Brussels, 12.5.2009
C(2009) 3828 final

Subject: State aid N241/2009 – Ireland
Recapitalisation of Allied Irish Bank by the Irish State

Sir,

I. PROCEDURE

(1) On 11 February 2009, the Irish Government announced its intention to inject €3.5 billion (the “measure at issue”) into Allied Irish Banks p.l.c. (“AIB” or the “Bank”), subject to shareholders' approval and approval by the European Commission under State aid rules. Following a number of preliminary contacts, the Irish authorities formally notified to the Commission the measure at issue on 22 April 2009.

II DESCRIPTION OF THE MEASURE

1. The Beneficiary

(2) Allied Irish Bank has a balance sheet size in excess of €182 billion (approximately 90% of the Irish GDP) and accounts for a significant share of customer deposits and lending in the Irish economy. It is one of the two largest banks in Ireland, with 183 main branches, 89 sub-offices and 13 business centres. It has approximately 6,940 staff. In terms of market share in Ireland, the Bank has approximately: […] of personal current accounts, […] of mortgages, […] of savings and […] of SME current accounts.

(3) AIB is a diversified financial services group which offers a full range of personal and corporate banking services. Relationship banking and investment management business account for more than 90% of AIB's activities. According to its Preliminary Results 2008, AIB had total deposits of approximately €155,996 million which consisted of customer deposits (€92,604 million), deposits by banks (€25,578 million)

* Confidential information also indicated below as […]

Mr Micheál MARTIN,
Minister for Foreign Affairs,
Department of Foreign Affairs
80, St. Stephen's Green,
Dublin 2,
Ireland

Commission européenne, B-1049 Bruxelles – Belgique
Europese Commissie, B-1049 Brussel – België
Telephone: 00-32 (0) 2 299 11.11.
and debt securities in issue (€37,814 million). As of the same date, AIB’s loan book was approximately €135,755 million. The loan to deposit ratio was 140%.

(4) AIB’s shares are quoted on the Dublin, London and New York stock exchanges. Its head office is located in Dublin and the Irish Financial Regulator is the lead regulator. AIB’s principal countries of operation are Ireland, Poland, the United Kingdom and the US although it also has locations in Jersey, France, Isle of Man, Hungary, Switzerland, Luxembourg, Canada and Australia. According to the Preliminary Results 2008, the Bank’s profit generation was distributed between Ireland (50%), Poland (16%), the United Kingdom (30%), the United States (3%) and the rest of the world (1%). According to the Irish authorities, AIB is of key importance to the maintenance of stability of the Irish financial system.

(5) According to the Bank’s Preliminary Results for the year ended 31 December 2008 (the “Preliminary Results 2008”), the Bank had a total loan book of €135,755 million made up of the following:

- residential mortgages: 24%
- property and construction: 36%
- services: 12%
- transport and distribution: 11%
- personal: 7%
- manufacturing: 5%
- agriculture: 2% and
- other: 3%

According to the Preliminary Results 2008, total provisions for impaired loans were €1,849 million and impaired loans constituted 2.3% of total customer loans.

(6) According to the IFSRA, the Irish Financial Services Regulatory Authority, AIB is fully in compliance with regulatory capital requirements. As at 31 December 2008, its Core Tier 1 capital amounted to €7,727 million (5.8%), its Tier 1 capital amounted to c. €9,906 million, which is approximately 7.4% of risk-weighted assets and its total capital to €14,050 million. According to a report the Irish authorities commissioned to PricewaterhouseCoopers ("PwC"), the capital position of AIB, was in excess of regulatory requirements as of 30th September 2008 and under a number of stress scenarios, its capital level will remain above regulatory minimum levels in the period to 2011. However, it has a strong requirement for additional Core Tier 1 capital in order to reassure the market regarding its capacity to fully provide for anticipated losses on its loan book. Market feedback is that there would be little if any private investment in an ordinary share rights issue or preference share issue by the Bank at this time.

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1 This report was carried out by Pricewaterhouse Coopers for IFSRA on the financial position of the six main Irish financial institutions participating in the Guarantee Scheme (the PwC Report).
AIB 5 Yr Senior debt CDS data went up from 205 bps on 18 December 2008 to 577 bps on 26 March 2009.

As to its rating, AIB ratings were downgraded on 12 February 2009 to Moody's Aa3 and S&P A. The outlooks are Negative and Stable respectively.

2. The events triggering the Measure

The decision to inject €3.5 billion into Allied Irish Bank was taken in light of the impact of the current global financial crisis on the Bank which has led to deterioration in its financial position. The measure at issue aims to ensure that the Bank is adequately capitalised to preserve financial stability, that its capital ratio levels meet the expectations of international investors and to facilitate lending to the real economy.

AIB is one of the financial institutions covered by the Irish Guarantee Scheme for financial institutions (“the Guarantee Scheme”), which was adopted under the Credit Institutions (Financial Support) Act, 2008 (hereafter the “CI(FS) Act”), and approved by the Commission under State aid Rules on 13 October 2008. The liabilities covered under the Guarantee Scheme were those liabilities existing at close of business on 29 September 2008 or at any time thereafter, up to and including 29 September 2010, in respect of the following: (i) all retail and corporate deposits (to the extent not covered by existing deposit protection schemes in the State or any other jurisdiction); (ii) interbank deposits; (iii) senior unsecured debt; (iv) asset covered securities; and (v) dated subordinated debt (Lower Tier 2), excluding any intra-group borrowing and any debt due to the European Central Bank arising from Eurosystem monetary operations. It is estimated that the total covered liabilities under the Guarantee Scheme amount to approximately €139 billion.

Despite its coverage under the Guarantee Scheme, market perceptions concerning the inadequacy of Allied Irish Bank’s capital ratio levels have led to deterioration in investor sentiment with regard to the Bank. The Bank’s shares have experienced a significant deterioration in value from around €7.5 in early October, 2008 to the position of €1.080 on 11 February 2009, when the Government announced the decision to make the State investment in the Bank with a market capitalisation of €953.38 million. Over the previous twelve months, the Bank’s shares had traded as high as €15.10, with a market capitalisation of €13,336 million. As a result, the Bank’s shares have lost more than 92% of their value over the last 12 months.

The primary objective of the Guarantee Scheme was to address the loss of confidence in interbank lending markets that led to liquidity difficulties for even fundamentally sound banks. The Guarantee Scheme was successful in stabilising the liquidity position of the Bank which, along with the other main banks in Ireland, was at the time at substantial risk of deterioration in its liquidity position. However, the Guarantee Scheme, which addresses liquidity difficulties, was not designed to address market perceptions concerning the adequacy of capital ratio levels of banks. The market perception of AIB is that, notwithstanding increased provisioning, it has underprovided for its loan risks in the light of the significant deterioration in the Irish property market and in the wider economy, and the share price has fallen sharply accordingly. In addition to difficulties caused by the global financial crisis, the deterioration in the financial position of the Bank has been accelerated by recent developments concerning Anglo Irish Bank Corporation plc (‘Anglo Irish Bank’) which, as a result of these
developments, was taken into public ownership pursuant to the Anglo Irish Bank Corporation Act 2009 on 21 January 2009. The developments concerning Anglo Irish Bank have had a negative effect on market investor sentiment towards Irish banks generally and this has impacted on the financial position of Allied Irish Bank.

3. The decision to intervene

(13) In these circumstances, the Irish Government, in consultation with the Governor of the Central Bank of Ireland (the “Governor”) and the Financial Regulator, decided that it was necessary for the State to take measures in relation to AIB in order to avoid further deterioration in the market investor sentiment in relation to the Bank, which, in turn, would represent a threat to the stability of both the financial system in the State and the wider economy. In particular, a loss of confidence in AIB could undermine confidence in the Irish financial sector as a whole, which is very dependant upon international funding through wholesale money markets. This would constitute a serious risk of a systemic crisis in the Irish financial system, which, in turn, would have significant negative spill-over effects into the wider economy. For these reasons, on 11 February 2009, the Irish Government announced the decision to take the measure at issue. The objectives of the capital injection into the Bank are to ensure that it is adequately capitalised to preserve financial stability and to ensure that the Bank’s capital ratio levels meet the expectations of international investors. The capital injection is also based on the results of a recent detailed review of the Bank’s loan book carried out on behalf of the Financial Regulator and the assessment that there was a low likelihood that AIB would be successful in raising additional equity from existing shareholders and new private investors at this time.

(14) A further objective pursued by the State is to facilitate lending to the real economy. The measure at issue is part of a wider Government Bank recapitalisation programme, the object of which is to ensure that the financial system in Ireland is capitalised to meet the everyday financial needs of individuals, businesses and the overall economy. In the Government announcement on 21 December, 2008, the Minister for Finance (the “Minister”) stated that "it is appropriate as part of the agreed recapitalisation programme that the banks should further build on the commitments given in the banks guarantee scheme through specific credit policies targeted at small medium enterprises, first time buyers and consumers generally. The banks will be expected to contribute to the economy in a verifiable manner in relation to credit and in relation to the maintenance of a payments system which is socially inclusive".

(15) In furtherance of these objectives, AIB agreed at the time of the Government’s announcement on 21 December 2008 to a credit package (the “Credit Package”). In the context of the Government announcement of 11 February 2009, AIB agreed to updated commitments to ensure lending to the real economy which form a bank customer package (the “Bank Customer Package”).

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2 The Irish authorities have not submitted a recapitalization scheme for the Commission's approval but expressed their intention to notify separately each individual case of recapitalization of banks in Ireland.
On 20 April, 2009, AIB issued a press release in which it announced that, following discussions with the Minister for Finance, the Bank has decided to take further action to strengthen its capital position over and above the State investment. The Minister issued a response to the AIB press release on 20th April, 2009. In advance of the State investment in AIB, the National Pensions Reserve Fund Commission (the “NPRF Commission”) has been carrying out a full due diligence exercise in relation to the Bank, with the assistance of PwC. This due diligence has shown that in certain extreme stress test scenarios AIB’s Core Tier 1 capital could need to be further strengthened. On this basis, the Minister and AIB have formed the view that it would be appropriate to strengthen the Bank’s capital position by a total amount of €5 billion new Core Tier 1 capital. Therefore, in addition to the State investment, the Bank aims to increase its Core Tier 1 capital by a further €1.5 billion before the end of 2009. In the event that the State proposes to make a further capital injection in the Bank in this context, any such measure would be notified separately to the Commission under EC State aid rules.

On 7 April, 2009, as part of the Minister’s Financial Statement on a Supplementary Budget, the Minister announced a proposal to bring forward measures to address the issue of asset quality in the Irish banking system. A National Asset Management Agency (“NAMA”) will be established on a statutory basis, under the aegis of the National Treasury Management Agency (the “NTMA”). Assets will be transferred from banks to NAMA with the purpose of ensuring that banks have a clean bill of health, their balance sheets are strengthened and uncertainty over bad debts is reduced. The purpose of the initiative is to ensure a sustained flow of credit on a commercial basis to individuals, households and businesses in the real economy. In its press release of 20 April, 2009, AIB signaled its intention to participate in the NAMA initiative. The NAMA initiative will be notified separately to the Commission under EC State aid rules.

The Measure

The Measure at issue is a €3.5 billion capital injection into the Bank in the form of Core Tier 1 New Preference Shares, which are non-cumulative perpetual preference shares plus detachable warrants (the ‘Warrants’). The Financial Regulator has confirmed that the New Preference Shares will be treated as Core Tier 1 Capital for regulatory capital purposes. The State investment will boost AIB’s Core Tier 1 capital ratio from 5.8% to 8.4% and its Tier 1 capital ratio will increase from 7.4% to 10%. The size of the capital increase represents 2.61% of the Bank’s risk weighted assets (RWA is €133,895 million as at 31 December 2008).

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AIB Preliminary Results 2008
Current Core Tier 1: EUR 7,727 million
Current RWA: EUR 133,895 million
Current Core Tier 1 ratio of 5.8%

Source AIB Preliminary Results 2008
After EUR 3.5 billion capital injection, pro forma Core Tier 1: EUR 11,227 million
Current RWA: EUR 133,895 million
Pro forma Core Tier 1 ratio of 8.4%
It is anticipated that the New Preference Shares will be acquired by the National Pensions Reserve Fund Commission (the “NPRF Commission”) which, pursuant to the National Pensions Reserve Fund Act (the "NPRF Act") 2000, would act under direction from, and on behalf of, the Minister in acquiring the New Preference Shares. The State investment will be financed by the National Pensions Reserve Fund ("NPRF") on behalf of the Government through a combination of the NPRF's current resources and through the frontloading of Exchequer contributions to the NPRF for 2009 and 2010.

The NPRF was established in April 2001 pursuant to the NPRF Act. Its objective is to meet as much as possible of the costs of social welfare and public service pensions from 2025 onwards when these costs are projected to increase dramatically due to the demographic profile of the Irish population. According to the NPRF Act, any revenues from the investments of the Fund will return to the Fund itself.

The NPRF is controlled and managed by the NPRF Commission. The NPRF Commission’s functions include the determination and implementation of the NPRF’s investment strategy in accordance with its statutory investment strategy. The National Treasury Management Agency (“NTMA”) has been appointed as the Manager of the NPRF (the “Manager”) until April 2011 and the NPRF Commission is required to perform its functions through the Manager.

The New Preference Shares are a hybrid form of Core Tier 1 capital. They are subordinated and non-cumulative and have a fixed dividend of 8% (or the right to shares in lieu) with detachable warrants. The dividend is payable annually in cash at the discretion of the Bank. If no cash dividend is paid, then ordinary shares are issued in lieu at a time no later than the date on which the Bank subsequently pays a cash dividend on other Core Tier 1 capital. The share value is calculated on the basis of the average closing price over the 30 trading days immediately preceding the annual dividend payment date. It is therefore fixed at that time and is unaffected by subsequent changes in share price. If the shares in lieu are not issued on the dividend payment date, a 5% discount is applied to the share value resulting in more ordinary shares being issued. The voting rights associated with such shares may be exercised from the date the dividend became payable.

In relation to dividends, the State's New Preference Shares rank pari passu with other Core Tier 1 instruments (preference shares) and in priority to dividends on ordinary shares. If no dividend is paid on the New Preference Shares, no dividend can be paid on ordinary shares or on other Core Tier 1 capital instruments. Since preference shares rank above ordinary shares, if there is no dividend paid to the ordinary shareholders, the bank still has discretion as whether to pay a dividend on the preference shares.

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5 The State investment will be made pursuant to the provisions of the NPRF Act 2000 (as amended pursuant to the provisions of the Investment of the National Pensions Reserve Fund and Miscellaneous Provisions Act 2009) NPRF Act: Number 33 of 2000. The amendments to the NPRF Act 2000 aim to enable the NPRF Commission to undertake this investment and ensure it is in accordance with its investment strategy.

6 Further details on the NPRF can be obtained at www.nprf.ie.
AIB may defer the issue of shares in lieu beyond the annual dividend payment date but may not defer it beyond the date on which the Bank next a) pays a cash dividend on preference shares or other shares of capital and b) redeems or purchases any of the preference shares or other capital. If any of the New Preference Shares are redeemed (in accordance with the repurchase or early redemption clauses), the dividend will still be payable on the remaining shares.

