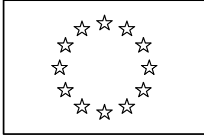

EUROPEAN COMMISSION

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Subject: **State aid N 29/2009 – French Republic**

Amendment to the capital-injection scheme for banks

Sir,

1. PROCEDURE

(1) On 8 December 2008 the European Commission approved[1] the French capital-injection scheme for banks deemed essential for financing the economy. That decision approved capital injections of up to EUR 21 billion for six banks. A first tranche of EUR 10.5 billion has already been paid in the form of deeply subordinated debt instruments, which qualify for the banks' Tier 1 ratio.

(2) On 21 January 2009 the French authorities notified the Commission of an amendment to the scheme.

[1] Decision C(2008) 8278 CORR of 8 December 2008, not yet published.

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2. DESCRIPTION OF THE SCHEME

(3) For the second tranche of operations, the French authorities wish to give eligible banks the option of issuing one of two instruments before 30 August 2009:

i. deeply subordinated debt instruments on the terms approved in the decision of 8 December 2008;

ii. preference shares on the terms set out below.

(4) The second recapitalisation tranche will be allocated among the beneficiary banks in accordance with the formula used for the first operation. However, the French authorities wish to have the power to adjust the second tranche at the margins to take account of the merger of the parent companies of Caisses d'Épargne and Banques Populaires by up to 50 basis points of the new entity's Tier 1 ratio. The adjustment represents an additional EUR 500 million (maximum) compared with the EUR 10.5 billion initially earmarked for the second tranche.

(5) The French authorities stress that all the features of the capital-injection scheme approved by the decision of 8 December 2008 which are not covered by the additional notification remain unchanged.

(A) The scheme approved by the decision of 8 December 2008

(6) The French State has set up the *Société de Prise de Participation de l'État* (hereinafter: SPPE) in which it is the sole shareholder and through which it will take part in operations to inject capital into sound financial institutions or to rescue financial institutions in difficulty,[2] with a view to maintaining financial stability and avoiding any serious disturbance to the French economy. SPPE intervention will therefore concern only those institutions that play a key role in this respect by maintaining sufficient lending activity.

(7) Any credit institution, including the subsidiaries of foreign groups, will be able to benefit from capital injection by SPPE provided that a marked and sudden reduction in its activity would have a serious impact on the French economy.

(8) The total of the first tranche was EUR 10.5 billion, allocated as follows:

Banking group	Amount (€billion)
BNP Paribas	2.55
Société générale	1.70
Groupe Crédit Agricole	3.00
Groupe Crédit Mutuel	1.20

[2] Possible measures of this kind are not dealt with in this decision.

Groupe Caisse d'Epargne	1.10
Groupes Banques Populaires	0.95

(9) A hybrid debt instrument (deeply subordinated debt instrument) was used, which qualifies for original own funds. The first tranche has increased the Tier 1 capital ratio of each of the banking groups concerned by around 0.5%.

(10) The main features of the deeply subordinated debt instruments acquired by SPPE, which are described in more detail in the decision of 8 December 2008, are as follows:

The deeply subordinated debt instruments will be remunerated in two phases:

i. remuneration based on a fixed entry rate for an initial period of five years;

ii. remuneration based on a variable rate after the initial period.

(11) The fixed entry rate applicable for the initial five-year period will be based on the following formula: BTAN 5 years + 300 bps + 5 x CDS (senior 5 years).

(12) The variable rate applicable[3] beyond the initial five-year period will be based on the following formula: EURIBOR + 250 bps + 5 x CDS (senior 5 years).

(13) Where:

i. BTAN 5 years is the average rate on 5-year government bonds over the 20 days preceding the issue;

ii. CDS (senior 5 years) is: (i) if the beneficiary bank had a CDS (credit default swap), the average value of 5-year CDS spreads over the period 1 January 2007 to 31 August 2008; (ii) if the beneficiary bank does not have representative CDS, but has a credit rating, the average value of 5-year CDS spreads for the rating category of the beneficiary bank over the period 1 January 2007 to 31 August 2008.

(14) Applying this formula to beneficiary banks produced an average entry rate of some 8% for payment of the first tranche.

(B) Amendments to the scheme notified on 21 January 2009

(a) Intervention using preference shares

Conditions attached to preference shares

(15) Amounts due to preference shares rank *pari passu* among themselves and with ordinary shares on a going concern basis and in the event of liquidation. From a prudential

[3] The variable rate is defined so that the remuneration in the initial and second phases is equivalent. It takes account of the risk premium included in the EURIBOR rate.

perspective, they are original own funds eligible without ceiling like core Tier 1 capital. The preference shares[4] will be non-convertible. They may account for only 50% of the share capital of an unlisted company and 25% of the share capital of a listed company.[5]

Remuneration

(16) The issuer will pay on an annual basis the higher of the following two rates, up to twice the entry rate of the deeply subordinated debt instruments:

i. The entry rate for deeply subordinated debt instruments increased by 25 additional basis points every year, applied to the actual amount[6] of preference shares so that the rate applied from the start of the seventh financial year will be the rate for deeply subordinated debt instruments plus 150 basis points;

ii. The rate equal to 105% of the dividend per ordinary share for the 2009 financial year, divided by the unit issue price for preference shares, 110% for the 2010 financial year, 115% for the 2011-2017 financial years and 125% for the 2018 financial year and following financial years.

(17) Remuneration must be suspended in the event of (i) insufficient funds to cover distribution (ii) suspension of payment of dividends on ordinary shares or (iii) prudential event.

(18) If dividends are distributed, they will be paid first to holders of preference shares. The remaining funds available for distribution will be paid to holders of ordinary shares after the dividend on the preference shares has been paid.[7]

(19) Applying the formula for deeply subordinated debt instruments set out in paragraph 12, the average entry rate for preference shares is around 8% under current market conditions.

Share buy-back

(20) The issuer may buy back the preference shares, subject to the prior agreement of the Secretariat-General of the Banking Commission, at a price equal to the highest of the following two amounts:

i. 110% of the current recapitalised amount of reconstitutable own funds;

ii. average price of the underlying shares over the 30 days preceding the date of buy-back.

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[4] Holders of preference shares have the same rights as holders of ordinary shares, with the exception of voting rights and the preferential right to subscribe to an increase in capital. However, in the event of any change to the issuer's capital (in particular an increase), the remuneration conditions for holders of preference shares must be maintained.

[5] Pursuant to Section L. 228-11 of the Commercial Code.

[6] Actual amount: subscription price of the preference shares (i) reduced by all the losses imputed to the subscription price (ii) increased by the share of the recapitalisation.

[7] In order to qualify for the banks' core Tier 1 capital, the preference shares must rank *pari passu* with ordinary shares on a going concern basis and in the event of liquidation. Consequently, if payment of dividends on ordinary shares is suspended, payment of dividends on preference shares is also suspended.

(21) In any event, the buy-back price may not be higher than a percentage of the subscription price for the preference share: 120% if buy-back takes place before 30 June 2013; 130% if buy-back takes place between 1 July 2013 and 30 June 2016; 140% if buy-back takes place between 1 July 2016 and 30 June 2019; 150% if buy-back takes place between 1 July 2019 and 30 June 2022; 160% if buy-back takes place after 1 July 2022.

(b) Budget

(22) However, the French authorities wish to be able to adjust the amount of the second tranche to allow for the merger of the parent companies of Caisses d'Épargne and Banques Populaires by up to 50 basis points of the new entity's Tier 1 ratio, which represents a maximum of EUR 500 million. The maximum amount of the budget under the second tranche is therefore EUR 11 billion.

(23) The French authorities maintain that the merger of Caisses d'Épargne and Banques Populaires involves a change in the consolidation method for their joint subsidiary Natixis. Natixis' weighted risks are currently consolidated by proportional consolidation *pro rata* with the percentage shareholding, i.e. 35% by Caisses d'Epargne and 35% by Banques Populaires. After the merger, the new entity will hold 70% of Natixis's share capital and will have to fully consolidate its weighted risks in accordance with prudential rules. If the merger goes ahead, it will therefore automatically lead to an increase in the weighted risks making up the denominator in the new entity's Tier 1 ratio. This change in accounting policy is irrespective of Natixis's results.

(24) Increasing the new entity's capital by 50 basis points in its Tier 1 ratio therefore represents a higher amount (EUR 2.55 billion) than the amount initially budgeted (EUR 2.05 billion) for Caisses d'Épargne and Banques Populaires.

(c) Window of operations

(25) Given the uncertainties surrounding the financing of the economy in 2009 and the time needed to issue preference shares,[8] the French authorities wish to give the banks the option of participating in the second operation, in the form of deeply subordinated debt instruments or preference shares acquired by the State, until 30 August 2009. The French authorities also wish to give the banks that benefit from the first tranche of capital injection the option of repaying it and of issuing preference shares instead, for a similar amount, subject to the conditions set out below.

(26) The undertakings regarding the conduct of the beneficiary banks laid down in the agreement with the State and presented to the Commission remain relevant for the second operation.

[8] The issue of preference shares by a bank requires approval by an extraordinary general meeting, for which at least 35 days' notice must be given, in this case at the earliest from the date the results for the 2008 financial year are released in the second half of February.

3. ASSESSMENT

B. Existence of state aid

(27) Under Article 87(1) of the 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, insofar as it affects trade between Member States, be incompatible with the common market.'

(28) The classification of a measure as state aid requires the following cumulative conditions to be met: (1) the measure in question confers an advantage through state resources; (2) the advantage is selective; and (3) the measure distorts or threatens to distort competition and is capable of affecting trade between Member States.

(29) First, the Commission notes that the French authorities have not provided any new information that calls into question the classification of the intervention in question as aid.[9]

(30) The Commission considers that the underwriting by the State of preference shares is an advantage because it is difficult, not to say impossible, to raise this sort of capital under current market conditions. The advantage is selective in that it concerns only a limited number of beneficiaries and is imputable to the State because the French authorities control SPPE. Lastly, where the beneficiary banks have a presence in other Member States or compete with banks from other Member States, competition is likely to be distorted and trade between Member States is likely to be affected. Consequently, the Commission considers that the cumulative conditions under Article 87(1) of the EC Treaty are met and that the notified scheme therefore constitutes state aid.

(31) Since the notified scheme constitutes state aid, the Commission must examine whether the aid qualifies for the exemptions provided by EC Treaty.

B. Compatibility of the aid with the common market

1) Application of Article 87(3)(b) of the EC Treaty

(32) Article 87(3)(b) of the EC Treaty states: '*3*. The following may be considered to be compatible with the common market: (b) aid to [...] remedy a serious disturbance in the economy of a Member State.'

(33) The Commission notes that the market conditions that led to its decision of 8 December 2008 still prevail and that the notified measure is limited to the use of a new intervention instrument, preference shares, to an adjustment of the budget and to a slight extension of the scheme's duration but in no way changes the other conditions applicable to the scheme approved by the decision of 8 December 2008. That is why the Commission takes the view that the notified measure is intended to remedy a serious disturbance in the French economy.

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[9] See points 52-61 of the decision of 8 December 2008.

2) *Conditions for compatibility under Article 87(3)(b) of the EC Treaty*

(34) The compatibility of the aid must be assessed having regard to the Commission Communication of 13 October 2008 on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (hereinafter: the Financial Communication)[10] and the Commission Communication of 5 December 2008 on the recapitalisation of financial institutions in the current financial crisis[11] (hereinafter: Recapitalisation Communication).

(35) Under the Financial Communication, a measure has to meet all three of the following conditions in order to be compatible with Article 87(3)(b) of the EC Treaty:

i. The aid must be well targeted. The measures deployed must be appropriate to achieve the desired objective, i.e. in this case to remedy a serious disturbance in the economy of a Member State.

ii. The aid must be necessary, i.e. the amount of aid must be limited to the minimum necessary to achieve the desired objective and to the most appropriate means for remedying the disturbance to the economy. In other words, if another aid measure involving a lower amount or a lesser distortion of competition (for example a temporary and limited guarantee rather than a capital injection) were sufficient to remedy the disturbance in the economy, the measure cannot be regarded as necessary;

iii. Finally, the aid must be proportionate, i.e. the actual or likely distortion of competition must be weighed against its positive effects. Any distortion of competition must therefore be kept to the minimum necessary to achieve the desired effect.

(36) The Recapitalisation Communication describes in more detail the principles that must govern recapitalisations of financial institutions so that they are compatible with the Community's state aid rules. It sets out the criteria for setting remuneration of recapitalisations and mechanisms to prevent undue distortions of competition. The Communication recognises the appropriate nature of the capital injection for financial institutions, in particular to strengthen financial stability, to support lending activity to the economy as a whole and to offset the risk of insolvency. It sets out three essential objectives of monitoring by the Commission: to ensure a level playing field between Member States, fair competition between banks and a return to normal market functioning. The Communication makes a distinction between fundamentally sound banks and banks in difficulty. In the case of temporary recapitalisations of fundamentally sound banks, the Commission accepts a minimum remuneration based on the methodology adopted by Eurosystem on 20 November 2008. The methodology includes the calculation of a price corridor with an average required rate of return of 7% on preference shares with features similar to those of subordinated debt and an average required rate of return of 9.3% on ordinary shares of euro area banks. In addition, the Commission requires sufficiently

[10] OJ C 270, 25.10.2008, p. 8.

[11] http://ec.europa.eu/competition/state_aid/legislation/specific_rules.html

attractive incentives for state capital to be redeemed when the market allows. Safeguards must also be established in order to prevent the use of public funds for anti-competitive ends. Lastly, the schemes must be reviewed regularly every six months on the basis of a report by the Member States.

3) Compatibility of the notified aid within the meaning of Article 87(3)(b) of the EC Treaty

Appropriateness of the measure to achieve the desired objectives

(37) As stated above, the notified scheme in no way changes the conclusions of the decision of 8 December 2008 concerning the context of state intervention, the consideration required from banks or the monitoring and mediation mechanisms put in place. The Commission's assessment on this point therefore remains unchanged.

(38) With regard to the additional possibility offered to banks to issue preference shares, the Commission takes the view that it allows an appropriate response to the increased pressure from the markets concerning capital injections and is likely to make the banking system more robust. The option for beneficiaries to strengthen their core Tier 1 ratio[12] or only their Tier 1 ratio will enable them to adapt the instrument to their needs in order to strengthen the banking system over the long term.

(39) For all the above reasons, and in line with recent decisions on similar schemes,[13] the Commission takes the view that the changes to the scheme seek to address the current financial crisis and that it is well targeted to facilitate the financing of the French economy and to restore confidence, and is therefore consistent with the objectives laid down by the Recapitalisation Communication. The measures deployed are appropriate to the desired objectives.

Necessity

(40) In paragraph 34 of the Financial Communication, the Commission recognised that 'a systemic measure in response to the ongoing financial crisis would be the establishment of a recapitalisation scheme which would be used to support financial institutions that are fundamentally sound but may experience distress because of extreme conditions in financial markets. The objective would be to provide public funds so as to strengthen the capital base of the financial institutions directly or to facilitate the injection of private capital by other means, so as to prevent negative systemic spillovers.'

(41) Moreover, in the Recapitalisation Communication, the Commission recognises that preservation of financial stability and access to credit for all operators in the real economy were objectives that could justify intervention by the Member States.

(42) In this context, the Commission takes the view that recourse to preference shares is justified in the same way as the use of deeply subordinated debt instruments. The additional capital provided by the scheme will directly facilitate access to credit for all operators in the real

[12] Preference shares are eligible for core Tier 1 ratio but deeply subordinated debt instruments are not.

[13] NN533/08 Support measures for the banking industry in Sweden, NN51/08 Guarantee scheme for banks in Denmark, N507/08 Financial support measures to the Banking Industry in the UK, NN48/08 Guarantee scheme for banks in Ireland, N512/08 Rescue package for the financial institutions in Germany, NN60/08 Guarantee scheme for credit institutions in Portugal.

economy. Moreover, the option of strengthening the core Tier 1 ratio is likely to consolidate the robustness of the banking system as a whole and can restore the confidence needed for the proper functioning of the financial sector.

(43) With regard to the budget increase for the measure, the notified scheme provides for a total increase of EUR 500 million in the budget initially approved by the decision of 8 December 2008, making a total budget of EUR 21.5 billion. The Commission notes that the only purpose of this increase is to ensure a level playing field for beneficiaries. As indicated under point 24 of this decision, the planned merger of Caisses d'Épargne and Banques Populaires involves a change in the consolidation method for their joint subsidiary Natixis, whose weighted risks are currently consolidated by proportional consolidation *pro rata* with the percentage shareholding, i.e. 35% by Caisses d'Epargne and 35% by Banques Populaires. After the merger, the new entity will hold 70% of the share capital in Natixis and will have to fully consolidate its weighted risks. If the merger goes ahead, it will therefore automatically lead to an increase in the weighted risks making up the denominator in the new entity's Tier 1 ratio. The increase in the budget therefore seeks only to take account of a change in accounting method and follows the logic of the decision of 8 December 2008 to increase the Tier 1 ratio of all beneficiaries by a maximum of 1%. The increase is therefore necessary to achieve the scheme's purpose.

(44) As regards the duration of the scheme, the decision of 8 December 2008 envisaged that the scheme would apply for a maximum period of 6 months, i.e. until 8 June 2009. In the notification, the French authorities requested that the scheme be extended until 30 August 2009. According to the French authorities, the extension is needed because the arrangements for preference shares are more complex. The issue of preference shares requires approval by an extraordinary general meeting, which is subject to strict requirements, in particular concerning the minimum notice to be given. Deeply subordinated debt instruments are not subject to such constraints, but since beneficiary banks are free to choose between the two instruments, they may exercise their choice at any moment during the operation of the scheme. Extending the scheme is therefore also necessary to allow recourse to preference shares.

(45) On the basis of these findings, the Commission takes the view that the change to the recapitalisation scheme is well targeted in order to remedy a serious disturbance in the economy.

(46) However, the Commission must verify that the planned measures are not disproportionate to the distortion of competition that they cause.

Proportionality

(47) In order to assess the proportionality of the measure, the Commission must verify that the distortion of competition caused by such state intervention is kept to a minimum, having regard to the risks of a serious disturbance in the economy. In accordance with the Recapitalisation Communication, if the aid is to be compatible with the common market, a balance must be struck between pursuit of the common objectives and distortion of competition between Member States and between banks. Recapitalisation schemes must also ensure a return to normal market functioning.

(48) In this context, the Commission believes that closeness of pricing to market prices is the best guarantee that distortions of competition will be limited.[14] 'Total remuneration must take appropriate account of the following factors:

i. current risk profile of each beneficiary;

ii. characteristics of the instrument chosen, including its level of subordination; risk and all payment arrangements;

iii. incentives for state exit from capital built into the instrument (such as step-up and early redemption clauses);

iv. appropriate risk-free rate of interest.'

(49) First, the Commission notes, with reference to the Recapitalisation Communication[15], that the French authorities have used a methodology that is consistent with the recommendations from the ECB and Eurosystem. The notified formula is structured appropriately by including a first factor, a risk-free interest rate, each beneficiary's risk profile expressed through the credit default swap component supplemented by an add-on fee. Moreover, in line with the recommendations in the Recapitalisation Communication, the mechanism provides for exit conditions that act as an incentive for credit institutions to buy back securities as soon as possible.

(50) The Commission notes first that the entry rate for preference shares is based on the formula for deeply subordinated debt instruments. The Commission validated the formula in its decision of 8 December 2008.[16]

(51) The Commission notes that the preference shares have a higher subordination rank than the deeply subordinated debt instruments. That factor must therefore be taken into account in the overall remuneration for this instrument, which must be higher than that for deeply subordinated debt instruments.

(52) In the case at hand, remuneration of the preference shares provides for payment of the higher of the following rates:

i. The entry rate for deeply subordinated debt instruments increased by 25 additional basis points every year, applied to the actual amount of preference shares[17] so that the rate applied from the start of the seventh financial year will be the rate for deeply subordinated debt instruments plus 150 basis points;

ii. The rate equal to 105% of the dividend per ordinary share for the 2009 financial year, divided by the issue price per preference share, 110% for the

[14] See point 19 of the Recapitalisation Communication.
[15] See point 28 of the Recapitalisation Communication.
[16] See points 101-103 of the decision of 8 December 2008.
[17] Actual amount: subscription price of the preference shares (i) reduced by all the losses imputed to the subscription price (ii) increased by the share of the recapitalisation.

2010 financial year, 115% for the 2011-2017 financial years and 125% for the 2018 financial year and following financial years.

(53) With regard to the coupon, its entry rate is equal to that of the deeply subordinated debt instruments but subsequently increases by 25 basis points per annum up to a maximum of 150 basis points. The coupon on the deeply subordinated debt instruments is fixed. If deeply subordinated debt instruments are used, over a period of five years the average annual return received by the French authorities will be above 9%. Whereas if preference shares are used, over a period of five years the average annual return should be higher by at least 85 basis points.

(54) As regards the payment of a dividend, the percentage is at least 110% the first year and may reach 125%.

(55) Account should also be taken of the conditions for buy-back of preference shares, which will be for a price at least equal to 110% of the actual amount.

(56) In the light of the above, it may be concluded that the overall return on the preference shares is higher than on the deeply subordinated debt instruments and therefore reflects correctly that instrument's greater degree of subordination and therefore higher risk.

(57) Moreover, the conditions of remuneration, in particular the increase in the coupon over time, the dividends and the ceiling for share buy-back (120% of the subscription price before 30 June 2013 rising to 160% from 1 July 2022) act as an exit incentive that ensures that beneficiaries will return to capital markets as soon as the situation has eased and also encourage beneficiary banks to limit the length of time the State holds preference shares.

(58) With regard to the increase of EUR 500 million in the total budget to allow for the merger of Caisses d'Epargne and Banques Populaires, it seem strictly proportional to the need to take account of the constraints associated with the planned merger. As indicated above, the sole purpose of the increase is to ensure that the merged entity can increase its Tier 1 ratio under the same conditions as other beneficiary banks.

(59) Finally, extending the duration of the scheme until 30 August 2009 does not appear disproportionate, having regard to the current market conditions and additional constraints involved in recourse to preference shares. On this point, to the extent that the duration of the scheme is extended, the Commission calls on the French authorities to submit a report on implementation of the scheme at the end of the extended period.

(60) For all the above reasons, the Commission takes the view that the measure is proportionate, having regard to the risks of serious disturbance to the economy.

4. CONCLUSION

(61) The Commission has therefore decided that the change to the recapitalisation scheme is compatible with the common market by virtue of the exemption provided for in Article 87(3)(b) of the EC Treaty.

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Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission