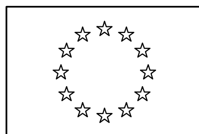

EUROPEAN COMMISSION

Brussels, 22.12.2008
C(2008) 8951 final

Subject: State aid N 638/2008
Guarantee scheme for banks in Latvia

Sir,

1. PROCEDURE

1. Following several preliminary exchanges, Latvia submitted a notification on a guarantee scheme and provisions concerning takeover of banks by the state for banks incorporated in Latvia on 16 December 2008. The Commission asked for further information on 19 December 2008, to which Latvia replied on the same day.

2. DESCRIPTION OF THE AID

2.1. General

2. In response to the ongoing exceptional turbulence in world financial markets, Latvia brought forward a guarantee scheme (together with a law on bank takeovers) designed to restore stability of the financial system and to remedy a serious disturbance in the Latvian economy.
3. The Latvian authorities intend to adopt a government regulation on a "Procedure for issuing and supervision of guarantees for bank loans" to implement a guarantee scheme to maintain the stability of the national financial system. It gives the Latvian authorities broad powers to grant urgent aid in form of guarantees to banks
4. The guarantee scheme has as its objective restoring confidence and encouraging inter-bank lending through the granting of a state guarantee to existing and new debt issuance. Furthermore, the guarantee scheme is to support the short and medium term financing needs of banks.

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5. Moreover, the purpose of the law on bank takeovers is the preservation of stability of the banking system of Latvia and of the smooth operation of the payment systems in the public interest.

6. The Latvian authorities commit that the 'standstill clause' of Article 88(3) EC will be respected.

2.2. The beneficiaries

7. Eligible undertakings will be banks incorporated in Latvia (including the Latvian subsidiaries of foreign banks) that are solvent. The scheme targets banks adequately capitalized which will be verified and confirmed by the Financial and Capital Market Commission and the Bank of Latvia.[1,2]

8. The scheme will enable these banks to raise the financial resources they need to meet their liabilities and fund their business operations. The scheme is principally targeted to systemically important banks. In this regard, the Latvian authorities confirmed that when evaluating the systemic importance of bank criteria such as the amount of assets, the number of customers, the importance in the payment system, the market share in deposits, the market share in the corporate and private lending will be taken into account.

9. The Latvian authorities confirmed that they will not differentiate between domestic banks and subsidiaries of foreign banks, in this respect. However, the Latvian authorities do not exclude the possibility that the guarantee may also be found to be appropriate for a smaller bank, if its collapse could cause a disruption in the Latvian financial system. Hence, the scheme is open to banks of all sizes.

2.3. Description of the measures

10. Latvia will make available a state guarantee to new short and medium term debt issuance as well as existing loans. As regards the latter, the State will guarantee existing loans only in exceptional cases, i.e. when a bank applies for a guarantee because its creditors can validly claim a major default event, which would lead to the bank's immediate bankruptcy without a state guarantee.[3]

11. The participating banks will pay an annual fee which, in principle, will follow the "Recommendations on government guarantees on bank debt" of the European Central Bank of 20 October 2008 (hereafter "ECB-Recommendations"). Since the Latvian banks do not have a rating or where they have a rating, the respective rating categories do not have representative CDS data the Latvian authorities will use, in line with the ECB-Recommendations, CDS data from a representative sample of euro area large banks.

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1 See, for example, a similar involvement of a supervisory authority in Commission Decision of 14 November 2008 in case N 520a /2008, 'Urgent measures to guarantee the stability of the Italian banking system'

2 This guarantee scheme would in principle also apply to JSC Parex Banka but only after Parex fulfils all requirements thereof and an amendment of the previous Commission decision on Parex has been adopted by the Commission.

3 See, for example, Commission Decision of 24 November 2008 in case NN 68/2008 Public Support Measures to JSC Parex Banka

12. In particular, the fee shall equal *i)* a service fee of 0.1% plus *ii)* the median value of 5 year CDS spreads of A-rated euro area large banks over the period 1 January 2007 to 31 August 2008 plus *iii)* an add-on fee of 0.5%. This would lead to a final fee of 1.048%.

13. The debt instruments that can be covered by the guarantee are all liabilities with exception of interbank deposits, subordinated liabilities and collateralized liabilities such as covered bonds. The scheme excludes all liabilities that qualify as either Tier 1 or Tier 2 capital. As regards the guarantee of existing loans, instruments with a maximum maturity of 3 years would be covered. As regards the guarantee of the loans taken for refinancing of the existing loans, the eligible liabilities will have a maturity between six months and three years.