The new Preference Shares will carry voting rights in AIB in respect of a limited number of matters.

Redemption/repurchase is at the option/discretion of the Bank. The Bank can repurchase the New Preference Shares at par in the first five years and at 125% of par thereafter. Therefore, if the Bank does not repurchase the New Preference Shares within five years, it must pay a premium of 25%. Repurchase may be made from profits available for distribution or from replacement capital which qualifies as Core Tier 1, in each case subject to the approval of the Financial Regulator.

An arrangement fee of €30 million is payable to the State by the Bank on closing.

On purchase of the New Preference Shares, the State will receive detachable Warrants for the equivalent of constituting 25% of the ordinary share capital of the Bank existing on the exercise date of the Warrants calculated on a post-dilution basis. The State may exercise this option from the fifth to the tenth anniversary of the purchase of the New Preference Shares.

If the Bank redeems up to €1.5bn in New Preference Shares from privately sourced Core Tier 1 capital prior to 31 December 2009, then the Warrants will be reduced pro rata to that redemption to an amount representing not less than 15% (the “Core Tranche”) of the existing ordinary shares of the Bank.

The strike price of the Core Tranche of the Warrants shall be €0.975. The strike price of the balance of the Warrants granted to the State shall be €0.375. The strike price is low compared to, for instance, the price as which the Bank's shares had traded over the last twelve months i.e. as high as €15.10 or on October 2008 (€7.50). Market standard anti-dilution protection will apply.

The State will vote no more than 50% of the votes associated with the ordinary shares which it receives through exercise of the Warrants. The State will have a right to 25% of the total votes on the appointment of directors for as long as any preference shares remain outstanding. If the State transfers the ordinary shares to a non-State third party, full voting rights will be restored to these shares.

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7 The significantly reduced strike price for the balance of the warrants over the Core Tranche is intended as an added incentive for the Bank to seek earlier redemption of up to €1.5 billion of the new preference shares prior to 31st December 2009 (as this would extinguish the State's right to the issue of ordinary shares at the reduced strike price).

8 In order to avoid the State controlling the Board, this 25% cap will remain no matter how many ordinary shares in the Bank the State may be issued pursuant to the exercise of the warrants or in lieu of payment of cash dividends.
The estimated internal rate of return on the State investment under a number of different scenarios is presented in the table below:

<table>
<thead>
<tr>
<th>Amount of Warrants</th>
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<td>15%</td>
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<td>25%</td>
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**IRR's under various scenarios – AIB**

(A) Share Price €0 Preference Shares redeemed at par 8% 8%
(B) Share Price €0 Preference Shares redeemed at 125% after year 5 12.10% 12.56%
(C) Share Price €7.5 Preference Shares redeemed at par 15.66% 17.46%
(D) Share Price €7.5 Preference Shares redeemed at 125% after year 5 18.72% 20.74%

The estimates above assume that the New Preference Shares coupon is paid at each due date and that the Warrants are exercised immediately prior to sale at year 5 or thereafter. Two scenarios are considered with regard to the amount of Warrants held by the State: (1) where the Warrants are not reduced and the State retains the rights to 25% of ordinary shares and (2) where the Warrants are reduced to 15% as a result of early redemption of New Preference Shares. The estimates in (C) and (D) are based on the assumption that the Bank’s ordinary shares would trade at net asset value (€7.5) at the time of exercise of the Warrants.9

Under the terms and conditions of the State investment, AIB has committed to draw up and submit within six months a plan which will be submitted to the Commission for assessment and approval. This plan will address the following issues:

a) presentation and analysis of the Bank’s strategy and business model to ensure its long-term viability in a reasonable timeframe so that it can continue to meet the credit needs of the economy thereby underpinning economic recovery;

b) minimisation of State aid, including ensuring the participation of the Bank and its shareholders to any restructuring costs that arise; and

c) minimisation of competition distortions as a consequence of the State investment.

While any New Preference Shares are outstanding, the Minister will have the right to directly appoint 25% of the Directors of the Board of the Bank (inclusive of the two directors appointed under the Guarantee Scheme, but this right will be unaffected by the expiry of the Guarantee Scheme).

In addition, in the context of the Government’s recapitalisation programme, Allied Irish Bank has agreed to a series of conditions in relation to sustaining lending to the real economy and the maintenance of a payments system which is socially inclusive. These conditions are focused on SMEs and individuals. They include increased capacity for lending to SMEs by 10% and first time buyers by 30%, and to the extent

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9 According to the Irish authorities, it is conceivable that the share price would trade in excess of this price at the time the warrants may be exercised. Indeed, the Bank's share price over the previous twelve months has traded as high as €15.10.
that this is not taken up in any quarter, it will be redirected to SMEs in the following quarter, new codes of practice for business lending to SMEs and increased assistance for householders in arrears on mortgage repayments, including a commitment not to seek legal action for at least six months and not to commence court proceedings for repossession of a principal residence within twelve (12) months. According to the Irish authorities, credit granted by AIB under the credit package will be issued on a commercial basis and such measures will not entail any selective advantage to undertakings. In case these measures would entail elements of State aid, the Irish authorities committed to notify them to the Commission separately for assessment under the State aid rules.

(37) Finally, AIB continues to be subject to the behavioural conditions and transparency and reporting conditions that may be imposed under paragraphs 24 to 50 of the Guarantee Scheme. In particular, AIB has been required to prepare and submit a strategic report to the Department setting out how it proposes to align the future direction of the Bank to meet the objectives of the Guarantee Scheme, as well as regular reports describing the progress made in complying with these objectives. In this respect, the following measures can be mentioned:

- Board of Directors: AIB has appointed two directors representative of the public interest nominated by the Minister to its Board;

- Remuneration arrangements for directors and executives: AIB has provided a plan for review by the Covered Institutions Remuneration Oversight Committee (CIROC) under the Guarantee Scheme on the proposed structure of the remuneration packages of the directors and executives of the bank so as to take into account the objectives of the CI(FS) Act and in order to comply with the requirements of the Guarantee Scheme;

- Ban on dividends until further notice (non applicable to the dividend payable to the State under the terms of the State investment);

- Prohibition of buy-backs without prior approval of the Financial Regulator after consultation with the Minister;

- Prohibition of funding initiatives without prior consultation;

- Prior consultation in relation to public disclosures concerning its assets;

- Prohibition on advertising on the basis of the Guarantee Scheme;

- Corporate Social Responsibility arrangements;

- Controls over recourse to interbank deposits;

- Requirements for quarterly compliance certificates in relation to the terms and objectives of the Guarantee Scheme; and

- Risk management arrangements to guard against technical default under the Guarantee.
An Extraordinary General Meeting (“EGM”) of the Bank in relation to the State investment is scheduled on 13 May, 2009 and, subject to shareholder approval at the EGM, the State investment is anticipated to take place on the same day or as soon as possible thereafter.

4. Position of Ireland

The Irish Government notes that the current global financial crisis has led to a sudden and dramatic increase in the market’s perception of the risks contained in banks’ balance sheets. Consequently, international capital market expectations in relation to capital levels for financial institutions have risen significantly. In particular, markets and rating agencies have increasingly focussed on the adequacy of Tier 1 capital and Core Tier 1 capital.

According to the Irish Government, the decision to inject €3.5 billion in Allied Irish Bank was taken in the light of the impact of the current global financial crisis on the Bank where market perceptions concerning the inadequacy of its capital ratio levels have led to a serious deterioration in investor sentiment with regard to the Bank and its financial position. The objectives of the State investment are to ensure that AIB is adequately capitalised to preserve financial stability, to ensure that the Bank’s capital ratio levels meet the expectations of international investors and to facilitate lending to the real economy.

The Irish authorities accept that, in the current market circumstances, the State investment may contain elements of State aid. However, they are of the view that the State investment is compatible with the Common Market on the basis of Article 87(3)(b) EC Treaty as it is necessary in order to remedy a serious disturbance in the Irish economy. The Irish authorities consider that the terms and conditions of the State investment, in particular the terms of remuneration and the redemption terms, are designed to encourage AIB to redeem the Minister's investment as soon as market circumstances permit.

The Irish Government, together with Allied Irish Bank, have provided the following commitments:

- AIB commits that it will refrain from mass marketing invoking the Measure as an advantage in competitive terms.

- AIB has committed to draw up and submit within six months a plan, along the lines of a restructuring plan within the meaning of the Commission's Communication on recapitalisations, which will be submitted to the Commission for assessment and approval.

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III. ASSESSMENT

1. Existence of State Aid

(43) According to Article 87 (1) EC, State aid is 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, in so far as it affects trade between Member States.

(44) Given that AIB is active in the financial sector, which is open to intense international competition, any advantage from State resources to the Bank would have the potential to affect intra-Community trade and to distort competition. This conclusion is reinforced by the fact that the activities of the Bank are not confined to Ireland but that the Bank is also active in the United Kingdom, the Isle of Man, Hungary, Switzerland, Luxembourg, the United States, Canada and Australia. Since the Irish Government proposes to invest € 3.5 billion in the Bank, it is also clear that the measure is imputable to the Irish State and that if any advantage is granted through the measure, State resources are involved.

(45) Finally, it has to be examined whether the measure leads to a selective advantage to AIB for it to constitute a State aid.

(46) The Irish authorities explained that, in view of the rising international capital market expectations in relation to capital levels for financial institutions, a State intervention was necessary for the Bank to reinforce its capital position.

(47) The Commission shares the view of the Irish authorities that, in the current market circumstances and given its situation, AIB could not have raised such financing in such time frame at comparable conditions. This view is reinforced by the fact that public policy considerations, and in particular the willingness to avoid a further deterioration in the Bank's financial position which would represent a threat to the stability of the financial system and to increase lending to the real economy, have determined the State intervention, rather than the possible return for the State as an investor.

(48) The Commission therefore comes to the conclusion that the measure provides a selective advantage to AIB and that it constitutes State aid in the sense of Article 87(1) EC.

2. Compatibility of the aid with the common market

Compatibility under 87(3)(b) EC Treaty

(49) Article 87(3)(b) 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) EC Treaty needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State

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

(50) 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" ("the Communication on the financial crisis")\(^{12}\), in order for an aid or aid scheme to be compatible under Article 87(3)(b) EC Treaty, it must comply with general criteria for compatibility under Article 87(3) 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\(^{13}\):

a. **Appropriateness**: The aid has to be well targeted 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.\(^{14}\)

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

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\(^{14}\) 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 [2008] ECR I-0000, judgment of 15 April 2008, where the Court held at paragraph 68 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 […]."
The fourth chapter of the "Communication on the financial crisis"\(^{15}\), as well as the Communication on recapitalisations\(^{16}\), then translate these general principles into conditions specific for recapitalisation schemes. The principles contained therein apply \textit{mutatis mutandis} also to individual cases. In the next paragraphs, the Commission will therefore assess the compatibility of the notified measure with these criteria.

\textit{Appropriateness of the measure to remedying a serious disturbance in the economy}

Following the introduction of the Guarantee Scheme, the Irish authorities commissioned PricewaterhouseCoopers to prepare a report on the financial position of the institutions participating in the Guarantee Scheme (the “PwC Report”). The PwC Report concluded that the capital positions of each of the institutions reviewed, including AIB, was in excess of regulatory requirements as of 30th September 2008 and that, under a number of stress scenarios, capital levels in each of the institutions will remain above regulatory minimum levels in the period to 2011. The Central Bank and Financial Regulator also share the view that AIB is currently fully in compliance with regulatory capital requirements.

However a letter from the Governor and Financial Regulator to the Minister dated 18\(^{th}\) November 2008 summarising and commenting on the conclusions of the PwC Report indicates that […] and that […]. In particular, in the current economic environment, […]. Moreover, given the current economic circumstances, […]. On that basis and bearing in mind the volatility of the economic and financial environment the Board of the Central Bank and the Financial Services Authority of Ireland are of the view that urgent steps should be taken to strengthen the capital positions of covered Institutions and therefore support the measure at issue which aims at strengthening the capital position of Allied Irish Bank.

The Commission acknowledges that rising international capital market expectations in relation to capital levels for financial institutions, in the context of the current crisis, can make it necessary also for banks that meet the regulatory solvency ratios to further strengthen their capital ratios.

The Irish authorities explained that, in view of the rising international capital market expectations in relation to capital levels for financial institutions, a State intervention was necessary for the bank to reinforce its capital position.

The Commission shares the view […] that, in the current market circumstances and given its situation, AIB could not have raised such financing in such time frame at comparable conditions. This view is reinforced by the fact that public policy considerations, rather than the possible return for the State as an investor, have determined the State intervention. In fact, the motivating factor was the willingness to avoid a further deterioration in the Bank's financial position, as highlighted by the results of a recent detailed review of its loan book, which would represent a threat to the stability of the financial system, and to increase lending to the real economy.


In the present market circumstances, it is doubtful whether AIB could have raised this amount of capital on comparable terms on the private market. Indeed, despite its coverage under the Guarantee Scheme, market perceptions concerning the inadequacy of its capital ratio levels have led to deterioration in investor sentiment with regard to it. The Bank’s shares have experienced a significant deterioration in value from around €7.5 in early October 2008 to the position of €1.080 on 11 February 2009 with a market capitalisation of €953.38 million. Over the previous 12 months, the Bank's shares traded as high as €15.10, with a market capitalisation of €13,336 million. As a result, the Bank's shares have lost more than 92% of their value over the last 12 months.

As to its rating, Allied Irish Bank's ratings have been downgraded on 12 February, 2009 to Moody's Aa3 and S&P A. The outlooks are Negative and Stable respectively.

In these circumstances, the Irish Government, in consultation with the Governor and the Financial Regulator, decided that it was necessary for the State to take measures in relation to AIB in order to avoid further deterioration in the financial situation of the Bank.

Further deterioration in the Bank's financial position and in market investor sentiment to relation to it could represent a threat to the stability of both the financial system in Ireland and the wider Irish economy. In this respect, it is important to note that the Irish financial sector is very dependent upon international finance through wholesale money markets. Therefore, a loss of confidence in AIB could undermine confidence in the Irish financial sector as a whole, thus entailing a serious risk of a systemic crisis in the Irish financial system, with significant negative spill-over effects into the wider economy. In a letter dated 24 March 2009, the Governor has confirmed the systemic importance of AIB to maintaining the stability of the financial system in the State and confirmed that the capital injection at issue is fully consistent with the Central Bank's advice to the Government on the need to strengthen the capital position of the Bank in order to maintain its credit standing in the continuing very difficult market conditions.

Therefore, the Commission considers that a public sector capital intervention in AIB is a necessary and appropriate means to strengthen the Bank's capital base with the aim of restoring market confidence in the Irish financial sector, thus avoiding the risk of a serious disturbance of the entire Irish economy.
Limitation of the aid to the strict necessary

(62) Capital interventions must be done on terms that minimise the amount of aid. This relates to the amount of the measure as well as to the conditions at which it is provided.

(63) As regards the total amount of the recapitalisation, the injection of €3.5 billion represents 2.61% of the Bank's risk weighted assets, which is above the 2% threshold indicated in Annex 1 of the Communication on recapitalisations. The measure will help AIB to improve its core Tier 1 capital ratio from 5.8% to 8.4% and its Tier 1 capital ratio from 7.4% to 10%.

(64) The Commission notes that the State guarantee on the balance sheet of AIB, in line with the Commission decision approving the Irish guarantee scheme for banks, has not proved sufficient to restore confidence in the bank in the above market and bank-specific circumstances (as shown in particular by market share) and needed to be supplemented by strengthening the Bank's capital base. In particular, the results of a recent detailed review of the Bank's loan book carried out on behalf of the Financial Regulator as indicated above, combined with the importance of AIB as funds provider to the Irish economy, are the reasons for the size of the capital injection in order to maintain its credit standing in the continuing very difficult market conditions.

(65) The Commission notes further that AIB is heavily exposed to the property market as indicated in paragraph 5 above, that the Financial Regulator's view is that it is appropriate for the State to proceed to such capital injection and the capital ratios thereby achieved (which are comparable to other cases), that AIB considers in its preliminary results for 2008 that it may fall below minimum capital requirements in 2010 under a stress test scenario without the issuance of the New Preference Shares and that the recent due diligence exercise carried out by the NPRF Commission has shown that it would be appropriate to strengthen the Bank’s capital position by a total amount of €5 billion new Core Tier 1 capital. Taking these elements into account, the Commission is satisfied that this capital injection of €3.5 billion is the minimum State aid necessary to contribute to the stability of AIB and thus the Irish financial system.

(66) As regards the remuneration of the measure, the Commission acknowledges that setting the remuneration as high as the current clearing levels would restrain financial institutions from using such measures. Moreover, it is the Commission’s intention to adjust to long-term market conditions and not to impose the current unfavourable conditions on financial institutions today.

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17 According to its preliminary results for the year ended 30 September, 2008, the Bank had a balance sheet size of €182 billion.

18 This level of recapitalization is comparable to that in other cases. See, for example, Commission decision of 18.12.2008 in case N 602/2008 KBC Belgium, where the core Tier 1 capital ratio increased to 8.2% and Tier 1 to 10.7% following State recapitalization, Commission decision of 10.12.2008 in case N 611/2008 SNS Reaal, where the Tier 1 capital ratio of SNS Bank NV increased to 10%, Commission decision of 13.11.2008 in case N528/2008 ING NL, where the Tier 1 ratio increased to 10% after recapitalization, Commission decision of 14 January 2009 in case N9/2009, Anglo Irish Bank where Tier 1 capital ratio will increase to 10.1% after recapitalization or Commission decision of 26 March 2009 in case N149/ 2009, Bank of Ireland, where the Core Tier 1 capital ratio increased to 9.3% and Tier 1 to 11.7% after recapitalization.

In its Communication on recapitalisations, the Commission accepts as a minimum remuneration based on the Eurosystem methodology of 20 November 2008. This methodology takes account of the banks' risk profile and involves the calculation of a price corridor with an average required rate of return of 7% on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9.3% on ordinary shares relating to Euro area banks\(^{20}\). The Communication distinguishes between fundamentally sound banks, for which the methodology above applies and distressed banks, for which remuneration should normally be higher. However, the minimum acceptable benchmark remuneration depends on the State aid instrument chosen and its characteristics and is an aspect to be considered in the restructuring on the basis of a viability analysis.

In the case at hand, in line with the Communication on recapitalisations, the Commission must take into account the type of capital provided and the risk profile of the Bank in order to evaluate the adequacy of the State capital remuneration.

As far as the Bank's risk profile is concerned, the following indicators are relevant (see the annex to the Communication): capital adequacy, size of recapitalisation, current CDS spreads, current rating of the bank and its outlook.

In this context, the Commission notes the fact that the Bank meets regulatory capital ratio requirements and the PwC report's finding that it could maintain them even under a number of stress scenarios. The Commission, however, notes that this study does not contain a detailed evaluation of the Bank’s exposure to various risks (such as credit risk, liquidity risk, market risk, interest rate and exchange rate risks), the quality of the asset portfolio, the sustainability of its business model in the long term and other pertinent elements, in line with the Recapitalisation Communication. The Commission also notes that the PwC's report findings have been reconsidered in the light of recent events. Indeed, the letter from the Central Bank and Financial Regulator to the Minister dated 18 November 2008 indicates that [...] and that, [...]. Furthermore, AIB considers in its preliminary results for 2008 that it may fall below minimum capital requirements in 2010 under a stress test scenario without the issuance of the New Preference Shares, and the recent due diligence exercise carried out by the NPRF Commission has shown that it would be appropriate to strengthen the Bank’s capital position by a total amount of €5 billion new Core Tier 1 capital. Furthermore, the Commission notes that the level of the recapitalisation is above the 2% threshold referred to in Annex 1 of the Communication on recapitalisations and that the Bank will be required to submit, within six months, a restructuring plan. This element will be considered within the context of the restructuring plan.

Also the risk profile of the Bank, as revealed by its CDS spreads and ratings, is relatively high (it went up to 577 bps on 26 March 2009, see para 7 above) and is perceived as such by the markets. Moreover, AIB is rated Aa3 by Moody's and A by S&P. The outlooks are negative and stable respectively.

As to the type of capital provided, the Commission notes that in the case at hand, the instruments that will be used to make the State investment are non-cumulative perpetual preference shares in the Bank with voting rights. The Shares have a fixed

As regards the overall position of the State in relation to its investment in the Bank, the Commission notes positively that the capital injection will give the State voting rights in a number of areas as well as the right to appoint 25% of directors. The Commission also notes that the probability of return for the State through dividends increases through a combination of their payment in cash or ordinary shares. Moreover, as indicated above (para 32), the Commission notes that the estimated internal rate of return on the State investment is likely to be in the region of 12.10% to 20.74%.

Moreover, the Commission notes the relatively low price at which the Warrants can be exercised i.e. the strike price of the Core Tranche of the Warrants is €0.975 and of the balance €0.375, which is much lower than the price at which the Bank's shares were traded over the last 12 months, namely €15.10 but also lower than the shares' price before the announcement of the capital injection i.e. the day of the announcement the share price was €1.080 per share. Moreover, the Commission notes positively that, based on different scenarios, the combination of the coupon, the warrants and the redemption possibility at 125% results in all likelihood to a remuneration above 10%.

Additionally, the Commission notes the €30 million arrangement fee which will be paid by AIB to the Irish authorities upon the closing of the transaction.

Considering AIB's announcement of 20 April regarding the possible need to further strengthen the Bank's capital position, the Commission considers it unlikely that AIB will be in the position to carry out an early redemption of €1.5 billion from privately sourced capital prior to December 2009. Consequently, the Commission has assessed the measure looking primarily at the other elements favouring an earlier redemption.

On the basis of the above, the Commission finds that all elements of the remuneration for this capital injection will result under plausible scenarios in the expected annualised remuneration above 10%, which is consistent with the Recapitalisation Communication, including its point 46.

The capital injection is furthermore conditional on the submission of a restructuring plan by the Irish authorities. As indicated above, this plan will address, inter alia, the Bank's strategy and business model to ensure its long term viability as well as methods to minimise State aid also taking into account the competitive impact of the support given by making commensurate provision for measures limiting as much as possible competition distortions. The Commission will evaluate the restructuring plan of the Bank taking into consideration the overall interventions of the State in the Bank (for instance, those announced in April 2009, if implemented).

In line with the Communication on recapitalisations, it is also necessary to ensure that there are sufficient incentives to redeem the State participation when the market will so allow. In the case at hand, such incentive provided through the level of remuneration is further complemented by redemption clauses and the presence of the Warrants. While redemption is at the discretion of the Bank and it can repurchase the Shares at par for up to five years, after that period, shares can be repurchased at 125% of par. This provides an incentive for AIB to redeem the shares during the initial five year period. In addition, replacement capital must be Core Tier 1, in each case subject to the
approval of the Financial Regulator which should ensure that the State investment is replaced with private equity investment in AIB. Moreover, there is a restrictive dividend policy while the State holds the shares: dividends on ordinary shares are not allowed where a dividend on the shares is not paid to the State. This encourages the Bank to redeem the State capital injection as soon as possible, while also providing the Bank with the flexibility to incentivise private equity investment through the payment of dividends on ordinary shares where a dividend is paid to the State on the shares.

(80) In the case at hand, the Commission considers that the terms and conditions of the State investment, together with the terms and conditions already imposed on AIB under the Guarantee Scheme, contain safeguards against possible abuses and distortions of competition (see para 37 above). In particular, the Commission views positively the commitment of the bank to refrain from mass marketing of the measure and a dividend ban (not affecting though the dividends due to the State on New Preference Shares).

(81) Additionally, the Commission notes that Ireland commits to submit a plan for AIB within six months which will take account of the competitive impact of the support given by making commensurate provision for measures limiting as much as possible competition distortion resulting from the aid. The Commission considers that the submission of a restructuring plan within the meaning of the Commission's Communication on recapitalisations is needed to secure the proportionality of the State's intervention(s) in the Bank and to limit possible distortions of competition.

(82) The Commission further notes positively the fact that the Board will have Government representation and the voting rights attached to the State's preference shares.

3. Conclusion

(83) Therefore, the Commission can conclude that the measure conforms to the conditions laid down in the Communication on the financial crisis and the Communication on recapitalisations.

IV. DECISION

(84) The Commission comes to the conclusion that the provision of capital by Ireland in the conditions described above constitutes State aid pursuant to Article 87(1) EC Treaty.

(85) The Commission considers that this measure fulfils the conditions to be considered compatible with the Common Market pursuant to Article 87(3)(b) EC Treaty. Consequently, the Commission raises no objection against the notified aid and authorizes it as emergency intervention in the face of the current financial crisis for a period of 6 months.

(86) The Commission takes note of Ireland's commitment to notify a restructuring plan to the Commission within six months from the recapitalisation21.

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

21 In line with the requirements under point 44 of the Commission Communication on recapitalisations.
not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter 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/index.htm.

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

- European Commission
  Directorate-General for Competition
  State aid Greffe
  Rue de la Loi/Wetstraat, 200
  B-1049 Brussels
  Fax No: (+32)-2-296.12.42

Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission