending guarantees and State acquisition of toxic assets with a view to their liquidation.

Many of these schemes have involved an element of State aid under Article 87 of the EC Treaty. Any such aid is, in principle, illegal unless approved by the Commission, and, in the past, the Commission has generally taken a strict and protracted approach to approval.

## New timetable for approving emergency aid

The Communication explains that the Commission has introduced a new accelerated procedure for assessing and approving emergency aid to financial institutions as swiftly as possible – within 24 hours or over a weekend, if necessary. The Commission stresses that the key is to give it details 'as early and comprehensively as possible'.

## A broadening of the basis on which aid can be given

The Commission confirms that it accepts that the financial crisis has become significant enough to allow Member States to justify State aid on the basis of a 'serious disturbance in the economy of a Member State'. It is on this basis that the recent packages of measures in the UK, Ireland and Denmark have been approved.

The Commission has resisted attempts over the course of many years to invoke this justification for aid measures, for fear of opening the floodgates. It has, however, now accepted that current circumstances fall into this category. This means that the stricter approach under the Rescue and Restructuring Aid Guidelines (which apply where an individual firm is ‘in difficulty’) will not be applied as rigorously.

However, the Commission draws a crucial distinction between ‘illiquid but otherwise fundamentally sound financial institutions’ and those whose problems are caused by their own ‘inefficiency or excessive risk-taking’. This may be a difficult distinction to draw in some cases, but it is an important one: firms falling into the latter category will generally benefit from the speedier approach but will have to undergo the higher level of scrutiny required by the Rescue and Restructuring Guidelines, while firms within the first category may benefit from a lighter touch.

## What aid is covered?

The Communication covers several different types of aid:

- guarantees of financial institutions’ liabilities;
- recapitalisation of financial institutions;
- controlled winding-up of financial institutions; and
- provision by central banks of short-term liquidity assistance, which the Communication notes is often not aid at all.

## A more flexible approach to these types of aid

While the criteria in the Communication for each of these types of aid reflect the Commission’s traditional approach, there are important elements of flexibility.

- *Limited in time*: for guarantees, the usual limit of six months for emergency rescue aid is generally extended to two years (with six-monthly reviews to establish that it is still necessary); for recapitalisation, the Commission acknowledges that this is ‘inherently irreversible’ but will conduct a broader review of its effects.

- *Well-targeted*: for guarantees, the Commission takes the view that guarantees covering retail deposits are generally justifiable to prevent bank runs; wholesale guarantees and other guarantee types may be permitted in certain cases – particularly if they stimulate the resumption of interbank lending; guarantees should not, though, extend to subordinated debt or be of general application.
- *Proportionate*: for guarantees, the Commission sets out the basis for ensuring adequate recompense from the beneficiary of the guarantee, which will need to be greater if the guarantee is called on (indeed, if the guarantee is called upon, this will have to be notified separately); for recapitalisation, the price of shares should be based on a market-oriented valuation, with components such as claw-back mechanisms or preference shares being viewed positively.
- *Constraints on recipients*: for both guarantees and recapitalisation, some limitations on the future behaviour of the recipients will be required, such as a prohibition on advertising based on their State-supported status, or on expansion of the business (eg via market share caps).
- *Restructuring plans*: these generally still have to be submitted to the Commission within six months.

But the Commission insists on *no discrimination*: any aid measure must apply to all institutions incorporated or with significant activities in its territory. It is in the light of this requirement that the Irish Government recently modified its guarantee scheme in order to gain Commission approval.

## Conclusion

The Communication confirms that, even in the current climate, EU Member States cannot adopt rescue measures which distort competition between different countries’ banks. The Commission’s message remains that the State aid rules, applied rapidly and flexibly in the present crisis, are ‘part of the solution, not part of the problem’.

However, the Commission will no doubt be keen to stress that the more flexible approach is limited only to the financial sector and to the current crisis.

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