14. Debt instruments guaranteed under this scheme may be issued during an entry window of six months, i.e. from 1 January 2009 until 30 June 2009. This may be prolonged subject to approval of the Commission until 31 December 2009. In this regard, the Latvian authorities have committed that they will notify any extension of the entry window into the scheme to the Commission.

15. The Latvian authorities have indicated that they will guarantee an amount of 10% of GDP in the first instance which currently sums up to approximately LVL 1.5 billion. This amount can be increased up to 20% of GDP. In case, the total amount guaranteed in the framework of the guarantee scheme exceeds 20% of GDP, Latvia will notify this change to the Commission. According to the Latvian authorities, about 10 banks are expected to apply for the State guarantee. The Latvian authorities estimate the maximum guarantee of a single bank to be approximately LVL 0.6 billion.[4]

16. The shareholders of the participating banks will have to pledge not less than 51% of shares of the bank as the first commercial pledge right. In case the bank defaults and the shares are taken over by the state, the Latvian authorities undertake that the maximum price paid to the shareholders for the shares would represent their respective value without state aid and without funding provided by the Bank of Latvia (and without having incorporated a speculation on the State's intervention). In case of non-quoted companies, the respective book value (i.e. fair value) would be used for determining the market value of the shares, the state aid, the funding by the Bank of Latvia and any value due to speculation on the state aid would be excluded. Such a takeover will be carried out according to the Law on Bank takeover which lays down the provisions regarding the implementation of a bank takeover. A bank takeover can take place by alienating shares issued by the bank or by alienating a bank's assets, rights and obligations. Latvia confirms that this Law as well as the takeover provision are targeted at distressed banks only, which are not fulfilling or risk not to fulfil the capital adequacy requirements.

17. Pursuant to this law, the State would take over a distressed bank (shares or its assets, rights and obligations) only when it would be needed to preserve the stability of the Latvian banking system and the smooth operation of payment systems. The shareholders would receive a fair compensation for their shares or the bank's assets rights and obligations on the basis of a special law. As regards the share price or the price for the bank's assets, rights and obligations, the same provisions as already described above would be used. The law for the takeover of banks will not have a limitation in time. However, Latvia commits to apply this

[4] This figure has been calculated without taking JSC Parex Banka into consideration.

law in exceptional cases only to prevent serious disturbances in the Latvian financial system and in case no other measures would lead to the intended aim of preservation of the stability of the Latvian financial system.

3. Obligations of Latvia and the Banks participating in the Scheme

18. Latvia will also impose certain conditions on banks availing of the state guarantee, aimed at eliminating or minimising any spill-over effects which may distort competition and at minimising the potential losses for the State. In particular, the participating banks will commit to the following constraints during the validity period of the guarantee:
    - Advertising of the bank or services thereof will not be conducted with reference to the received guarantee;
    - The bank will not pay dividends without the agreement of the Minister of Finance;
    - Gross annual remuneration to members of the Board, including mandatory State social insurance contributions, will not be fixed at more than LVL 150,000 per member of the Board;
    - Before repayment of the guaranteed loans to the credit institutions, early repayment of subordinated loans will not be made.
19. The Latvian authorities further ensure that the banks benefitting from the guarantee scheme continue to accommodate the credit demand of the Latvian economy, especially of small and medium sized enterprises and households.
20. The Latvian authorities undertake to present every six months reports on the operation of the scheme. The six months reports will also include a list of all beneficiary companies indicating for each of them the necessary data to understand the full scope of the support measures.
21. In addition, the Latvian authorities commit to file individual restructuring/liquidation plans, within 6 months, for banks that default on their liabilities and which call upon the guarantee, for banks that have been taken over and for banks whose existing liabilities were guaranteed due to the claim of a major default event.
22. The Latvian authorities commit to seek the Commission's approval, should it be necessary for the guarantee scheme to continue beyond the initial period of six months following the adoption of the present decision. If Latvia terminates the guarantee measures before the intended end of the scheme, the Commission will be informed thereof.
23. Latvia undertakes to notify to the Commission, if any further measures would need to be granted by the State beyond the State guarantee covered by this decision.
24. Latvia also undertakes, first, to monitor how the banks taking advantage of the measures of the scheme comply with the abovementioned behavioural constraints, second, to take necessary actions if the banks fail to comply with them and, third, to inform the Commission thereof.

4. POSITION OF LATVIA

25. Latvia accepts that the notified scheme constitutes state aid within the meaning of Article 87(1) of the EC Treaty.

26. Latvia seeks urgent authorisation of the measures. According to the Latvian authorities, fears regarding the creditworthiness of counterparties have led to an extreme and dangerous flight to quality across the global financial system. Public sector intervention is necessary to restore market confidence. The notified state aid scheme is, together with the other parts of the package, necessary and proportionate to restore financial stability in Latvia. Given the severe stress in global financial markets and in the Latvian financial system, it is in their view imperative that the measures are implemented rapidly.

27. The Latvian authorities claim that the measures are compatible with the common market, because they are necessary to remedy a serious disturbance in the Latvian economy pursuant to Article 87(3)(b) of the EC Treaty.

28. A letter from the Bank of Latvia dated 17 December 2008 confirms that the notified measures are urgently required to prevent harmful spill-over effects on the entire Latvian financial system and on the economy as a whole.

5. ASSESSMENT

5.1. State aid character of the measures

29. As set out in Article 87(1) of the EC Treaty, 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 common market.

30. The Commission agrees with the position of Latvia that the guarantee scheme constitutes aid to the banks concerned pursuant to Article 87 (1) EC Treaty.

31. The guarantee on the newly issued debt allows the beneficiaries to refinance at advantageous conditions and the guarantee on the existing debt will allow the respective banks to avoid possible bankruptcy proceedings. This gives an economic advantage to the beneficiaries and strengthens the position of these beneficiaries compared to that of their competitors in Latvia and other Member States and must therefore be regarded as distorting competition and affecting trade between Member States. The advantage is selective since it only benefits the beneficiaries of the scheme and is provided through State resources.

32. In particular, the Commission is convinced that in the current circumstances of the financial crisis no private investor would have granted such a significant guarantee on debt of the participating banks.[5]

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[5] Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, at point 32 and Commission decision of 21 October 2008 in case C 10/2008 *IKB,* not yet published, at point 74.

33. As regards the bank takeover provisions, the Commission considers that a mere change of ownership does not in itself entail state aid to the banks. The Commission, however, notes that this measure would be used only in exceptional cases by the Latvian authorities for distressed banks that do not qualify as fundamentally sound and in such cases, when no other measures would lead to the intended aim of preservation of the stability of the Latvian financial system.

34. In this regard, the Commission notes positively that the Latvian authorities committed to notify to the Commission if any further measures would need to be granted by the State beyond the State guarantee or the takeover of a bank (shares or its assets, rights and obligations) covered by this decision. The Commission also notes positively that the Latvian authorities have undertaken to submit a restructuring or liquidation plan within six months after state aid was granted to such banks or as soon as they qualify as not fundamentally sound banks, which is in particular the case if a bank defaults on a guaranteed debt, is taken over by the State or needs a guarantee on existing debt.

35. As regards the price paid to the shareholders in the event of takeover of the bank, the Commission takes note that the price paid would be a fair compensation for the shares or the bank's assets, rights and obligations to the extent that such compensation excludes any effects of state aid granted to the bank and funding provided by the Bank of Latvia and any speculation on State support. In such circumstances, the price would not seem to include state aid elements to the former owners of the bank. However, such an assessment will be undertaken within the assessment of an obligatory restructuring plan.[6]

5.2. Compatibility of the Financial Support Measures

5.2.1. Application of Article 87(3)(b) EC

36. Latvia intends to provide operating aid under a guarantee scheme by assisting banks, which have problems accessing liquidity. Given the present circumstances in the financial market, it is appropriate to examine this measure directly under the Treaty rules and in particular under Article 87(3)(b) of the EC Treaty.

37. Article 87(3)(b) of the EC Treaty enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State". The Commission recalls that the Court of First Instance has stressed that Article 87(3)(b) of the EC Treaty needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State.[7]

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[6] Therefore this decision is without prejudice to the examination of the price paid on nationalisation in any individual case, which the Commission would deal with in the context of the restructuring plan that would be triggered by the guarantee being called.

[7] Cf. in principle case Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Confirmed in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, page 1, points 153 *et seq* and Commission Decision in Case C50/2006 *BAWAG*, not yet published, points 166. See Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43 of 16.2.2008, p. 1,

38. The Commission notes that the present scheme concerns the entire Latvian banking industry. The current global financial crisis has made access to liquidity more difficult for financial institutions across the board and has also eroded confidence in the creditworthiness of counterparties. In these circumstances, even fundamentally sound financial institutions are facing the prospect of going out of business. The Commission considers that if the issues of lack of liquidity and lack of confidence are not addressed, it will result not only in difficulties for the banking sector but, due to that sector's pivotal role in providing financing to the rest of the economy, will also have a systemic effect on the Latvian economy as a whole. The Commission does not dispute that the present scheme is designed to address the problems of the lack of liquidity and lack of confidence that are currently striking Latvian banks. Therefore it finds that the scheme aims at remedying a serious disturbance in Latvian economy.

5.2.2. Conditions for compatibility under Article 87(3)(b) of the EC Treaty

39. In line with the Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis"[8], in order for an aid or aid scheme to be compatible under Article 87(3)(b) of the EC Treaty, it must comply with general criteria for compatibility under Article 87(3) of the EC Treaty, viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(g) and 4(2), which imply compliance with the following conditions[9]:

    a. *Appropriateness*: The aid has to be well targeted to in order to be able to effectively achieve the objective of remedying a serious disturbance in the economy. This would not be the case if the measure is not appropriate to remedy the disturbance

    b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case law of the Court of Justice.[10]

    c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives. This follows from Article 3 (1)

Commission Decision of 30 April 2008 in case NN 25/2008, *Rescue aid to WestLB*, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, not yet published.

[8] Communication of 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, OJ. C 270, 25 October 2008, p. 8.

[9] Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, at point 41.

[10] Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in. Case C-390/06, *Nuova Agricast v Ministero delle Attività Produttive* of 15 April 2008, where the Court held that, "As is clear from Case 730/79 […], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market […]."

g EC and Article 4 (1) and (2) EC, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87 (1) EC prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) of the EC Treaty which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective.

5.2.3. Application of the criteria to the measures

40. As regards appropriateness, the Commission acknowledges that the objective of the guarantee scheme is to provide security to investors in newly issued debt of participating banks, in order to provide sufficient liquidity to these participating banks. This is a reaction to the international market-failure where even solvent banks are having difficulties getting access to liquidity. The Commission considers that such guarantee schemes should help to overcome this market failure, by establishing the conditions for the revival of the interbank lending market and financial markets more generally and regards it therefore as an appropriate means.[11] The Commission also considers it appropriate that the existing debt of the banks would be guaranteed only in exceptional circumstances i.e. if needed to avoid an uncontrolled winding up of the banks in order to preserve financial stability.

41. Moreover, the scheme is targeted at the appropriate beneficiaries as the eligibility of participating firms is limited in principle to banks complying with the minimum capital adequacy. The scheme comprises all banks incorporated in Latvia, including Latvian subsidiaries of foreign banks.

42. As regards necessity, the guarantee scheme, which is required to restore confidence and to stimulate the interbank lending market, is limited to the minimum necessary in scope and time.

43. As regards scope, the Commission does not dispute that the guarantee scheme is needed to restore confidence of lenders.[12] A guarantee on retail deposits would not be sufficient as it would only avoid bank runs but not restore confidence of institutional lenders. Moreover, the Commission notes positively that Latvia is in principle limiting the guarantee to the form of financing that is currently experiencing the greatest difficulties, namely short to medium term interbank lending. Firstly, subordinated debt is not guaranteed. Secondly, Latvia has also limited the scope of the guarantee scheme so that the banks have only a window of six months to issue the new debt that will benefit from the guarantee. As regards the State guarantee on existing debt, the Commission notes that it would only be granted in exceptional cases, i.e. if a major default event may be claimed in respect of the bank's liabilities which would lead to the bank’s immediate bankruptcy without a state guarantee.[13]

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[11] See Commission Decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, at point 42, Commission Decision of 13 October 2008 in case N 507/2008 Financial *Support Measures to the Banking Industry in the UK*, not yet published, at point 56, and Commission decision of 13 October 2008 in case NN 48/2008 *Guarantee scheme for banks in Ireland*, not yet published, at point 59.

[12] See the above mentioned Commission Decisions in cases NN 51/2008 (at point 47) NN 507/08 (at point 59), N533/08 (point 41) and 567/2008.

[13] See Commission Decision of 24 November 2008 in case NN 68/2008 Public Support Measures to JSC Parex Banka

44. As regards temporal scope, the guarantee applies to debt for up to three years which was found to be appropriate in the Commission's previous decisions.[14] In general, the Commission is of the view that the duration of a guarantee should be as short as possible. In this regard, the Commission notes positively an additional safeguard in the present scheme in so far as it has a limited issuance period of six months only. The temporal scope is thus justified.

45. As regards proportionality, the distortion of competition is minimised by various safeguards. Above all, the aid amount is reduced through a market orientated premium. The banks will pay a fee which is equal or above the fees set in the ECB-Recommendations. This can be considered proportionate and consistent with the recent practice of the Commission.[15] The Commission's assessment of the current fee level is without prejudice to the position it may take if the guarantee period is prolonged.

46. As to the proposed behavioural constraints (see 18), the Commission finds them appropriate to limit the aid to the minimum necessary and safeguard against undue distortions of competition.

47. In particular, the Commission notes that, as explained above, in this case the remuneration for the provision of the State guarantee and other terms are in line with the ECB recommendation and similar to those of existing guarantee schemes[16], which reduces the likelihood of undue displacement of capital flows. Finally the Latvian authorities have indicated that they will guarantee a maximum amount of 10% of GDP in the first instance which currently sums up to approximately LVL 1.5 billion. This amount can be increased up to 20% of GDP. In case, the total amount guaranteed in the framework of the guarantee scheme exceeds 20% of GDP, Latvia will notify this change to the Commission. Therefore, the Commission is of the view that the scheme contains sufficient safeguards to minimise the risk of distortion of competition through undue displacement of capital flows between Member States.

48. In addition, the Commission notes that the banks receiving a State guarantee will have to abide by restrictions on marketing of the guarantee. In light of the foregoing, the Commission concludes that the beneficiaries of the scheme do not receive more support than necessary.

49. Furthermore, the Commission acknowledges that Latvia has committed to provide a restructuring or liquidation plan, within 6 months, for any bank that does not qualify anymore as fundamentally sound, i.e. for the banks that cause the guarantee to be drawn, the banks that have been taken over by the State and the banks the existing liabilities of which were guaranteed due to the claim of a major default event.[17]

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[14] See Commissions decisions of 19 November 2008 in case N 560/2008 Support Package for Greek Credit Institutions and of 12. December 2008 in case N 625/2008 Support Package for Financial Institutions in Germany, not yet published.

[15] A similar approach is taken in Commission decision of 27 October 2008 in case NN 512/2008 *Guarantee scheme for banks in Germany*, not yet published, Point 66 and in the Commission Decision of 13 October 2008 in case N 507/2008 *Financial Support Measures to the Banking Industry in the UK*, not yet published, point 61.

[16] Cf. Commission Decision of 12. December 2008 in case N 625/2008 N 625/2008 Support Package for Financial Institutions in Germany, not yet published.

[17] Such plans are the cornerstone of the Community Guidelines on State aid for Rescuing and Restructuring Firms in Difficulty; see OJ 2004 C 244, p. 2.

50. Regarding the law on bank takeovers, the Commission takes note that Latvia intends to apply this law in a restrictive way and that banks in Latvia are only nationalized if they are in distress and no other measures would also lead to a stabilization of the Latvian financial sector. Given that only banks in distress are nationalized, Latvia undertakes to submit a restructuring plan for each of these banks, wherein a detailed evaluation of this measure and its consequences is carried out.
51. The Latvian authorities confirmed that the maximum price paid to the shareholders for the shares or the bank's assets, rights and obligations would represent their respective value without state aid and without funding provided by the Bank of Latvia (and without having incorporated a speculation on State's intervention). Also in determining the market value of the shares, state aid and speculation on it and the funding provided by the Bank of Latvia would be excluded. Given the commitment of the Latvian authorities in this regard, it does not appear that State Aid in favour of the former owners of the bank would arise in this context. However, such an assessment will be undertaken within the assessment of an obligatory restructuring plan.[18]
52. Taking into account the commitments from Latvia concerning the takeover of banks and the narrow framework within which it will be applied, the Commission considers this measure to be appropriate and proportional as well as necessary to overcome instabilities in the Latvian financial system.
53. On the basis of the above, the proposed measures can be considered compatible with the Common market.

6. DECISION

The Commission finds that the notified measures are compatible with the Common market and has accordingly decided not to raise objections.
If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

[18] Therefore this decision is without prejudice to the examination of the price paid on nationalisation in any individual case, which the Commission would deal with in the context of the restructuring plan that would be triggered by the guarantee being called.

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Yours faithfully,

For the Commission

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