EUROPEAN COMMISSION

Brussels, 03.09.2009
C(2009)6740 final

Subject: **State aid N 355/2009 - Hungary**
Prolongation and modification of the Hungarian bank support scheme N 664/2008

Sir,

1. PROCEDURE

(1) On 15 June 2009 Hungary notified a request to prolong and modify its guarantee and recapitalisation scheme (hereinafter "the Original Scheme" or "the Scheme") for banks in Hungary.

(2) The Original Scheme, notified on 22 December 2008, was approved by Commission decision of 12 February 2009 in State aid case N 664/2008 (hereinafter "the Original decision")[1].

(3) Following the notification, a request for information was sent to Hungary on 14 July 2009. Hungary replied on 12 August 2009. Hungary submitted further information on 24 August 2009.

2. DESCRIPTION

2.1 Objective of the Scheme

(4) In response to the exceptional turbulence in global financial markets, Hungary brought forward a scheme for banks in Hungary, designed to restore stability of

[1] Commission decision C(2009) 993 final; OJ C 147, 27.06.2009, p.2.

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the financial system and to remedy a serious disturbance in the Hungarian economy.

(5) The Scheme consisted of two measures, a recapitalisation measure and a guarantee measure.

2.2 The Original Scheme (Commission Decision of 12 February 2009)

(6) The Beneficiaries of the Scheme are fundamentally sound credit institutions of systemic importance established in Hungary[2].

A – The Recapitalisation Scheme

(7) Under the recapitalisation scheme, the Hungarian State was empowered to undertake the recapitalisation of certain financial institutions with an overall budget of HUF 300 billion. The measure aimed at increasing the capital adequacy ratio of the participating banks in order to strengthen the credit institutions' capital base and thereby boost the confidence of other market players.

(8) The measure expired on 31 March 2009.

(9) The recapitalisation takes the form of preference shares, designed to be classified as Tier 1 capital. The objective of the recapitalisation is to bring the participating banks' Capital Adequacy Ratio (CAR) up to […] [*] %.

(10) The preference shares are non-cumulative, senior to all other categories of shares as regards payout of dividends and bear no voting rights. The Scheme provided that the preference shares were issued at nominal price, i.e. the amount of recapitalisation equals the face value of the shares.

(11) The remuneration of the preference shares is a combination of an annual interest plus a step up clause related to the redemption price.

(12) The annual return on the preference shares has been calculated in line with the recommendations of the European Central Bank (ECB) of 20 November 2008, which are the following:

- the average yield of the benchmark 5 year EMU government bond[3] in the preceding 20 working days;
- the average sovereign yield spread between the 5 year HUF denominated government bonds and the 5 year EMU benchmark government bond over the period 1 January 2007 and 31 August 2008;
- since there is no reliable CDS data available for Hungarian banks, the median CDS spread of euro area banks with a rating "A" was used;
- an add-on fee of […]% to cover operational costs;
- an add-on fee of […]% (required since preference shares are the choice of recapitalisation instrument in this case).

[2] Including subsidiaries of foreign banks but excluding banks operating in the form of branch offices.

[*] Confidential information

[3] The benchmark EMU bond is the German 5 year government bond.

(13) According to the Hungarian Authorities, as a result of the above figures, the expected annual return on the preference shares will be […]% above the relevant benchmark rate[4] at the time of the investment.

(14) Furthermore, in order to provide an incentive to the banks to redeem the state capital as soon as circumstances make it possible, the amount that has to be repaid to the state increases by a step-up of […] percentage point each year.[5]

B – The Guarantee Scheme

(15) Under the guarantee scheme, the Hungarian state is empowered to make available a State guarantee to the credit institutions covering new debt.

(16) The guarantees cover any new debt issued up to 30 June 2009. Only interbank lending activities are guaranteed, subordinated loans and capital investment are not covered by the measure. The maximum amount that can be guaranteed is HUF 1500 billion[6].

(17) The guarantee is limited in so far as only debt with duration from 3 months up to 5 years is eligible[7].

(18) The guarantee will be provided for a fee of 123.50 basis points, calculated based on the European Central Bank Recommendations on Government Guarantees on Bank Debt (hereinafter: "ECB recommendation").

C - Veto Right and Behavioural Conditions

(19) As a safeguard element, the recapitalisation and the guarantee are coupled with the subscription of the state to a so called special veto share.

(20) The veto shares have a symbolic price, since their aim is to enable the State to object to decisions which would lead to a misuse of the funds or which would be detrimental to the stability of the financial system.

(21) Moreover, each participating credit institution is obliged not to advertise the state interventions and the State may introduce limitation in the salary, remuneration and benefits for the top managers of the financial institutions concerned during the existence of the State participation.

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4 Since the first figure in the above calculation (average yield of the 5 year German government bonds in the period of 20 working days prior to the capital injection) depends on the exact date of the recapitalisation concerned, it is only possible to give an indicative benchmark. In this regard, if a recapitalisation took place on 17 January (prior to the Original Decision), when the benchmark interest rate would have been calculated at 2.3%, the annual interest rate on the preference shares would have been […]%. On 21 August 2009, the benchmark interest rate would be 2.4 %, therefore the annual interest rate on the preference shares would be […]%.

5 Paragraphs 15-17 of the Original Decision.

6 HUF 1500 billion is equivalent to approximately EUR 5.6 billion using exchange rates of 28 July 2009.

7 As it is foreseen by the Original Decision, the amount of the guarantee for loans exceeding 3 years is limited to one third of the scheme's budget and in any case cannot exceed HUF 450 billion

2.3 Operation of the Scheme to Date

(22) Only one bank participated in the recapitalisation measure, FHB Jelzálogbank Nyrt. The bank received HUF 30 billion[8] in recapitalisation in the form of preference shares.

(23) According to the Hungarian Authorities, the fact that only one bank used the measure is due to the very short time window left between the approval of the Scheme by the Commission (12 February 2009) and the expiry date of the recapitalisation Scheme (31 March 2009).

(24) The guarantee measure has not been used. According to the Hungarian Authorities, the downgrading of the risk rating of the Hungarian State shortly after the approval of the measure has not helped to alleviate the shortfall in funding supply for Hungarian banks.

(25) According to the Hungarian Authorities, the comprehensive economic programme introduced recently by the Hungarian Government will help to re-establish market confidence in the Hungarian State and ultimately result in an upgrade of its risk rating. This should then make the funding covered by the State guarantee more attractive for the banks.

2.4 Description of the Proposed Amendment

(26) The modification relates to the subscription price of the preference shares for the recapitalisation of banks. Hungary would like to delete from the decision the reference that the subscription pricewill be equal to the nominal value of the recapitalisation[9].

(27) According to the Hungarian Authorities, it has been realised only after the Commission decision that this provision might be in contradiction with certain provisions of the Act on Business Associations[10]. The Act of Business Association provides that: "The total nominal value of all issued ordinary shares of a limited company shall be higher than half of the total share capital of the limited company at all times"[11]. Depending on the size of the recapitalisation and the amount of ordinary shares, a recapitalisation might breach this rule. Therefore, it should be possible for the preference share to have a nominal value different from subscription price.

(28) The return on the preference shares and the total amount of recapitalisation as a proportion of risk weighted assets will however always be calculated on the subscription price, so this modification will not affect the remuneration of the preference shares and the assessment of the magnitude of the recapitalisation.

(29) In addition, the Hungarian Authorities confirm that the preference shares are non-convertible and emphasise that there is no voting right attached to the preference share.

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8 HUF 30 billion is about EUR 112 million using exchange rates of 28 July 2009.

9 According to point 14 of the original decision, "the preference shares will be issued at nominal price, i.e. the amount of recapitalisation equals the face value of the shares".

10 Act IV of 2006, "2006. évi IV. törvény a gazdasági társaságokról".

11 "A részvénytársaság által kibocsátott törzsrészvények névértéke összegének mindenkor meg kell haladnia a részvénytársaság alaptőkéjének a felét."

(30) All other conditions as approved by the Commission on 12 February 2009 remain unchanged and Hungary confirms that all the commitments made in relation to the Original Scheme continue to apply.

2.5 Prolongation of the Scheme

(31) As regards the recapitalisation scheme, it was aimed at building and maintaining an adequate buffer of capital for the credit institutions concerned, thus enhancing their liquidity and their lending ability to the real economy. The current financial and global economic crisis is still affecting Hungary, and because of the very short time window only one financial institution was able to take part of the Scheme. Hungary would like to extend the deadline for participation in the Scheme to 31 December to allow other banks to participate and hence allow the Scheme to meet the goal initially set.

(32) As regards the guarantee scheme, Hungary claims that the financial crisis continues to impede access to liquidity for Hungarian banks. However, the current perception of risk of the sovereign is such that the guarantee of Hungary is not opening up access to funding. However, Hungary believes that the measures being put in place to restore the economic stability of the country will ultimately result in a lowering of the sovereign risk and make the guarantee more attractive. Therefore they would like to extend the temporal scope of the guarantee scheme to 31 December 2009.

(33) In the context of the prolongation, the Hungarian Authorities agree to maintain their commitment or to commit to the following:

(a) To submit to the Commission a full update on the implementation of the recapitalisation and guarantee schemes six months from the date of prolongation. The content of this report will be in line with the requirements of point 40 of the Recapitalisation Communication[12].

(b) To inform the Commission ex ante of each recapitalisation under the scheme and to provide the Commission with all relevant information necessary to allow it to take an informed view on whether the beneficiary institution in question can be considered fundamentally sound or unsound. Moreover, in the event that a bank receives a second capital injection under the scheme, the Hungarian authorities commit to notify this measure individually to the Commission.

(c) To limit the issuance window of any guaranteed debt to the duration of the scheme. No guaranteed debt will be issued beyond the expiry date of the guarantee scheme.

(d) To submit a restructuring plan if the guarantee is called upon for any participating institution at any time or if a participating bank initially considered as fundamentally sound falls into difficulties after recapitalisation.

(e) For banks which are not fundamentally sound and submit a restructuring plan, to commit to ensure that in future contracts concluded between Hungary and banks for recapitalisations, Hungary will prohibit banks from

12 Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum and safeguards against undue distortions of competition. OJ C 10 of 15.1.2009, p.2.

using reserves for the purpose of paying coupons on hybrid instruments for as long as they benefit from State capital. Whilst existing contracts between banks and hybrid capital investors cannot be changed, Hungary commits to try to persuade banks regarding existing contracts not to use reserves for the purpose of paying coupons on hybrid instruments as long they benefit from State capital insofar this is legally possible.

3. POSITION OF HUNGARY

(34) In line with the original decision, Hungary accepts that the Prolonged Scheme constitutes State aid within the meaning of Article 87(1) EC Treaty.

(35) Hungary seeks the authorisation of the prolongation to 31 December 2009. According to the Hungarian Authorities, the measures contained in the Scheme are necessary and proportionate to restore financial stability in Hungary.

(36) The Hungarian Authorities claim that the prolongation, like the Original Scheme, is compatible with the common market, because due to the ongoing crisis it is necessary to remedy a serious disturbance in the Hungarian economy pursuant to Article 87(3)(b) EC Treaty.

4. ASSESSMENT OF THE MEASURE

4.1 State aid character of the Scheme

(37) As set out in Article 87(1) 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.

(38) For the reasons indicated in the original decision, the Commission considers that the Scheme constitutes State aid within the meaning of Article 87(1) EC Treaty. Hungary shares this position.

4.2 Compatibility

(39) In its decision of 12 February 2009 the Commission considered the notified measures compatible with the common market under Article 87(3)(b) EC Treaty.

(40) The recapitalisation and guarantee scheme's objectives are to restore market confidence in banks through improved capital buffers and improved liquidity and ultimately to avoid any negative spill over on the Hungarian real economy.

(41) The Commission notes that the original time window for participation in the recapitalisation scheme was short, preventing it from being used to a fuller extent.

(42) The Commission notes too that because of the downgrading of Hungary sovereign risk rating, the guarantee scheme has not helped in improving the

banks' access to funding. Consequently the guarantee scheme has not yet contributed to improving the banks' liquidity positions.

(43) Therefore the Commission understands that the timing and the conditions of the implementation of the Scheme to date have not allowed for the optimisation of its results. In addition, the Commission considers that the exceptional circumstances at the origin of those notified measures still persist.[13] Therefore, the Commission recognises that the prolongation of the validity of the scheme until 31 December 2009 is still appropriate and necessary to remedy the disturbance of the Hungarian economy.

(44) The Commission views the proposed modification of the Scheme as technical in nature and having no impact on the substance of the Scheme.

(45) The prolongation of the Original Scheme does not therefore contain any substantial modification of the measures already approved. The Commission notes that Hungary confirms that all the commitments made in relation to the Original Scheme will continue to apply, in particular those related to presenting every six months a report on the operation of the Scheme and submitting individual restructuring or liquidation plans within six months for banks that default on their liabilities and which cause the State guarantee to be called upon for banks for which existing liabilities were guaranteed.

(46) Furthermore, the Commission notes that the extension is limited in time (not exceeding six months) which will limit the potential distortion of competition. Accordingly, recapitalisations and debt instruments guaranteed under this Scheme may be undertaken or issued during an entry window to 31 December 2009. Any further extension will require the Commission's approval and will have to be based on a review of the Scheme's effectiveness in view of the monitoring report Hungary has undertaken to submit to the Commission.

(47) The Commission therefore does not object to prolonging the measures under the Scheme until 31 December 2009.

5. DECISION

The Commission concludes that the prolongation in question does not alter its previous assessment in the decision of 12 February 2009 in State aid case N 664/2008 that the measures under the Scheme are compatible with the common market. The Commission has accordingly decided not to raise objections. The Commission notes that Hungary accepts the decision to be adopted in the English language.

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[13] According to the Hungarian authorities, the lack of long-term liquidity source on the market is still exists. Moreover, as regards the Hungarian economy as a whole, in its statement of August 2009, the MNB reports that the Hungarian GDP will likely to contract by 6.7% in 2009 and to decline further by 0.9% in 2010. The inflation on the basis of the consumer price index is forecasted 4.5% in 2009 and 4.1% in 2010. Although the HUF has gained in value in recent months, the EUR/HUF exchange rate remains volatile. In essence, markets are still characterised by uncertainty.

deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/community_law/state_aids/state_aids_texts_en.htm .

Your request should be sent by registered letter or fax to:

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Yours faithfully,
For the Commission

Neelie KROES
Member of the Commission