
14. Southern Program Countries – Cyprus, Portugal, Spain

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PART I CYPRUS

1. THE CYPRIOT BANKING LANDSCAPE

(a) Introduction

After the 2008–09 turmoil in the financial markets, the Cypriot economy had a modest recovery during 2010 and 2011, but underwent a deep downturn from 2012 onwards with a contraction of real GDP of 2.4 per cent in that year and 5.9 per cent in 2013.¹ As a consequence, unemployment rates increased and real estate demand and prices – which had been continuously increasing before the crisis – came under pressure.

Cypriot banks are essentially built on a traditional banking business model, i.e., they collect deposits from and grant loans to residents and non-residents. They have generally avoided wholesale funding and risky investments such as structured credits. Before the crisis, deposits by non-residents (especially from Russia) represented a significant chunk of total deposits because Cyprus had a low corporate tax rate.²

Until the recession, the banking sector in Cyprus underwent a rapid expansion. At the end of 2011, the total balance sheet of all banks active in Cyprus accounted for 817 per cent of GDP of which around 250 per cent was accounted for by foreign banks.³ This led to a serious imbalance in the Cypriot macro-economy, straining the resilience of the Cypriot banking system and creating potential for spillover implications into the financial sector.

A strong increase of bank credit to the private sector fuelled a real estate bubble, increased the level of private indebtedness (310 per cent of GDP in 2011) and exposed Cypriot banks to overleveraged local property companies. In addition, Cypriot banks

* The information and views set out in this chapter are those of the authors alone.

¹ See European Commission's Directorate-General for Economic and Financial Affairs, Macroeconomic Forecast for Cyprus (autumn 2015) <http://ec.europa.eu/economy_finance/eu/forecasts/2015_autumn/cy_en.pdf> accessed 7 December 2015.

² For an interesting look at potential causes to the Cypriot banking crisis, see the interview with Athanasios Orphanides, Governor of the Central Bank of Cyprus from 2007 to 2012, published by *The Economist* on 28 March 2013 <<http://www.economist.com/blogs/freexchange/2013/03/interview-athanasios-orphanides>> accessed 7 December 2015 (2013 Interview with former Governor of the Central Bank of Cyprus).

³ Commission Decision in Case SA.34827 (2012/NN) – Cyprus, Rescue Recapitalization of Cyprus Popular Bank, 12 September 2012 (Commission Decision on Cyprus 2012), para. 10.

engaged in substantial expansion in Greece, which – as a consequence of the deep recession there and the haircut on the Greek sovereign debt arising from the private sector bond exchange known as the private sector involvement program (PSI) – resulted in large losses on both their loan books and their holdings of Greek government bonds.

In 2011 Cypriot banks were severely hit by the impairments on their Greek debt write-downs. The three largest Cypriot banks – Bank of Cyprus, Cyprus Popular Bank and the Hellenic Bank – booked around €1.8 billion, €2.3 billion and €77 million of losses, respectively, on their Greek government bond holdings, which amounted to a combined loss of more than 20 per cent of Cypriot GDP.⁴ By that time Cypriot sovereign debt had been downgraded to non-investment grade and the country lost access to international capital markets. This situation aggravated funding issues for Cypriot banks, which relied heavily on Central Bank funding.

(b) The Financial Assistance Program

(i) Overview

The Bank of Cyprus and Cyprus Popular Bank – the country's two largest banks, accounting for nearly 80 per cent of the sector – participated in the 2011 capital exercise of the European Banking Authority (EBA). In order to reach the Core Tier 1 capital ratio of 9 per cent by 30 June 2012, as required by the exercise, the capital shortfall for the two banks was initially estimated at €3.5 billion. The probability of having to provide for a public recapitalization of both banks, combined with less appetite in the market for its sovereign bonds, led Cyprus to request external financial assistance from its international partners on 25 June 2012.

(ii) Underlying objectives

Following this request, the European Commission (the Commission), the European Central Bank (ECB) and the International Monetary Fund (IMF) agreed to an Economic Adjustment Program with the Cypriot authorities on 2 April 2013. The Program was agreed by the Eurozone Member States on 24 April 2013, signed between Cyprus and the European Stability Mechanism (ESM) on 26 April 2013, and approved by the IMF Board on 15 May 2013. It covers the period 2013–16. The financial package entails a €10 billion rescue, with the ESM providing €9 billion and the IMF contributing the remaining €1 billion.⁵

The main objectives of the Cypriot assistance program were to restore the soundness of the Cypriot banking sector, continue the process of fiscal consolidation (in order to correct the excessive general government deficit) and implement structural reforms to support competitiveness and sustainable and balanced growth.

(iii) Bail-in of deposits

Due to the large banking recapitalization needs and the reluctance of the left-wing government in place at the time to adopt consolidation measures and structural adjustments,

⁴ *Ibid.*, paras 12–14.

⁵ Program documents <http://www.mof.gov.cy/mof/mof.nsf/financial_assistance_en/financial_assistance_en?OpenDocument> accessed 26 November 2015.

a discussion arose around the pressing situation in Cypriot public finances and led to questions of debt sustainability.

The combination of all these, together with possible political arguments,⁶ led to an unprecedented bail-in attached to the bailout program. The Cypriot parliament rejected the government's initial proposal to impose a one-off levy of 10 per cent on all bank deposits in Cyprus and instead the Central Bank of Cyprus passed two decrees providing for the in-depth restructuring and bailing-in of the country's two largest banks: Cyprus Popular Bank (which operated under the trading name 'Laïki') and Bank of Cyprus.⁷

In order to prevent the build-up of future imbalances, Decree No 104 ordered the transfer of the majority of Laïki's assets to Bank of Cyprus, including liabilities associated to deposits of up to €100,000 (i.e., insured deposits). Uninsured deposits in excess of (€100,000) remained with Laïki, pending its liquidation.

Bank of Cyprus, on the other hand, was in need of capital to meet the regulatory requirements and, to prevent the use of taxpayer money, its depositors, shareholders and bondholders were also bailed-in to rescue the institution. Decree No 103 imposed a haircut on deposits above €100,000 initially as follows:

- 37.5 per cent of the balance over €100,000 was converted into shares of Bank of Cyprus;
- 22.5 per cent of the balance over €100,000 was converted into instruments that could be converted either into shares or deposits of Bank of Cyprus depending on an *ex post* valuation;
- The remaining 40 per cent of the balance over €100,000 was converted into a Bank of Cyprus deposit and temporarily blocked until an evaluation was conducted on the bank's scale of losses.

On July 2013, the Central Bank of Cyprus announced that Bank of Cyprus' uninsured deposits would be levied an effective and final 47.5 per cent, with the remaining 12.5 per cent (out of the 22.5 per cent) initially frozen being released and converted into time deposits.⁸

Along with the recapitalization and restructuring efforts focusing on the banking sector, Cyprus also introduced severe administrative restrictions on capital movements in order to prevent disorderly capital flights and bank runs when the uninsured depositors in the two largest Cypriot banks were bailed-in. A prolonged bank holiday was enforced from 16 March 2013, followed by capital controls as of 28 March. There were also restrictions on money withdrawals and transfers for all banks to head off a run on funds. These measures helped contain the amount of deposit outflows, which had already surged to about €3.8 billion during the first two weeks of March 2013.⁹

⁶ 2013 Interview with former Governor of the Central Bank of Cyprus.

⁷ 2013 Regulatory Administrative Act No 103 on the bailing-in of Bank of Cyprus ('Decree No 103'), and 2013 Regulatory Administrative Act No 104 on the transfer of certain assets and liabilities from Cyprus Popular Bank to Bank of Cyprus ('Decree No 104').

⁸ Press release <http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12896> accessed 26 November 2015.

⁹ See the European Commission's program reports <http://ec.europa.eu/economy_finance/assistance_eu_ms/cyprus/index_en.htm> accessed 26 November 2015.

(iv) Contentious reactions

The idea of having depositors with more than €100,000 – and not taxpayers – sponsoring the bailout of the financial system was heavily criticized. At the time Cypriot authorities were of the view that this scheme had the advantage of waiving future generations from the burden of repaying the loan,¹⁰ but the measure was subject to massive litigation.

Following implementation of the above decisions, approximately 4,000 legal actions were filed before the Supreme Court of Cyprus by depositors of Laïki and Bank of Cyprus, seeking orders to annul Decrees No 103 and 104 on the grounds that they violated basic constitutional protections such as the right to property and the principles of non-discrimination and proportionality.¹¹ However, in July 2013 the Supreme Court ruled that such decrees were not subject to judicial review by the country's highest tribunal as the rights of depositors were a private law matter falling within the jurisdiction of civil law district courts.¹²

Important judicial proceedings were also taken to the EU courts. Between May and June 2013, 12 applications were lodged before the General Court by a number of legal persons and individuals that held funds on deposit at either Cyprus Popular Bank or Bank of Cyprus when Decrees No 103 and 104 entered into force.¹³

The applicants in these cases sought one of two types of remedies. Some of the petitioners claimed that the General Court should annul the paragraphs of the Memorandum of Understanding concluded between Cyprus and the ESM on 26 April 2013 that contained the restructuring and resolution measures to be adopted in respect of Laïki and Bank of Cyprus and should also compensate the applicants for damage allegedly suffered as a result of the diminution or loss in value of their deposits stemming from the measures envisaged in such paragraphs.¹⁴

In a second set of proceedings, petitioners asked the General Court to annul the Eurogroup's statement of 25 March 2013 declaring that it had reached an agreement with the Cypriot authorities on the key elements for a future macroeconomic adjustment program and welcoming plans for restructuring the financial sector in general and Cyprus Popular Bank and Bank of Cyprus in particular.¹⁵

All mentioned legal actions were filed against the Commission and the ECB since, under the ESM Treaty, the Commission is entrusted with negotiating financial assistance programs with Member States, in cooperation with the ECB (and the IMF, where applicable), and with signing the program documents on behalf of the ESM.

This was the first time EU courts were called upon to rule on whether the acts of the Eurogroup were attributable to the EU for the purposes of legal scrutiny. The General

¹⁰ Press release <[http://www.mof.gov.cy/mof/mof.nsf/All/BB670607715A44D6C2257B3200368FE9/\\$file/agreemenfinancialassistance.pdf?OpenElement](http://www.mof.gov.cy/mof/mof.nsf/All/BB670607715A44D6C2257B3200368FE9/$file/agreemenfinancialassistance.pdf?OpenElement)> accessed 26 November 2015.

¹¹ See George Y. Yiangou L.L.C. | Advocates – Legal Consultants, 'Legal Actions in Cyprus following the Haircut', <<http://yiangou.com.cy/news-read/80>> accessed 26 November 2015 (Yiangou 2015).

¹² Ibid.

¹³ Cases T-289/13 to T-294/13, all dismissed by Order of the General Court of 10 November 2014; and cases T-327/13 to T-332/13, all dismissed by Order of the General Court of 16 October 2014.

¹⁴ Cases T-289/13 to T-294/13.

¹⁵ Cases T-327/13 to T-332/13.

Court found that they were not, and the same conclusion was reached concerning actions taken in the framework of the ESM.

Under the provisions of Articles 268 and 340 TFEU, paragraphs 2 and 3, the General Court only holds jurisdiction in non-contractual liability disputes originating in actions taken by EU institutions or its servants.

In the cases at hand, it is clear that neither the ESM nor the Eurogroup is an EU institution. The General Court added that the tasks entrusted to the Commission and the ECB in respect of such a mechanism did not entail any power to make decisions of their own, and also that actions pursued by the Commission and the ECB – particularly the negotiation and signing of financial assistance documents – solely commit and bind the ESM.

In conclusion, the General Court considered that the Eurogroup statement of March 2013 and the adoption of the Memorandum of Understanding entered into between Cypriot authorities and the Commission (on behalf of the ESM) could not be imputed to either the Commission or the ECB, and thus the court lacked jurisdiction to consider the question of annulment or compensation. In addition, the General Court also held that the statement in question made by the Eurogroup was of a purely informative nature and did not qualify as a measure capable of producing legal effects with respect to third parties.

These judgments are currently pending appeal before the European Court of Justice.¹⁶ During the course of its Economic Adjustment Program, Cyprus managed to sporadically return to the market for medium- and long-term debt.¹⁷ However, the volume of such issuances remains limited and their cost high. Therefore, market access conditions for the Cypriot banking system as a whole have not yet been fully restored and adverse effects of the sovereign crisis persist. This is evidenced by the fact that the assessments carried out in 2015 by the ECB in its capacity as supervisor of systemic banks identified a further need for recapitalization in the Cypriot cooperative banks, which was met by an additional amount of aid approved by the Commission as recently as December 2015.

2. AID SCHEMES

(a) Special Government Bond Scheme

(i) Overview

In late 2009 the Commission approved a Cypriot regime to issue special government bonds as a support measure for the financial sector.¹⁸ This was the first State aid measure

¹⁶ Joined Cases C-8/15 P to C-10/15 P *Ledra Advertising v Commission and ECB* [2016] and Joined Cases C-105/15 P to C-109/15 P *Mallis and Malli v Commission and ECB* [2016]. In April 2016, Advocate General Wathelet and Advocate General Wahl proposed the Court dismiss both sets of appeals essentially relying on the arguments brought forward by the General Court.

¹⁷ For instance, on 28 April 2015 Cyprus issued a seven-year government bond of €1 billion with a 3.875 per cent coupon rate. See press release issued by the Cypriot Ministry of Finance on 30 April 2015 <[http://www.mof.gov.cy/mof/mof.nsf/All/D292F5CA02486651C2257E37003A816D/\\$file/PRESS%20RELEASE%20-%20CYPRUS%207YR%20-%20APRIL%202015_v2.pdf](http://www.mof.gov.cy/mof/mof.nsf/All/D292F5CA02486651C2257E37003A816D/$file/PRESS%20RELEASE%20-%20CYPRUS%207YR%20-%20APRIL%202015_v2.pdf)> accessed 17 November 2015.

¹⁸ Commission Decision in Case N511/2009 – Cyprus, Special Government Bonds Scheme [2009] OJ C53/1.

specifically targeted at credit institutions brought forward by Cyprus in response to the international crisis.

Under such scheme the Cypriot government issued special State bonds and lent them to banks against a collateral subject to a significant haircut¹⁹ and also a market-driven premium calculated on the basis of ECB recommendations regarding guarantees on bank debt.²⁰ Borrowing banks were then able to use such illiquid assets (loans) to obtain liquidity from the ECB and interbank markets.

(ii) Scope of the scheme

The scheme had a narrow temporal scope in that the period of issuance ended on 31 May 2010, and the bonds had a maximum maturity of three years, following which they had to be returned to the State and cancelled. If a bank was unable to return or repay the bonds and the collateral provided was not sufficient, Cyprus committed to notify a restructuring or liquidation plan for such institution to the Commission.

The beneficiaries of the scheme were credit institutions incorporated in Cyprus (including subsidiaries of foreign institutions). To become eligible, credit institutions ought to be solvent and maintain a capital ratio of over 8 per cent.

The overall budget of this support measure was €3 billion. Allocation to credit institutions was made in packages of €1 million calculated on the basis of the institution's aggregate domestic market share in business and housing loans. The bonds paid no coupon and were listed on the Cypriot Stock Exchange.

Beneficiaries were bound to use the proceeds of the liquidity raised to grant housing loans and loans to SMEs on competitive terms. They were further subject to a number of behavioural constraints such as a ban to undertake aggressive market strategies and a prohibition to expand their balance sheet above the country and the industry's growth rate.

(b) State Guarantee Scheme for Cypriot Banks

(i) Overview

In September 2012 Cypriot authorities informed the Commission of their intention to set up a guarantee scheme aimed at temporarily offering appropriate measures to establish backstops for the financial system in a timely and efficient manner, where banks encountered difficulties obtaining sufficient funding on the financial markets.

Under the scheme participating banks obtained liquidity support in the form of guarantees for newly issued liabilities in circumstances that would not be available to them under prevailing market conditions.

The scheme was originally approved by the Commission in November 2012²¹ and was

¹⁹ Depending on credit quality, haircuts could go up to 50 per cent in some cases and the collateral was monitored throughout the duration of the scheme.

²⁰ Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, 20 October 2008 <https://www.ecb.europa.eu/pub/pdf/other/recommendations_on_guaranteesen.pdf> accessed 19 November 2015.

²¹ Commission Decision in Case SA.35499 (2012/N) – Cyprus, State Guarantee Scheme for Cypriot Banks, 6 October 2012.

extended on eight occasions,²² the last on 28 June 2016 approving prolongation of the scheme until 31 December 2016.

(ii) Scope of the scheme

Eligible beneficiaries were banks incorporated in Cyprus and licensed by the Central Bank of Cyprus (including subsidiaries of foreign banks operating in the country). Although cooperative credit institutions were among the eligible beneficiaries, government guarantees would only be granted to their central body, the Cooperative Central Bank Ltd., which acts as their manager of liquid assets and is the only entity with access to central bank funding.

The remuneration of the guarantees is calculated in accordance with the formula outlined in the 2011 Prolongation Communication,²³ which requires the application of a pricing methodology based largely on market data. Since credit default swaps (CDS) data are unavailable for any of the domestic credit institutions,²⁴ Cypriot authorities determine the guarantee fee on the basis of the CDS of a sample of banks in the lowest rating buckets (BBB rating or lower).

Aid recipients must provide the government with adequate eligible collateral fully covering the amount of guarantee allocated to them or, where this requirement is exceptionally waived, pay an add-on fee of 50 bp.

The scheme had an initial budget of €6 billion, with the total amount of guarantees allocated to each bank capped at 15 per cent of their domestic deposits. However, according to information made available by the Commission in July 2015,²⁵ the guarantees awarded under such a scheme total €1 billion to date and were all granted in November 2012.

(iii) Commission's assessment and conditions for approval

The Commission has periodically prolonged the approval of the scheme under Article 107(3)(b) TFEU recognizing that the tensions in sovereign debt markets since 2011 and

²² Commission Decision in Case SA.35852 (2012/N) – Cyprus, First Prolongation of Cypriot Guarantee Scheme for Banks H1 2013, 22 January 2013; Commission Decision in Case SA.36930 (2013/N) – Cyprus, Second Prolongation of Cypriot Guarantee Scheme for Banks H2 2013, 25 July 2013; Commission Decision in Case SA.37870 (2013/N) – Cyprus, Third Prolongation of the Cypriot Guarantee Scheme for Banks H1 2014, 18 December 2013; Commission Decision in Case SA.38867 (2014/N) – Cyprus, Fourth Prolongation of Cypriot Guarantee Scheme for Banks H2 2014, 25 June 2014; Commission Decision in Case SA.40027 (2014/N) – Cyprus, Fifth Prolongation of Cypriot Guarantee Scheme for Banks H1 2015, 14 January 2015; Commission Decision in Case SA.42080 (2015/N) – Cyprus, Sixth Prolongation of Cypriot Guarantee Scheme for Banks H2 2015, 13 July 2015; Commission Decision in Case SA.43874 (2015/N) – Cyprus, Seventh Prolongation of Cypriot Guarantee Scheme for Banks H1 2016, 11 January 2016; and Commission Decision in Case SA.45598 (2016/N) – Cyprus, Eighth Prolongation of Cypriot Guarantee Scheme for Banks H2 2016, 28 June 2016.

²³ Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356, 7.

²⁴ This is essentially because the very high CDS of banks in program countries do not accurately reflect their risk profile, but are rather exacerbated by the sovereign debt crisis in their Member State.

²⁵ Commission Decision, Sixth Prolongation 2015, para. 9.

the exposure of many Cypriot banks to the Greek crisis had put the country's banking sector under increasing pressure, particularly in terms of access to term funding.

Approval of the support scheme by the Commission was conditional on a number of behavioural and monitoring commitments imposed on Cyprus, which varied over the course of several prolongations but included e.g., to grant the guarantees only for new issuance of banks' senior debt; submission of a restructuring plan; a remuneration in accordance with the formula set out in the Commission's 2011 Prolongation Communication; an advertising ban and periodic reports to the Commission.

3. INDIVIDUAL AID

(a) Cyprus Popular Bank (and the Subsequent Integration into Bank of Cyprus)

(i) Overview

As mentioned above, one of the conditions attached to the Cypriot Assistance Program was the obligation to close the country's second largest bank, Cyprus Popular Bank or 'Laiki' (which was insolvent at the time) and transfer its good assets to the largest financial institution of the system, Bank of Cyprus.

Thus, in September 2012 the Commission transitionally approved a €1.8 billion recapitalization for Cyprus Popular Bank,²⁶ a full service credit institution founded in 1901 and the country's second-largest bank, with a share of 18 per cent of deposits and 19 per cent of loans. Consolidated assets amounted to *circa* €32 billion on March 2012.

(ii) Events leading to the State intervention

The events triggering aid awarded to Cyprus Popular Bank were essentially linked to the Greek crisis. The bank was heavily exposed to the Greek economy and sovereign debt. Greek activities alone accounted for 50 per cent of the bank's assets. By the end of 2011 Cyprus Popular Bank had suffered losses of €2.3 billion stemming from the Greek PSI and an additional €972 million resulting from provisions to cover non-performing loans in its Greek loan portfolio. As a consequence of the reduction of deposits collected in Greece, it also faced severe liquidity issues and had lost access to the capital markets and ECB funding.

(iii) Aid measure

Subsequent to the EBA 2011 exercise, Cyprus Popular Bank had a capital shortage of roughly €2.5 billion vis-à-vis the Core Tier 1 target of 9 per cent to be reached by end of June 2012. To cope with this – and together with other measures worth approximately €177 million, designed to strengthen its prospective capital adequacy – on 30 June 2012 the bank made a capital increase of €1.8 billion underwritten by the State in the form of a rights issue. As there was very limited private participation in the public offering of the shares, ultimately the vast majority of the issued capital (99.8 per cent, amounting to €1,796 million and representing an 84 per cent stake) was subscribed by the Cypriot

²⁶ Commission Decision on Cyprus 2012.

State, which became, by far, the largest shareholder. Hence, the aid had great intensity, as it amounted to 7.5 per cent of the bank's risk weighted assets (RWA).²⁷

Despite the recapitalization, by 30 June 2012 Cyprus Popular Bank fell short of the EBA capital requirement of 9 per cent Core Tier 1 by €630 million.

(iv) Commission's assessment and conditions for approval

The Commission deemed that the aid measure was the underwriting of the capital increase in the form of a rights issue, as the subsequent acquisition of the new shares was merely the implementation of the State's commitment. Although this approach could be seen as conflicting somewhat with previous decisions where the Commission took the view that an underwriting commitment and the resulting public recapitalization are separate aid measures,²⁸ the specificities of this case may help explain the different angle retained.

When the capital raising and the subscription of shares by the State took place in June 2012, i.e., before the Commission's approval, which was only issued in September 2012 – the Commission was already aware of the precise conditions attached to the rights issue and the State's underwriting and most likely had a say in the setting of the discounted subscription price (and thus the State's remuneration) and the underwriting fee.

Therefore, although the Commission recognized that the aid was put into effect in breach of Article 108(3) TFEU,²⁹ and was for that reason illegal, it was conscious at the time of the notification (May 2012) and certainly when it temporarily approved the measure (September 2012) that the size of the prospective capital increase (€1.8 billion) was very large compared to the depressed market capitalization of Cyprus Popular Bank

²⁷ Historically, the Commission deemed that a structural aid / RWA ratio in excess of 2 per cent suggested the bank was in distress. See Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270 (Banking Communication), 8, paras 14 and 29–33; Communication from the Commission on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10 (Recapitalization Communication), 2, paras 40–45; and Communication from the Commission on the return to viability and assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] OJ C195 (Restructuring Communication), 9, paras 4, 8 and 14. See François-Charles Lapr votte, 'Selected Issues Raised by Bank Restructuring Plans under EU State Aid Rules' (2012) 11(1) *European State Aid Law Quarterly* 93–112; and 'The Economic and Financial Crisis in Europe: State Aid and Banks in the European Union – Selected Examples', in C. Botelho Moniz and P. de Gouveia e Melo (eds), *The Economic and Financial Crisis in Europe: On the Road to Recovery*, XXVII General Congress – European Lawyers Union (Lisbon-June 2013) (Bruylant 2015) (Moniz and de Gouveia e Melo 2015), 57. See Sophie Bertin Hadjiveltcheva, 'Overview of State Aid for Banks since the Beginning of the Financial Crisis' in Moniz and de Gouveia e Melo 2015, 49.

²⁸ E.g., Commission Decisions in Case SA.34724 (2013/N) – Portugal, Restructuring of the Banco Comercial Portugu s (BCP) Group; joined cases SA.34825 (2012/C), SA.34825 (2014/NN), SA.36006 (2013/NN) SA.34488 (2012/C) (ex 2012/NN) SA.31155 (2013/C) (2013/NN) (ex 2010/N) – Greece, December 2012 Recapitalization of Eurobank; and case SA.43363 (2015/N) – Greece, Amendment of the Restructuring Plan approved in 2014 and Granting of New Aid to Eurobank.

²⁹ Commission Decision in Case SA.35334 (2014/N) – Cyprus, Recapitalization and Restructuring of the Cooperative Central Bank Ltd and of the Cooperative Credit Institutions, 24 February 2014 (Commission Decision on Cyprus 2014), para. 40.

(circa €200 million). This meant that, when the underwriting commitment was assumed, it was very implausible that the bank would be able to raise significant funds from the general public or private shareholders, and as such there was a high probability that the State would end up with the large majority of the new stakes.

This was probably the reason why the Commission considered that in this case the aid measure was the underwriting by the State of the capital increase, and the acquisition of the new shares simply followed from the fact that the State had underwritten the rights issue. The Commission itself acknowledged in the approval decision that the very low private participation was 'in line with the expectation at the time of the underwriting and confirms ex post the high risk of the underwriting'.³⁰

The temporary approval of the recapitalization of Cyprus Popular Bank was subject to several commitments including a dividend and coupon ban; an advertising ban; an obligation to submit a restructuring plan; quarterly reports to the Commission on the commitments' implementation *etc.*

(v) Integration into Bank of Cyprus

Notwithstanding the aforementioned, in March 2013, following the agreement of the Eurogroup with the Cypriot government on the key elements of the future macro-economic adjustment program in the country,³¹ Cyprus Popular Bank was wound down and split into a 'good' and 'bad' bank. The good bank – entailing the Cypriot operations and insured deposits under €100,000 – was merged with Bank of Cyprus in the framework of the latter's restructuring, while the legacy entity is currently in the process of being sold and finally wound down.

The uninsured depositors were subject to a bail-in and became the new shareholders of the legacy entity, which, in turn, was the largest shareholder of Bank of Cyprus with a 9.6 per cent stake.

The recipient of the assets (Bank of Cyprus) was under resolution from March 2013 until July 2013, a period during which it was recapitalized and restructured. Shares of the recapitalized bank were offered to depositors in exchange and the levy placed on uninsured depositors was used as equity to recapitalize the Bank of Cyprus.

The recapitalization was implemented via the bail-in of depositors through the conversion of 47.5 per cent of uninsured deposits into equity. In addition, the holders of ordinary shares and debt securities issued by Bank of Cyprus as of March 2013 have contributed to the recapitalization through the absorption of losses.

To the best of our knowledge, neither the transfer of assets from Cyprus Popular Bank to Bank of Cyprus nor the recapitalization of the latter was qualified as State aid considering that: (i) Cyprus Popular Bank's assets were acquired by Bank of Cyprus at fair value and the former's insured deposits and Emergency Liquidity Assistance exposure were taken over at nominal value;³² (ii) the recapitalization of the Bank of Cyprus was effected at the full expense of uninsured depositors, shareholders and bondholders (no taxpayer

³⁰ *Ibid.*, para. 37.

³¹ See <http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136487.pdf>, <http://www.centralbank.gov.cy/nqcontent.cfm?a_id=8170&lang=en> and <<http://www.bankofcyprus.com/en-GB/Start/About/Group-history/>> accessed 25 November 2015.

³² Memorandum of Understanding, paras 1.23–1.28.

money involved); (iii) funds from the Cypriot Financial Assistance Program were not used in either of those banks, in contrast to what happened in the cooperative banking sector (as we will see next); and (iv) to prevent an overcapitalization of Bank of Cyprus, there was an independent and in-depth valuation of the combined entity's assets (whose terms of reference were agreed with the Commission, the ECB and the IMF).

As such, the bail-in rescue plan of Bank of Cyprus was not a (typical) restructuring plan under EU State aid rules.

(b) Cooperative Credit Institutions and Cooperative Central Bank

(i) Overview

In Cyprus, before its restructuring, the cooperative banking sector comprised 93 legally independent retail banks, the Cooperative Credit Institutions (CCI), and a central body, the Cooperative Central Bank Ltd (CCB), providing liquidity to the former (together, the Cooperatives).

In line with their cooperative status, the CCI were owned by their members who were typically also their loan customers.³³ Since the vast majority of the CCI were affiliated to the CCB as their central body – with the latter guaranteeing their liabilities and commitments and the CCI guaranteeing the liabilities of the CCB – the CCI did not have to comply individually with the capital requirements for banks but were rather computed as a 'group' on a consolidated basis with their central body.

The CCB has the legal status of a bank and works *de facto* as the central bank of the CCI. The latter have to process all their banking transactions through the former, which provides them with liquidity if needed. In addition, the CCB has its own limited business, which mostly comprises lending to the central and local authorities and other public entities. As mentioned, retail banking activities are predominantly carried out by the CCI.

The Memorandum of Understanding that lays down the underlying policy conditionality of the Cypriot Financial Assistance Program already provided, in its initial drafting of April 2013, for a State-supported recapitalization and restructuring of the Cooperatives. In June 2013 Cyprus submitted to the Commission its calculation of the capital needs of the Cooperatives totalling €1.5 billion to be covered by program funds.³⁴ However, the final version of the first restructuring plan was only notified to the Commission on 31 January 2014, which means the aid measure was assessed under the most recent 2013 Banking Communication that lays down additional requirements in terms of burden-sharing and minimization of the aid to the minimum.³⁵

(ii) Events leading to the State intervention

The Cooperatives are a key player in the Cypriot banking sector. In December 2012, they held total assets of €17.1 billion, more than 95 per cent of the country's GDP. After the resolution of Cyprus Popular Bank, the Cooperatives were the second-largest Cypriot

³³ Although this was not the case for depositors.

³⁴ Commission Decision on Cyprus 2014.

³⁵ See Karel Lannoo, 'Bank State Aid under BRRD and SRM' (2014) 13(4) *European State Aid Law Quarterly* 630–35.

banking group (after Bank of Cyprus) with a market share of 41 per cent in deposits and 30 per cent in loans amongst local residents.

Since the Cooperatives do not carry out business abroad, unlike most Cypriot banks they have not suffered losses stemming from significant exposure to Greek sovereign bonds or the Greek economy in general. However, the problem source of the Cooperatives was its large volume of overdue loans. In November 2013, payments on almost one loan in two were in arrears and the level of non-performing loans accounted for over 40 per cent of the Cooperatives' gross loans, with a tendency to increase over time. In other words, the €1.5 billion of capital shortfall in the Cooperatives was mainly the result of credit losses in the loan portfolio. Without such recapitalization, the Cooperatives would have a projected negative equity of €300 million by the end of 2014, meaning that the aid amount was meant to enable equity to be at €1.2 billion at any point in time.

This situation was essentially driven by the profound economic recession experienced in 2012–13, which led to a sharp increase in unemployment rates and put real estate demand and prices under pressure. Nevertheless, in addition to a risky lending practice from the CCI, the corporate governance framework was insufficient to ensure effective: (i) monitoring and supervision of operations and risks undertaken or underwritten by the CCIs; as well as (ii) enforcement of policies, procedures and sanctions when necessary.

(iii) Aid measure

The underlying strategy for the recapitalization of the Cooperatives was agreed between Cypriot authorities and the Commission within the framework of the Financial Assistance Program for Cyprus.

The cornerstone of the original aid was the injection by the State of €1.5 billion into the CCB – through ESM bonds – in exchange for 99 per cent of its ordinary shares (the former owners, the CCI, being left with the remaining 1 per cent). The CCB would then inject capital in the newly-merged CCI to allow them to reach a minimum Core Tier 1 capital ratio of 4 per cent (with the Cooperatives as a group subject to the general minimum capital requirement of 9 per cent at consolidated levels). To enable the CCB to control the CCI, the one-member-one-vote principle was quashed. The aid allowed CCB to retain surplus capital to inject into the CCI if they fell below the regulatory minimum.

(iv) Commission's assessment and conditions for approval: the 2014 restructuring plan

The first restructuring plan had a five-year term ending on 31 December 2018. However, many of the measures covered by the plan were already in progress or even implemented by the time the Commission approved the initial aid in February 2014.³⁶

The almost complete dilution of the previous shareholders was an essential feature of the beneficiaries' own contribution to the restructuring costs attached to the 2014 restructuring plan, together with envisaged cost-cutting measures involving a general payroll reduction of 15–16 per cent, a pay-scale harmonization in the remuneration levels across the CCI, and a general cap on remuneration.

In order to improve operational efficiency, the 2014 restructuring plan included at the

³⁶ Commission Decision on Cyprus 2014.

outset a merging of the initial 93 individual CCI into a maximum of 18 institutions.³⁷ The initial plan also involved a reduction of the number of branches from roughly 400 in December 2012 to approximately 260 by the end of 2015. This meant decreasing the number of full-time equivalent employees from almost 3,000 to around 2,600 by 2018.

Moreover, a number of legislative measures were put in place to deal with the new ownership and governance structure of the Cooperatives and tackle other systemic issues causing the Cooperatives' difficulties (e.g., annual auditing by an internationally recognized and independent firm and the transfer of the supervision of the Cooperatives to the Central Bank of Cyprus). Ultimately, the CCB retains a leading role in the Cooperatives' internal control (including the power to remove the CCI's board members in case of non-compliance with set policies), compliance levels and risk management and is now the highest credit-approving authority.

The overhaul of the governance structure and the new procedures and limits designed for the operation of the Cooperatives were deemed by the Commission as crucial elements to restore the long-term viability and profitability of the cooperative banking sector.

In the decision approving the first aid, the Commission noted that the prospected downsizing of the Cooperatives, and consequently the burden-sharing effort to be undertaken, was rather limited for entities receiving a recapitalization amounting to 13 per cent of their RWA. However, the Commission accepted the argument put forward by the Cypriot authorities, which pointed to the fact that, in the absence of a significant presence abroad or in non-banking activities prior to the aid concession, further downsizing of the cooperative banking sector would endanger the Cypriot economy. On 31 December 2013, the Cooperatives played a systemic role as a domestic lender. Their loan portfolio represented almost 30 per cent of the total domestic banking system and the Commission sustained that the Cypriot banking industry was not in a position to take over the necessary function of lender to the national economy. This view also took into account that the remaining Cypriot banking sector had heavily shrunk due to the crisis and the subsequent sale of foreign assets and high losses on the domestic loan book. All the more, the traditionally largest local lender, Bank of Cyprus, was limited in its capacity to provide new funding to the real economy in the medium term as a result of the restructuring undergoing at the time.³⁸ Other banks, including the third-largest (Hellenic Bank), were too modest in terms of size to serve as a true substitute.

The original restructuring plan for the Cooperatives also entailed a number of typical behavioural commitments relating to its implementation, such as refraining from advertising referring to State support, from employing aggressive commercial strategies and from acquiring stakes or assets in companies, and continuing to finance the Cypriot economy.

Cypriot authorities also committed to appoint a monitoring trustee.

³⁷ If one or more of these CCI turns out to be non-viable during the restructuring period, the restructuring plan foresees the merger of non-viable institutions with viable ones and thus a reduction in their number.

³⁸ See the section on Cyprus Popular Bank and Bank of Cyprus, above.

(v) Commission's assessment and conditions for approval: the 2015 restructuring plan

Following the injection of €1.5 billion by Cyprus into the CCB and the governance, ownership and commercial measures adopted in the framework of the 2014 restructuring plan, the ECB conducted, in the course of 2015, an on-site inspection of risk management and risk control systems in the CCB and identified a capital shortfall of approximately €471 million from the assessment of adequacy of specific loan loss provisions. As a result, in November 2015 the CCB was required by the ECB to increase its ratio to a minimum 12.25 per cent of Common Equity Tier 1 capital on a consolidated basis by 30 June 2016 pursuant to Regulation (EU) No 575/2013 of the European Parliament and of the Council.³⁹

Accordingly, in December 2015 Cyprus notified the ECB⁴⁰ and the Commission an additional recapitalization of €175 million, which was subsequently authorized.⁴¹ Neither the CCB nor the CCI is a listed company. Since they are unable to raise capital directly on the market (at least within the timeframe prescribed by the ECB), the new plan foresees the injection of that amount into the CCB by the recently enacted Recapitalization Fund⁴² in return for ordinary shares, together with a new restructuring plan amending the 2014 version.

According to the Commission, there was no outstanding subordinated debt, junior debt or other hybrid/Tier 2 instruments issued by the Cooperatives, so the options for burden-sharing by shareholders and creditors were limited to a dilution of existing shareholders.

As a consequence of the second capital injection and following the final valuation of the CCB approved by the Commission in April 2016,⁴³ the Recapitalization Fund has a shareholding ranging from 22 per cent to 24 per cent, whilst the State remains the largest owner, albeit reducing its stake from 99 per cent to 75–77 per cent. The remaining shareholders (the CCB's minority shareholders and the previous shareholders of the CCI) were also diluted and left with a combined participation of less than 1 per cent.

Unlike Laïki and Bank of Cyprus, the depositors of CCI were not bailed-in. The deposit policy going forward was only subject to a customary price leadership ban.

The 2015 restructuring plan comprises essentially the measures of the first plan approved by the Commission as well as new commitments aimed at enhancing the viability and profitability of the new entity through further operational and organizational efficiencies and at restoring market access.

In particular, to streamline the operations of the CCB and of the CCI, the new plan

³⁹ Regulation of 26 June 2013 on prudential requirements for credit institutions and investment firms [2013] OJ L176, 1.

⁴⁰ For the purposes of Article 16(2)(c) of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287, 63.

⁴¹ Commission Decision in Case SA.43367 (2015/N) – Cyprus, 2015 Additional Restructuring Aid to the Cooperative Central Bank Ltd, 18 December 2015.

⁴² The Recapitalization Fund was initially capitalized by the State and is meant to be funded from the special levy imposed on credit institutions operating in Cyprus (0.15 per cent on their customer deposits).

⁴³ Commission Decision in Case SA.45051 (2016/N) – Cyprus, Final Valuation of the Cooperative Central Bank Ltd, 27 April 2016. The definitive allocation of shares was based on an *ex post* valuation carried out by an independent expert after completion of the recapitalization.

entails further centralization with regard to control and support functions, which will be exclusively conducted at the CCB level.

There is also a more ambitious target for the maximum number of branches (from 260 to 200), although the number of employees has been adjusted upwards (from 2,580 to 2,700) to accommodate the absorption of a former subsidiary of the CCB (and its 120 employees) not envisaged by the 2014 restructuring plan.

An interesting feature of the new plan to achieve market access is the prospect of either listing the majority of the CCB's shares on the Cypriot stock exchange (so that the residual combined shareholding of the State and the Recapitalization Fund does not exceed 25 per cent) or selling the corresponding capital to private financial investors.

Another important aspect is the provision of a contingent commitment, whereby, if the beneficiary fails to achieve the main targets of the new plan, there should be a full legal merger of the existing 19 Cooperatives (the CCB and 18 CCI) into a single entity (or an identical alternative).

From a financial perspective, figures for the restructuring period (ending in 2018) were revised under the 2015 plan. It is expected that after the consolidation process the Cooperatives will recover from a negative return on equity (ROE) of -85 per cent in 2014 to a positive ROE of 8.5 per cent in 2018. In view of the restructuring measures the cost-to-income ratio (CIR) is estimated at roughly 49 per cent by the end of the restructuring period. There is also a projected Core Tier 1 capital ratio of between 10.1 per cent and 14.2 per cent throughout the same period.

Under the 2014 restructuring plan, the Cooperatives' balance sheet was expected to be reduced from €17.1 billion in 2012 to approximately €15 billion in 2018, which represented a limited downsizing of 10 per cent. According to the new plan, the balance sheet should increase marginally, primarily due to the growth in client deposits which will fund the bond portfolio of the group. As it did in the framework of the first plan, the Commission considered that a quicker or stronger de-leveraging (which could only be achieved by further reducing the already low new lending envisaged) would risk endangering the financing of the Cypriot economy, as other local banks have limited capacity to provide funding to families and companies.

PART II PORTUGAL

1. THE PORTUGUESE BANKING LANDSCAPE

(a) Introduction

At the onset of the global financial crisis in 2009 the Portuguese economy had already experienced weak growth over almost a decade, mainly due to low productivity growth and long-standing structural weaknesses, while rising unit labour costs undermined external competitiveness.⁴⁴

In the same period, however, the activity of the Portuguese banking system was carried out in a particularly favourable international financial environment, marked by ample liquidity, easy access to financing markets and low borrowing costs. The growth in Portuguese banks' assets even continued over the 2008–10 period, and only began to fall after the beginning of the sovereign debt crisis, which ultimately led to the Economic and Financial Adjustment Program of May 2011. With the exception of State interventions in two small banks (BPN and BPP, each in very specific circumstances, as we will see below), Portuguese banks went through the first years of the financial crisis without needing State support in the form of recapitalization, only having recourse to the State guarantee scheme put in place in 2008.⁴⁵

From 2011 onwards, however, the Portuguese banking system encountered several difficulties, as some of the banks were highly leveraged, had high loan-to-deposit ratios and had to cope with an increasing ratio of non-performing loans. In these circumstances, Portuguese banks were also faced with increasingly difficult access to wholesale funding and, from 2012 onwards, with stricter regulatory requirements on solvency and capital levels.

It is therefore unsurprising that, of the five main Portuguese banks, four received State support: CGD, BCP and BPI benefitted from recapitalization measures in 2012 pursuant to the New Recapitalization Scheme approved by the Commission, and BES, while opting for not requesting recapitalization support from the State, later encountered serious difficulties and had to be resolved in 2014. Another smaller bank, Banif, also received recapitalization support in 2013, but was not able to return to viability and was also the object of a resolution measure in 2015. We will analyse each of these individual cases in turn below.

(b) The Financial Assistance Program

In the first months of 2011, Portugal came under increasing pressure in financial markets, creating rising concerns about the sustainability of its public finances. The sovereign debt crisis, which began in April 2011, led to a sharp increase in sovereign spreads, and in the

⁴⁴ See European Commission, *The Economic Adjustment Program for Portugal 2011–2014*, Occasional Papers 202, October 2014, 1315, and *Country Report Portugal 2016*, Commission Staff Working Document, SWD(2016) 90 final, of 26 February 2016.

⁴⁵ Associação Portuguesa de Bancos, *Portuguese Banking Sector Overview*, November 2015, 3 and 62.

continuous downgrading by credit ratings agencies of Portuguese bonds. In parallel, the banking sector, which was heavily dependent on external financing, particularly within the Eurozone, was increasingly cut off from market funding.

Following a request for financial assistance submitted by the Portuguese Government to the European Union (EU) and the IMF, on 3 May 2011 the Commission, the ECB and the IMF reached an agreement on a comprehensive economic and Financial Assistance Program, totalling €78 billion over three years (the Program).

The Program, contained in a Memorandum of Understanding on Specific Economic Policy Conditionality (2011 MoU),⁴⁶ aimed to restore confidence in sovereign debt and in the banking sector and support growth and employment.

In the financial sector the main objectives of the Program were, in particular:

- maintaining liquidity, through the issuing of government guaranteed bank bonds, subject to EU State aid rules;
- supporting a balanced and orderly deleveraging, including requiring institution-specific funding plans to achieve a market-based funding position, to be examined in quarterly reviews;
- reinforcing capital buffers, in particular requiring all banking groups supervised by the Bank of Portugal to reach a Core Tier 1 capital ratio of 9 per cent by the end of 2011 and 10 per cent by the end of 2012, as well as requiring some banks to reach these higher capital levels on an accelerated schedule based on their specific risk profile;
- streamlining State-owned *Caixa Geral de Depósitos* (CGD), Portugal's largest bank, in order to increase the capital base of its core banking business as needed, in particular through the gradual disposal of non-core subsidiaries and if necessary a reduction of its activities abroad;
- monitoring bank solvency and liquidity by the Banco de Portugal (Bank of Portugal), the Portuguese Central Bank and banking regulator, through the design of a program of special on-site inspections to validate data provided by banks and quarterly updates of banks' potential capital needs;
- strengthening bank regulation and supervision by the Bank of Portugal;
- finalizing the privatization of *Banco Português de Negócios* (BPN);
- strengthening the bank resolution framework by imposing early reporting obligations based on clear triggers and the preparation of contingency resolution plans subject to regular review;
- reinforcing the deposit guarantee fund;
- reinforcing the corporate and household insolvency framework; and
- monitoring of corporate and household indebtedness.

By the end of June 2014, 12 review missions of the Program had taken place. Portugal received 11 disbursements, the first on the occasion of the approval of the Program,

⁴⁶ Portugal: Memorandum of Understanding on Specific Economic Policy Conditionality, of 3 May 2011. A Memorandum of Economic and Financial Policies, with a similar content, was signed with the IMF.

with a total amount corresponding to approximately 97 per cent of the agreed package. The Program expired successfully on 30 June 2014, without the government requesting disbursement of the last agreed tranche. Portugal is currently under post-program surveillance, in line with the relevant European and IMF rules.

2. AID SCHEMES

(a) The State Guarantee Scheme

In order to support the access to liquidity of solvent credit institutions, and ensure the stability of the Portuguese financial sector in the context of the international financial crisis, Portugal put in place a special guarantee scheme for credit institutions.⁴⁷ This scheme was originally approved by the Commission on 29 October 2008⁴⁸ and, after successive prolongations and a number of amendments,⁴⁹ is still in force.

All credit institutions incorporated in Portugal, including subsidiaries of foreign banks, can benefit from the scheme, as long as they are solvent under Portuguese law. The guarantee scheme covers the issuing of non-subordinated euro-denominated debt with a minimum maturity of three months and a maximum maturity of up to five years, which can be extended to seven years in case of guarantees on the issuing of covered bonds on mortgages and on the public sector.⁵⁰

The remuneration for the guarantee is calculated in accordance with the formula set out in the Annex to the 2011 Prolongation Communication.⁵¹ The total budget of the Guarantee Scheme was initially €20 billion and is presently €24.67 billion.⁵²

In the event the guarantee is called in as a result of default by the beneficiary institution,

⁴⁷ See Law 60-A/2008 of 20 October 2008, Portaria 1219-A/2008 of 23 October 2008 (as amended by Portaria 946/2010 of 22 September 2010 and Portaria 80/2012 of 27 March 2012), and Article 100 of Law 7-A/2016, of 30 March 2016, approving the State Budget for 2016.

⁴⁸ Commission Decision C(2008) 8686 on State aid NN60/2008 – Portuguese Guarantee Scheme for Credit Institutions in Portugal, 17 December 2008.

⁴⁹ Up to the present date the Commission has approved 14 prolongations of the scheme. See Commission Decisions in State aid Case N51/2010, 22 February 2010, in State aid Case N315/2010, 23 July 2010, in State aid Case SA.32158, 21 January 2011, in State aid Case SA.33178, 30 June 2011, in State aid Case SA.34034, 21 December 2011, in State aid Case SA.34958, 27 June 2012, in State aid Case SA.35743, 17 December 2012, in State aid Case SA.36869, 1 August 2013, in State aid Case SA.376980, 19 December 2013, in State aid Case SA.389001, 30 July 2014, in State aid Case SA.39991, 4 February 2015, in State aid Case SA.42404, 22 July 2015, in State aid Case SA.43996, 13 January 2016, and in State aid Case SA.43996, 29 July 2016.

⁵⁰ See art. 2 of Portaria 1219-A/2008, as amended by Portaria 80/2012. The following instruments cannot benefit from the guarantee: interbank deposits in the money market, subordinated debt, operations which already benefit from other types of guarantees as well as financing operations in jurisdictions not complying with internationally accepted transparency standards.

⁵¹ See Section 1 of the Annex of Portaria 1219-A/2008, as amended by Portaria 80/2012, as well as the Annex to the Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis (2011 Prolongation Communication) [2011] OJ C356, 7.

⁵² See Art. 100 of Law 7-A/2016, of 30 March 2016, approving the State Budget for 2016.

the State is subrogated to the rights of the creditor until full repayment of the loan. All assets of the defaulting beneficiary can be used in payment of the debt.

Under the above scenario the State can, under certain circumstances, decide to convert its rights as a creditor into preferential shares. In this case, according to commitments provided by the Portuguese authorities, these shares will confer the right to a dividend of not less than 10 per cent of their nominal value, taken from profits, and to the priority reimbursement of their nominal value in the event of liquidation of the credit institution.

In addition, the Portuguese authorities have committed:

- that any credit institution that is granted guarantees on new liabilities or on renewed liabilities for which the total outstanding guarantees exceeds both a ratio of 5 per cent of total liabilities and a total of €500 million will be required to present a restructuring plan within two months of the granting of the guarantees;
- that any institutions which cause the guarantee to be called upon will be required to submit individual restructuring or liquidation plans within two months;
- to impose a ban on advertising that refers to State support of the beneficiaries and to prevent them from employing any aggressive commercial strategies which would not be implemented without State support;
- to present a report on the operation of the scheme every three months, on guaranteed issuances and the actual fees charged.⁵³

The guarantee scheme has been used by several Portuguese banks, which have also benefitted from other aid measures. Since the restructuring plans submitted by aided banks should contain all State aid received as individual aid or under a scheme during the restructuring period as foreseen in the Restructuring Communication, the guarantees provided to such banks will be analysed together with the individual aid cases below.⁵⁴

(b) The 2009 Recapitalization Scheme

A first scheme to strengthen the financial soundness of credit institutions was notified by the Portuguese government to the Commission in November 2008.⁵⁵ The scheme allowed for the recapitalization of all credit institutions with a registered office in Portugal, independently of their financial soundness, following an application submitted by the interested credit institution to the Bank of Portugal (together with a plan for strengthening the own capital), and could be performed with any financial instruments eligible as Tier 1 capital.

The scheme was approved by the Commission under Article 87(3)(b) EC [presently

⁵³ See Commission Decision in Case SA.43996 – Portugal 13th Prolongation of the Portuguese Guarantee Scheme, 13 January 2016.

⁵⁴ A further guarantee scheme, under which Portugal issues banks operating in Portugal with State guarantees which, in turn, guarantee lending by the European Investment Bank was approved by Commission Decision C(2013) 4142 final on State aid SA.36180 – Portuguese Guarantee Scheme on EIB Lending, 27 March 2013.

⁵⁵ The scheme was established by Law 63-A/2008, of 24 November 2008, as originally approved.

107(3)(b) TFEU], subject to a number of behavioural commitments undertaken by Portugal.⁵⁶ However, no requests for recapitalization were submitted under this scheme.

(c) The 2012 Recapitalization Scheme

In the context of implementation of the Financial Assistance Program, a new recapitalization scheme for credit institutions was notified by Portugal to the Commission in December 2011, with an allotted budget of €12 billion⁵⁷ (New Recapitalization Scheme).⁵⁸

The New Recapitalization Scheme was intended as a ‘safety net’ in order to allow Portuguese banks to comply with the more demanding solvency requirements, at a time when access to capital markets was still unavailable. As seen above, in the context of the Financial Assistance Program the Bank of Portugal required banks to maintain a minimum Core Tier 1 capital of 9 per cent by 31 December 2011 and of 10 per cent by 31 December 2012.⁵⁹ In addition, the Bank of Portugal incorporated EBA Recommendation EBA/REC/2011/1, of 8 December 2011, requiring that Portuguese banks included in the EBA capital exercise of December 2011 strengthened their capital positions by building up a capital buffer against sovereign debt exposures such as that the core Tier 1 capital ratio reached a level of 9 per cent by 30 June 2012.⁶⁰

Under the new scheme, recapitalization operations were able to be carried out with special shares and other financial instruments eligible as Core Tier 1 capital.

Special shares subscribed by the State generally had limited voting rights,⁶¹ and enjoyed preferential treatment in terms of dividends. Special shares were acquired by the State based on a discount to the market price, which was at least 35 per cent for non-voting shares and at least 25 per cent for voting shares (taking account of dilution before that discount was computed).⁶² Existing shareholders had a pre-emptive right to buy back the shares, insofar as the State had a return of at least 10 per cent and a share of any upside of the market price ranging from 20 per cent to 40 per cent of the capital gain (depending on the year of exit). Special shares not bought back by existing shareholders at the end of a five-year investment period were converted into ordinary shares.

Recapitalization by the State could also take the form of convertible instruments eli-

⁵⁶ Commission Decision C(2009) 4028 final on State aid N556/2008 – Portugal, Recapitalization Scheme of Credit Institutions in Portugal, 20 May 2009.

⁵⁷ The new recapitalization scheme was established by Law 4/2012, of 11 January 2012, which altered Law 63-A/2008, of 24 November 2008, and was implemented by Portaria 150-A/2012, of 17 May 2012.

⁵⁸ See Commission Decision C(2012) 3525 final on State aid SA.34055 – Portugal, New Recapitalization Scheme for Credit Institutions in Portugal, 30 May 2012.

⁵⁹ Aviso 3/2011 of the Bank of Portugal, of 10 May 2011.

⁶⁰ See Aviso 5/2012 of the Bank of Portugal, of 10 January 2012. Further capital shortfalls at some Portuguese credit institutions resulted notably from the transfer of their pension funds to the Portuguese Social Security, the haircuts recognized on Greek debt and from additional impairments recognized in the loans portfolio (See *Associação Portuguesa de Bancos, Portuguese Banking Sector Overview*, April 2013, 39).

⁶¹ Except when exceeding half of the share capital of the institution, when the State could fully exercise the voting rights conferred by the shares exceeding that threshold.

⁶² The value of the special shares was determined by two independent experts when the shares of the beneficiaries were not listed.

gible for solvency purposes as Core Tier 1. The remuneration of hybrid securities was defined by Ministerial Order and was at least 8.5 per cent for the first year of the investment, increasing annually in order to reach an average of 9 per cent over the five-year investment period. Hybrid securities that were not reimbursed by the beneficiaries at the end of the five-year investment period were automatically converted into ordinary shares. Mandatory conversion also took place in case of a material breach of the recapitalization plan or if the hybrid securities became ineligible to be considered as Core Tier 1 capital. Conversion into ordinary or special shares was done with a discount to market prices determined by the Portuguese authorities, subject to prior authorization by the Commission under State aid rules.

Portugal undertook to inform the Commission of the terms and conditions of each recapitalization before it was completed and to submit a restructuring plan in accordance with the Restructuring Communication within six months of the date of the recapitalization under the Scheme.

Portugal also agreed to impose the following behavioural commitments on beneficiaries of the New Recapitalization Scheme, in accordance with the Commission's standing practice: (i) a dividend ban; (ii) a ban on buy-backs of hybrid instruments and subordinated debt; (iii) a ban on coupon and interest payments in hybrid instruments and subordinated debt; (iii) a ban on aggressive commercial strategies; and (iv) a ban on the acquisition of equity stakes in other companies.⁶³

The Commission reviewed the New Recapitalization Scheme under Article 107(3)(b) TFEU and recognized that it was appropriate and necessary to remedy a serious disturbance in the Portuguese economy, since the high instability on the financial markets arising from concerns about sovereign risk continued to have a significant impact on the capacity of most Portuguese financial institutions to raise funds without some form of support.

In addition, the scheme was deemed to comply with the requirements of the 2011 and 2012 Prolongation Communications on the pricing of capital injections and on the requirement of a restructuring plan for all recipients,⁶⁴ and the commitments submitted by Portugal were found to be sufficient compensatory measures in the 'rescue phase' prior to approval of the restructuring plan. The New Recapitalization Scheme was therefore approved on 30 May 2012⁶⁵ until 31 December 2012.⁶⁶

Two recapitalization operations were carried out pursuant to the New Recapitalization

⁶³ See Decision of 30 May 2012, para. 23. While not expressly mentioned in the Decision of 30 May 2012, in the recapitalizations carried out under the New Recapitalization Scheme which will be analysed below the State also imposed limitations on the remuneration policy of the banks' managing bodies. This was later incorporated into the commitment catalogue in the first prolongation of the scheme by Decision of 17 December 2012.

⁶⁴ Communication from the Commission on the application, after 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis [2010] OJ C329 (the 2011 Prolongation Communication), 7; and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356 (the 2012 Prolongation Communication).

⁶⁵ See fn. 63.

⁶⁶ Further to a prolongation requested by Portugal, the Commission approved an extension of the scheme until 30 June 2013. See Commission Decision C(2012) 9782 final on State aid SA.35747

Scheme: those of BCP and BPI, both in June 2012. Moreover, while two additional operations, the recapitalization of State-owned CGD in June 2012 and BANIF in January 2013, were notified to the Commission as individual aid measures, their terms and conditions closely followed the requirements of the New Recapitalization Scheme.

3. INDIVIDUAL AIDS

(a) The Nationalization and Restructuring of BPN

The first intervention by the Portuguese government in the context of the financial crisis was the case of *Banco Português de Negócios, S.A. (BPN)*, which was nationalized on 11 November 2008. After a number of support measures and a lengthy restructuring process, which included the opening of the formal investigation procedure by the Commission,⁶⁷ BPN was finally reprivatized in March 2012, with significant losses to the State.⁶⁸

(i) Events leading to the State intervention

In the years leading up to 2008, BPN had evolved from being a niche investment bank to a full-service bank, in part through an aggressive deposit-taking strategy, but also resorting to (what was later revealed as) fraudulent behaviour, including a hidden ‘virtual bank’ with a significant credit portfolio.⁶⁹ BPN started facing liquidity issues in the summer of 2008, which worsened in October, after the fall of Lehman Brothers in September. To prevent default, ELA was provided by the Portuguese Central Bank and by the State-owned CGD, but given accumulated losses, recapitalization plans presented by management were considered unfeasible. Despite the Bank’s small size, the government and the Central Bank feared that an uncontrolled liquidation would affect the stability of the financial system as a whole and the bank was nationalized on 11 November 2008 at zero price by an act of parliament.⁷⁰ Although the Commission was informed of the nationalization, no prior notification was submitted by Portugal for any of the measures granted to BPN by the State, which were therefore qualified as unlawful aid under Article 108(3) TFEU.⁷¹

(2012/N) – Portugal, First Prolongation of the Recapitalization Scheme for Credit Institutions in Portugal, 17 December 2012.

⁶⁷ See Commission Decision C(2011) 7659 final on State aid SA.26909 (ex NN62/2008) – Portugal, Nationalization and Restructuring of Banco Português de Negócios [2011] OJ C371 (BPN Opening Decision).

⁶⁸ See BPN Opening Decision, Commission Decision C(2012) 2043 final on the Measures SA.26909 implemented by Portugal for the Restructuring of Banco Português de Negócios (BPN) [2012] OJ L301 (BPN Final Decision), and the Final Report of the Parliamentary Inquiry Commission on BPN (*Comissão Parlamentar de Inquérito ao Processo de Nacionalização, Gestão e Alienação do Banco Português de Negócios, SA*) of 16 November 2012 <www.parlamento.pt> accessed 27 October 2016.

⁶⁹ See Bank of Portugal, Financial Stability Report 2008, 131.

⁷⁰ Law 62-A/2008 of 11 November 2008.

⁷¹ See the BPN Opening Decision, para. 4; and BPN Final Decision, para. 273.

(ii) Aid measures

The bank's management was assigned to CGD under the nationalization law. In order to ensure liquidity and reimburse the emergency loans prior to nationalization, BPN issued commercial paper with subscription guaranteed by CGD and a State guarantee (remunerated at 0.2 per cent per year), which amounted to €4.5 billion by 2012. An initial restructuring plan was submitted to the Commission in September 2010 whereby BPN's impaired assets were transferred to a 'bad bank', with the 'good bank' being subsequently reprivatized. Assets and liabilities totalling €3,895 million were accordingly transferred to three Special Purpose Vehicles (Parvalorem, Parups and Parparticipadas (SPVs)) in December 2010, reducing BPN's balance sheet by 30 per cent. However, a first tender launched by Portugal to sell the bank in 2010 failed to attract interested parties.⁷²

Further to the Financial Assistance Program, the government undertook to initiate a new privatization process and find a buyer by the end of July of 2011, and a new tender procedure was launched without a minimum price. Although four offers were submitted, only the one submitted by Banco BIC Português, S.A. (BIC), the Portuguese subsidiary of an Angolan-based bank, complied with the tender's requirements. BIC was therefore selected by the government on 31 July 2011 to continue exclusive negotiations, which culminated in the signing of a framework agreement for the sale of BPN on 9 December 2011.⁷³ Given BIC's unique negotiation position and the time constraints for negotiating the sale, the framework agreement provided for a significant number of additional State support measures to BPN prior to its sale, including: (i) recapitalization of the bank of (ultimately) €600 million; (ii) an additional transfer of assets to the SPVs, in order to achieve an LTD ratio of 110–150 per cent; as well as (iii) the right to transfer certain additional loans and deposits post-implementation of the sale; the (iv) granting of a new credit line and the maintenance of the commercial paper program, both from CGD; and (v) the transfer of litigation risks to the State. BIC was to pay an acquisition price of €40 million, and share 20 per cent of any earnings exceeding €60 million over the next five years. It also committed not to pay dividends to shareholders for five years after the sale.⁷⁴

(iii) Commission's assessment and conditions for approval

As Portugal did not respond to several requests for a revised restructuring plan, the Commission initiated the formal investigation procedure on 24 October 2011. The Commission considered that most of the measures concerning BPN constituted State aid,⁷⁵ and expressed doubts as to whether: (a) BPN as a combined entity with the purchaser was viable; (b) the aid granted to BPN was limited to a minimum and the sale

⁷² See the BPN Final Decision, paras 34–45.

⁷³ *Ibid.*, paras 46–53.

⁷⁴ *Ibid.*, para. 56.

⁷⁵ The Commission considered that State aid was involved, in particular, in: CGD's liquidity support before and after nationalization of BPN, with a guarantee from the State; the transfer of assets from BPN to the State-owned SPVs; the recapitalization of BPN prior to the sale to BIC; the transfer of additional assets and liabilities from BPN linked to the sale; the right of BIC to transfer non-performing loans to the State after the sale; the transfer of litigation risks to the State; and the granting or maintenance of credit lines by CGD to BIC after the sale. See the BPN Opening Decision, paras 49–69, and BPN Final Decision, paras 94–170.

to BIC was the least expensive option compared to a liquidation scenario; (c) the measures limiting distortions of competition were sufficient; and (d) the sale process entailed any aid to the buyer.⁷⁶

Accordingly, on 20 January 2012 the Portuguese authorities submitted an updated restructuring plan for BPN and on 16 March 2012 provided a series of commitments to the Commission to address the concerns expressed in the decision opening the formal investigation procedure. Portugal and the buyer committed to ensuring, notably, that:

- the Core Tier 1 capital ratio of BPN at the date of sale would not be higher than 10–18 per cent;
- if BIC or the combined entity chose to return non-performing loans to the State after the sale (up to a specific date, and only after having exhausted the provisions available in the BPN accounts at the date of sale), it would pay back to the State the capital associated with those loans, in order not to increase the Core 1 capital ratio at the time of sale; and
- the existing credit line in relation to BPN's commercial program would not be extended beyond a specific date, the remuneration of the new liquidity line to be granted by CGD would have a given minimum premium, and Portugal would not grant any additional credit or guarantees to BIC or to the combined entity without the prior approval of the Commission until 31 December 2016.

The commitments also included a ban on acquisitions and a ban on the early call of subordinated debt issued by BPN, until 31 December 2016, as well as the prohibition of reference to State aid in marketing and communication campaigns.⁷⁷

In the final decision, of 27 March 2012, the Commission confirmed that all measures analysed in the decision opening the procedure constituted State aid,⁷⁸ but that the conditions of the sale did not involve aid to buyer, since the commitments ensured that BIC or the combined entity did not benefit from more advantageous conditions relative to BIC's final offer of 20 July 2012.⁷⁹ The Commission then assessed the compatibility of the aid measures under Article 107(3)(b), concluding that the revised restructuring plan complied with the criteria of the Restructuring Communication.⁸⁰

In particular, the strategy underlying the restructuring plan was found to be based on sound assumptions and to lead to the long-term viability of BPN.⁸¹ The Commission also accepted that the orderly liquidation of BPN would have been more costly to the State than the sale to BIC, and that the restructuring costs of BPN were limited to a minimum: BPN would cease to operate as an independent bank; the business to be taken over by BIC had a balance sheet of less than 35 per cent of BPN's balance sheet before its nationalization; and the additional measures demanded by BIC, as modified by the

⁷⁶ BPN Final Decision, para. 56.

⁷⁷ *Ibid.*, paras 84–93.

⁷⁸ *Ibid.*

⁷⁹ *Ibid.*, paras 171–80.

⁸⁰ Restructuring Communication, 9.

⁸¹ BPN Final Decision, paras 191–211.

commitments, did not go beyond those necessary to ensure viability and effect the sale of the bank.⁸²

With regard to own contribution and burden-sharing, BPN's shareholders were wiped out with the nationalization at zero price and the management was replaced. The Commission noted that BPN did not comply with the Commission's policy on the payment of coupons on outstanding subordinated debt,⁸³ but accepted that the far-reaching restructuring of the bank was sufficient to compensate for the lack of burden-sharing. In addition, while the remuneration of the measures (and in particular of the guarantees, the capital injection and the transfer of assets to the SPVs) was not in line with the Commission's relevant communications, this was also deemed to be compensated by the far-reaching restructuring of the Bank.⁸⁴ Finally, the commitments accepted by BIC (in particular the limitations to the continuing and new credit lines of CGD and the right to transfer further assets after the sale), represented adequate measures to limit undue distortions of competition.⁸⁵

Further to the Commission's approval, BPN was sold to BIC on 31 March 2012 and subsequently merged with the buyer. Implementation of the BPN restructuring was characterized by significant delays, which were connected to the exceptional circumstances affecting the Portuguese economy and led to the signing of the MoU of 17 May 2011,⁸⁶ but nevertheless contributed to the deterioration of the bank's business, and the difficulties affecting its privatization. Up to December 2012, the net loss for the State arising from BPN was calculated at €3,405 million, and the phasing-out of the SPVs' assets is still ongoing.⁸⁷ Commitments are monitored by the Commission through six-monthly reports from the Portuguese authorities⁸⁸ (conversely, subsequent commitment decisions are monitored by specially-appointed Monitoring Trustees, as we will see below).

(b) Negative Decision: The Guarantee Provided to BPP

The second Portuguese State aid case of the financial crisis was Banco Privado Português, S.A. (BPP). BPP was a small, private financial institution providing private banking, corporate adviser and private equity services, with €2.9 billion in assets on 30 June 2008, representing less than 1 per cent of Portuguese banking sector assets.⁸⁹

⁸² Ibid., para. 215.

⁸³ BPN continued to pay coupons for subordinated bond holders holding €245 million, having taken the view that it was not appropriate to seek burden-sharing from those clients, given the specific circumstances of the sale of those instruments (which according to press reports were sold as 'guaranteed remuneration' products), and in some cases the terms of the contracts prevented BPN from refusing to pay interests and reimburse capital to clients. See the BPN Final Decision, paras 76 and 241.

⁸⁴ BPN Final Decision, paras 245–251.

⁸⁵ Ibid., para. 226.

⁸⁶ Ibid., paras 253–272.

⁸⁷ See the Parliamentary Inquiry Report on BPN of 16 November 2012 (referred to in fn. 73 above), 271.

⁸⁸ BPN Final Decision, para. 273.

⁸⁹ See Commission Decision C(2009) 1892 final on State aid NN71/2008 – Portugal, State Aid to Banco Privado Português-BPP, 13 March 2009 (BPP Rescue Decision).

(i) State intervention

In the fall of 2008, BPP developed liquidity difficulties due to the deterioration of the global economic situation, and on 1 December 2008 the Portuguese Central Bank allowed it to suspend all payments. On 5 December 2008 BPP received a €450 million loan from six major Portuguese banks, backed by a State guarantee, which was remunerated at 20 bp, in consideration of the collaterals presented by BPP.

Portugal notified the support measures to the Commission on 5 December 2008, seeking urgent approval of rescue aid to BPP. Despite the small size of the bank, the Portuguese government and Central Bank considered that there was a risk of harmful spillover effects on the Portuguese financial system and the Portuguese economy as a whole, in view of the unstable market conditions prevailing at the international level.

(ii) Commission's assessment

The Commission confirmed that the guarantee granted to BPP constituted State aid, and accepted that Article 87(3)(b) EC [presently Article 107(3)(b) TFEU] was applicable, since the BPP default could have had a domino effect on several financial institutions, thereby undermining confidence in the Portuguese financial system and the Portuguese economy as a whole.

The Commission then reviewed the measure under the conditions of the 2008 Banking Communication for compatibility with Article 87(3)(b),⁹⁰ and approved it as rescue aid for a period of six months, concluding that the State guarantee: (a) could be considered an *appropriate* measure to keep the bank afloat; (b) was limited to the minimum *necessary* in scope and time; and (c) its *proportionality* was guaranteed by a number of behavioural safeguards (notably the limitation of the use of the loan to face existing liabilities), which minimized distortion of competition.⁹¹

The Commission noted in this regard that the guarantee's remuneration was below the ECB's recommendation of 20 October 2008 (which indicated a flat fee of 50 bp), but concluded it could exceptionally be considered appropriate, in view of the collaterals offered (which were estimated at the time to be worth around 150 per cent of the value of the loan), and of the short term of the loan (six months). In any event, the Commission anticipated that this higher cost of public intervention would be reflected in compensatory measures provided in BPP's restructuring plan, which the government committed to presenting within six months of granting of the measure.⁹²

However, no restructuring plan was ever submitted by the Portuguese government to the Commission. BPP's difficulties were aggravated when the Bank of Portugal rejected the recovery and restructuring plan submitted by BPP's administrators in June 2009 (the Central Bank and the Securities Regulator (CMVM) meanwhile found serious irregularities that amounted to criminal practice on the part of BPP, especially regarding 'absolute guaranteed return' investment products placed with a large number of BPP's clients), and the Portuguese authorities twice extended the State guarantee beyond the period initially

⁹⁰ Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270, 8.

⁹¹ BPP Rescue Decision, paras 25–45.

⁹² *Ibid.*, paras 39–41.

approved.⁹³ Given the impossibility of restructuring or recapitalizing the bank, the Bank of Portugal revoked BPP's banking licence on 16 April 2010, and subsequently petitioned the Lisbon Commerce Court for its liquidation. The State guarantee was then called in by the bank syndicate and was executed on 7 May 2010, when Portugal reimbursed €450 million to the six banks, and became the largest BPP creditor in the pending court proceedings.⁹⁴

The Commission initiated the formal investigation procedure on 10 November 2009, questioning the pricing and extension of the guarantee, as well as the absence of a restructuring plan. Despite the Portuguese government's arguments, the Commission concluded on 20 July 2010 that the failure to submit a restructuring plan rendered the State guarantee incompatible with the internal market as of 5 December 2008, and adopted a negative decision⁹⁵ and a recovery order for the amount of aid received plus interest (the aid was calculated as the difference between a theoretical market rate, set by the Commission at the reference rate plus 400 bp, and the price actually paid by the guarantee), as well as evidence demonstrating that the Portuguese State had enforced its priority rights over the collateral offered by BPP within the pending court proceedings.

(iii) Appeals and preliminary ruling

BPP and the Insolvency Estate of BPP lodged an annulment action before the General Court, which dismissed the appeal and confirmed the Commission's Recovery Decision in full in its judgment of 12 December 2014.⁹⁶ A further appeal to the ECJ was dismissed as manifestly unfounded by order of the Court in 15 October 2015.⁹⁷ Meanwhile, the Lisbon Commerce Court had submitted a reference for a preliminary ruling inquiring about the validity of the Commission's Recovery Decision, and the ECJ ruled on 5 March 2015 that the decision was entirely valid.⁹⁸

In the three decisions, the EU courts found that the Commission had not erred in considering that the guarantee affected trade between Member States, even after BPP

⁹³ On 11 December 2009, the government also decided to establish a closed Special Investment Fund (SIF), made up of the resources held in the absolute return investment products, activate the Deposit Guarantee Fund (DGF) and the Investor Compensation System (ICS), and grant insurance of up to €250,000 to clients who joined the SIF, in order to cover the negative difference, if any, between reimbursements from the DGF and ICS and that €250,000 ceiling. The Commission considered that although SIF clients could have received an advantage from the measure, which could constitute State aid if benefitting undertakings, the disbursement by the State would be well below the €200,000 *de minimis* threshold over three years, after account was taken of the cover provided by the DGF and the ICS.

⁹⁴ See Commission Decision of 20 July 2010 on State aid C33/09 (ex NN57/09, CP 191/09) implemented by Portugal in the form of a State guarantee to BPP [2011] OJ L159 (BPP Recovery Decision), paras 23–42.

⁹⁵ In fact the only negative decision taken by the Commission between 2008 and the adoption of the 2013 Banking Communication.

⁹⁶ ECJ, Case T-487/11 *Banco Privado Português and Massa Insolvente do Banco Privado Português v Commission* [2014] ECR I-000.

⁹⁷ Case C-93/15P *Banco Privado Português and Massa Insolvente do Banco Privado Português v Commission* [2015] ECR I-000.

⁹⁸ Judgment of the Court (Second Chamber) of 5 March 2015, Case C-667/13 *Estado português v Banco Privado Português SA and Massa Insolvente do Banco Privado Português SA* [2015] ECR I-000.

ceased operating, as inter alia the bank could (until its licence was later revoked), have resumed its normal commercial activities.⁹⁹ BPP and the insolvency estate had also claimed that non-compliance of the aid with the internal market was purely procedural, in particular the absence of the submission of a restructuring plan and the failure to notify the guarantee's extension. In this respect, the courts recalled the Commission's discretion under Article 107(3)(b) TFEU, which involves complex assessments of an economic and social nature, and that the Commission had imposed a limit on its discretion by adopting the 2008 Banking Communication. The Commission's reasoning followed, and complied with, the criteria of this Communication.¹⁰⁰ In addition, the ECJ clarified that the obligations to notify the extensions to the guarantee and submit a restructuring plan are not merely formal requirements but rather necessary conditions for that aid to be declared compatible.

At the time of writing, the liquidation proceedings of BPP are still pending, and a recent decision of the Lisbon Commerce Court confirmed the privileged status of the State as guaranteed creditor, meaning that the State may be able to recover the €450 million paid to the bank syndicate in execution of the guarantee in 2010.¹⁰¹

(c) Recapitalization and Restructuring: BCP, BPI and CGD

Immediately following the approval of the New Recapitalization Scheme by the Commission, two large Portuguese banks, BCP and BPI, submitted requests for recapitalization under the scheme. In parallel the government also approved a significant recapitalization of State-owned CGD, the largest bank in Portugal, which was notified as an individual aid measure to the Commission. All three banks were duly recapitalized on 29 June 2012,¹⁰² and subsequently submitted restructuring plans to the Commission.

One of the common elements in the recapitalization and restructuring plans of the three banks was the commitment assumed by each bank vis-à-vis the Portuguese government to allocate €30 million per year to a fund that would invest in the equity of Portuguese SMEs and mid-cap corporates in view of securing financing and deleveraging of the real economy. This commitment, which does not appear to fit easily into a State aid analysis, was nevertheless included in the commitment catalogue submitted together with the restructuring plans of the three banks, and was considered by the Commission.

(i) Banco Comercial Português, S.A.

Banco Comercial Português, S.A. (BCP), also known as Millenniumbcp, is the largest privately-owned banking group and the second largest in Portugal after CGD. BCP is

⁹⁹ Case T-487/11, paras 70–72, case C-667/13, paras 5–54 and case C-93/15P, paras 54–56.

¹⁰⁰ Case T-487/11, paras 61–67, case C-667/13, paras 67–72 and case C-93/15P, paras 60–66.

¹⁰¹ See *Expresso*, 'BPP. Tribunal do Comércio indefere créditos e confirma privilégio do Estado', 30 September 2016 <<http://expresso.sapo.pt/economia/2016-09-30-BPP-Tribunal-do-Comercio-indefere-creditos-e-confirma-privilegio-do-Estado>> accessed 31 October 2016. The Portuguese government foresees recovering in full the guarantee granted to BPP, which is included in the revenues foreseen in the Draft State Budget for 2017 (see Ministry for Finance, *Relatório do Orçamento de Estado para 2017*, October 2016, 39).

¹⁰² See Orders of the Minister of Finance 8840-A/2012 (BPI), 8840-B/2012 (BCP) and 8840-C/2012 (CGD), of 28 June 2012, DR II 127, 3 July 2012, 23346-2.

listed in Euronext Lisbon, and in June 2012 its main international subsidiaries were in Poland and in Greece, as well as in Africa (Mozambique and Angola). At the end of 2012 BCP's balance sheet comprised €89.7 billion in assets, and the bank represented 18.1 per cent of total deposits and 19.1 per cent of total loans in Portugal.

The reasons for State intervention Besides the stricter regulatory requirements on prudential capital outlined above, BCP was affected by the Greek sovereign debt crisis and subsequent deterioration of the Greek economy, having to recognize a €533 million impairment in its holdings of Greek government bonds, as well as further loss provisions in its Greek subsidiary.

In addition, the negative effects of the crisis on the Portuguese economy were reflected in a sharp increase in both BCP's loan loss provisions and impairments on financial assets. Furthermore, the transfer of BCP's pension plans to the General Social Security Scheme in the course of 2011 had a negative impact on its annual accounts and capital ratios.

Finally, as other Portuguese banks that relied heavily on wholesale funding, BCP saw a sharp decrease in its interest rate margin due to increasing funding costs and decreasing loan rates of the mortgage book, caused by the continued reduction of Euribor reference rates during this period. The bank was therefore in need of a substantial raise in capital by 30 June 2012.

Aid measure The Portuguese government accordingly approved a recapitalization operation consisting of the subscription of €3 billion of contingent convertible bonds (CoCos) issued by BCP, which were eligible for treatment as Core Tier 1 and bore an interest rate that started at 8.5 per cent and gradually increased to 10 per cent over the restructuring period, so as to incentivize its repayment. The capital injected amounted to approximately 5.4 per cent of BCP's RWA.

In its assessment the Commission took into account other State aid received by BCP, in particular the State guarantees provided to BCP's newly issued subordinated debt, pursuant to the State Guarantee Scheme approved by the Commission (up to July 2013, BCP had a cumulative amount of guaranteed debt of €7.5 billion), and State guarantees on EIB lending (€306 million to be granted by the end of 2013, and a further €250 million to be granted in the 2014–17 period).¹⁰³ The Commission also considered that 14 per cent of the capital shortfall was provided by the bank's shareholders and other private investors, as in the second semester of 2012 BCP completed a capital increase of €500 million, which although initially underwritten by the State, was subscribed fully by private investors.

Commission's assessment The Portuguese government notified BCP's restructuring plan to the Commission on 19 October 2012. Between November 2012 and August 2013 intense discussions took place between the Commission, the Portuguese authorities and BCP, including adjustments to the restructuring plan, further to which the Commission

¹⁰³ The Portuguese Guarantee Scheme on EIB lending was approved by the Commission on 27 June 2013. Commission Decision C(2009) 4028 final on State aid N556/2008 – Portugal, Recapitalization Scheme of Credit Institutions in Portugal, 20 May 2009.

adopted a final decision approving BPC's recapitalization and restructuring under Article 107(3)(b) TFEU.¹⁰⁴

In order to address the overall weak profitability of the Bank's domestic operation, considered the core weakness of the BCP Group, the plan concentrated on focusing and improving the profitability of domestic operations, and specifically on splitting BCP's activities into a 'Core Unit' (to be restructured and improved) and a 'Non-Core Unit' (to be disposed of). Significant divestitures of international and non-core operations were also foreseen. The restructuring plan was based on: (i) focusing on BCP's core activities; (ii) deleveraging domestic non-core activities; (iii) divesting of international operations; (iv) exiting the mutual fund management business; and (v) repayment of the CoCos within the five-year restructuring period.

The detailed commitment catalogue included a number of standard behavioural commitments, such as bans on: (a) acquisitions; (b) dividends; (c) coupon payments; (d) buy-backs; and (e) commercial aggressive practices, as well as restrictions on (f) business with related parties and on (g) remunerations of management bodies and employees.¹⁰⁵ Implementation of the plan and commitments would be monitored by a monitoring trustee, which has become standard in bank restructuring cases.¹⁰⁶

Reviewing BCP's restructuring plan in light of the Restructuring Communication, the Commission concluded that it led to the restoration of the bank's viability. In particular, the various measures outlined above were credible despite the difficult economic situation of Portugal, including in a stress test scenario, in which BCP would still comply with the applicable regulatory requirements.

The Commission also acknowledged that the aid was limited to the minimum and there was sufficient own-contribution by the beneficiary, in particular because the recapitalization amount was not more than what was necessary to meet the shortfall and the remuneration of the CoCos (in line with the requirements of the New Recapitalization Scheme) was adequate.

Lastly, the measures limiting distortion of competition were found to be sufficient. Besides the adequate remuneration of the CoCos, the Commission placed particular emphasis on a rigorous schedule of repayment, and in particular to the possible divestiture of BCP Poland, the 'crown jewel' of BCP's subsidiaries outside Portugal. It was also noted that even without the divestiture in Poland, the plan resulted in a significant downsizing of BCP, which amounted to 15–30 per cent of total assets and to 30–50 per cent of RWA by December 2017 as compared to 30 June 2012. In addition, the main behavioural commitments applied during the whole of the restructuring period.

As of 31 October 2016, BCP had already repaid the State €2.25 billion of the CoCos and had announced its intention to repay an additional amount in the near future.¹⁰⁷

¹⁰⁴ Commission Decision C(2013) 5669 final on State aid No. 34724 – Portugal, Restructuring of the Banco Comercial Português (BCP) Group, 30 August 2013 (the BCP Restructuring Decision).

¹⁰⁵ As mentioned above, the plan also includes the commitment to allocate €30 million per year in a fund that will invest in equity in Portuguese SMEs and mid-cap corporates.

¹⁰⁶ See ss 4.1–4.14 and 5.1–5.4 of the Commitments annexed to the BCP Restructuring Decision.

¹⁰⁷ See *Expresso*, 'BCP quer pagar 250 milhões dos 750 que ainda deve ao Estado', 2 May 2016 <<http://expresso.sapo.pt/economia/2016-05-02-BCP-quer-pagar-250-milhoes-dos-750-que-ainda>>

(ii) BPI

BPI is a Portuguese Bank listed in Euronext Lisbon. With total assets of €42.9 billion by 31 December 2012, it is the fourth-largest bank in Portugal, and its international activities are concentrated essentially in Angola and Mozambique.

The reasons for intervention and aid measure BPI was also affected by the difficult economic environment and the sovereign debt crisis. In particular, impairments registered for Greek exposure lead to BPI recording losses in 2011, the first time in 30 years. However, the largest part of the capital need was due to the sovereign buffer requested by the EBA, with the amount allocated to BPI set at €1,359 million.

BPI therefore applied for recapitalization under the New Recapitalization Scheme, and on 29 June 2016 issued €1.5 billion in CoCos, which were fully subscribed by the State, in terms equivalent to those of BCP. The aid amount was equal to approximately 6 per cent of RWA.

Between the recapitalization and the final approval by the Commission of BPI's restructuring plan, on 24 July 2013,¹⁰⁸ the Bank managed to repay CoCos for a total of €580 million. The restructuring plan concerned only the repayment of the outstanding CoCos (€920 million).

The Commission's assessment The restructuring plan was notified to the Commission on 15 November 2012. Its scope was considerably narrower than that of BCP or CGD, and was centred on: (i) focusing on core activities and deleveraging of domestic non-core activities; (ii) increasing operational efficiency; and (iii) repayment of the CoCos during the restructuring period.

As in the BCP and CGD restructuring decisions, the BPI commitments also included a complete set of behavioural commitments, including bans on: (a) acquisitions; (b) dividends; (c) coupon payments; and (d) commercial aggressive practices, as well as restrictions on (e) business with related parties; (f) advertising; (g) proprietary trading; and (h) remunerations of management bodies and employees, and (i) support for Portuguese SMEs.¹⁰⁹

In addition, in contrast with the BCP and CGD Restructuring Decisions, there was considerable flexibility as to the application of the commitments over the restructuring period. In effect, except for the ban on acquisitions, all behavioural commitments were to cease with the full reimbursement of the CoCos, and the restructuring period itself would end earlier, on 31 December 2015 (meaning that the commitments ceased to apply at all), if the CoCos were repaid and the quantitative targets on balance sheet size and total number of branches were met by that date.¹¹⁰

deve-ao-Estado> accessed 30 October 2016; and *Jornal de Negócios*, 'Analistas: Resultados do BCP negativos mas entrada da Fosun gera oportunidades', 1 August 2016 <<http://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/analistas-resultados-do-bcp-negativos-mas-entrada-da-fosun-abre-oportunidades>> accessed 30 October 2016.

¹⁰⁸ Commission Decision C(2013) 4802 final on State aid SA.35238 – Restructuring of BPI, 24 July 2013 (BPI Restructuring Decision).

¹⁰⁹ See ss 5.1–5.9 of the Commitments annexed to the BPI Restructuring Decision.

¹¹⁰ See ss 3.2. and 6.1(c) of the Commitments annexed to the BPI Restructuring Decision. The CoCos were fully repaid by BPI by the end of June 2014, but no information is publicly available

BPI's capital needs were mainly the result of the confidence crisis on the sovereign debt of Portugal, as the capital shortfall of the bank was almost entirely due to the sovereign debt buffer. Moreover, since no excessive risk-taking in the acquisition of the debt portfolio was found, and the bank had followed a rather conservative approach in this regard, the Commission undertook a 'proportionate assessment' of the bank's viability,¹¹¹ which suggests a less exacting approach in assessing BPI's deleveraging and burden sharing requirements relative to the BCP and CGD cases, which were reviewed in parallel.

BPI's restructuring plan, including the stress test exercise and the repayment of the CoCos, was found to be capable of restoring long-term viability. By running-off its non-core portfolio and streamlining its core activities, BPI was deemed to be able to generate an appropriate return on equity.

With regard to limiting the aid to the minimum necessary, own contribution and compensatory measures for distortion of competition, the Commission noted at the outset that the CoCos were adequately remunerated. In addition, while the capital injection amounted to 6 per cent of the beneficiary's RWA, and was considered 'large' relative to BPI's total assets, the Commission 'positively observed' that BPI had already repaid more than one-third of the aid amount (€580 million), and that it projected to repay the outstanding CoCos by the end of 2015, two full years before the end of the five-year restructuring period. Considering furthermore the behavioural constraints (in particular the acquisition ban), the Commission concluded that the 'proportionate' downsizing was appropriate compared to the distortions of competition resulting from the aid.¹¹²

The only concern in an otherwise straightforward assessment was the payment by BPI of dividends amounting to €1.2 million on preference shares issued by BPI Capital Finance Ltd., subsequent to the recapitalization, which in the Commission's view breached the dividend ban established in the New Recapitalization Scheme. BPI argued, and the Commission acknowledged that, if such payments had not been made, the terms and conditions of the preference shares at issue would have prevented BPI from repaying the CoCos early. Nevertheless, the Commission took the formalistic view that the payment had taken place in contravention of the dividend ban, even though Portuguese authorities had requested prior explicit authorization from the Commission. This issue was resolved with a commitment by BPI to pay back to Portugal an amount equalling the dividend payment, and therefore the amount by which the aid granted exceeded the minimum necessary.¹¹³

BPI finished repaying the CoCos on 24 June 2014, when it repurchased the remaining €420 million.¹¹⁴ Of the three banks recapitalized in 2012, BPI was the first, and as of 31

on whether the quantitative targets on balance sheet size and number of branches were met by the end of 2015.

¹¹¹ See the BPI Restructuring Decision, para. 62.

¹¹² *Ibid.*, paras 80–81 and 91–95.

¹¹³ *Ibid.*, paras 2–3 and 81–87.

¹¹⁴ See *Jornal de Negócios*, 'BPI finaliza reembolso da ajuda do Estado', 25 June 2014 <<http://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/bpi-finaliza-reembolso-ao-estado>> accessed 31 October 2016 and *Expresso*, '*BPI deixa de ter dinheiro do Estado*', 25 June 2014 <<http://expresso.sapo.pt/economia/bpi-deixa-de-ter-dinheiro-do-estado=f877667>> accessed 31 October 2016.

October 2016 the only bank that was able to return in full the State aid received, which vindicates the Commission's 'proportionate' assessment of the Bank's restructuring plan.

(iii) CGD

CGD is the largest banking group in Portugal, with total assets amounting to €120.6 billion on 31 December 2011 and a leading market position in most of the business areas where it was active in Portugal. Besides Portugal, CGD had a significant international presence, notably in Spain and in all Portuguese-speaking countries in Africa and in Brazil. CGD is fully-owned by the Portuguese State, which is its sole shareholder.

The reasons for intervention and aid measure Like the other Portuguese banks, CGD's access to wholesale funding was affected by the sovereign debt crisis, and its profitability suffered as a result of the deterioration of the Portuguese economy during the crisis. However, the additional capital needs of CGD in 2012 were directly related to the increased regulatory requirements. CGD accordingly identified a need for an additional capital of €1,650 million.

On 28 June 2012, the Portuguese government approved two recapitalization measures concerning CGD: (i) a capital increase of €750 million, through the subscription of new ordinary shares; and (ii) the subscription of CoCos issued by CGD amounting to €900 million, in terms equivalent to those foreseen in the New Recapitalization Scheme.¹¹⁵

On the same day the Portuguese government notified the measures to the Commission.

The Rescue Decision On 18 July 2012 the Commission provisionally authorized the measures notified by Portugal as rescue aid within the meaning of Article 107(3)(b) TFEU.¹¹⁶

In view of the BCP and BPI decisions, qualification of the CoCos as State aid was not surprising. However, the Portuguese State was CGD's sole shareholder and, since accession by Portugal to the (then) European Communities in 1986, had carried out a number of capital increases of CGD, which according to public information were never questioned by the Commission under State aid rules.

In the present case, and following the notification submitted by the Portuguese government, the Commission took the view that the capital increase carried out by the Portuguese State, as sole shareholder of CGD, constituted State aid within the meaning of Article 107(1) TFEU for three reasons.

First, no prior analysis of the expected return on the State's additional investment was carried out until the decision to effect the capital increase was announced by the government on 4 June 2012. The Commission noted that a private investor in a market economy would have based its decision to invest on such an analysis, pursuant to a business plan and an independent evaluation.

¹¹⁵ See Order of the Minister of Finance 8840-C/2012 (CGD), of 28 June 2012, DR II 127, 3 July 2012, 23346-2.

¹¹⁶ Commission Decision C(2012) 5046 final on State aid SA.35062 – Portugal, Recapitalization of Caixa Geral de Depósitos, S.A., 18 July 2012 (the CGD Rescue Decision).

In addition, estimates provided by an external consultant suggested that the expected return in the 2012–15 period was less than the cost of equity of banks at the time, which would not in principle be acceptable for a private market investor. As the Commission noted, a private investor could accept low profitability and even losses in the first years but only if it were compensated by above-average profits at a later stage, as per the *ex ante* business plan prepared by for the shareholder's assessment and decision.

Third, the capital increase of CGD was decided at the same time and in the same context as the subscription of CoCos (and not only those of CGD, but also those issued by BCP and BPI). Since these instruments were considered State aid, this finding had a 'pollution effect' on the nature of the capital increase as aid.¹¹⁷ The simultaneity of the measures and the specific market circumstances were indeed the reasons behind the notification of capital increase as a State aid by Portuguese authorities.¹¹⁸

Portugal committed to ensuring that the behavioural commitments applicable in the context of the New Recapitalization Scheme and analysed below would apply in this case as if CGD had been recapitalized under that scheme.¹¹⁹ For this reason, and considering the systemic importance of CGD, and the fact that the recapitalization amount did not exceed the threshold to meet additional regulatory requirements, the Commission concluded that the aid could be provisionally approved, subject to the submission of a restructuring plan within six months.¹²⁰

The Restructuring Decision CGD's restructuring plan was presented to the Commission on 15 October 2012. Shortly afterwards the Commission decided to open the formal investigation procedure when an affiliate of CGD paid dividends on perpetual shares to the amount of €405,415, which in the Commission's view violated the dividend and coupon bans established in the New Recapitalization Scheme and in the CGD Rescue Decision.¹²¹

Further to revisions of the restructuring plan and of the commitment catalogue as a result of the multiple contacts between the Commission, the Portuguese authorities and CGD between October 2012 and July 2013, the plan was finally approved by the Commission on 24 July 2013.¹²²

CGD's restructuring plan was focused on: (i) deleveraging the balance sheet of CGD by selling non-core assets; (ii) increasing operational efficiency, by reducing operational costs, number of employees and branch network in Portugal; (iii) restructuring the operations of CGD in Spain, which had been continuously loss-making in previous years;¹²³ and (iv) repayment of the CoCos over the five-year restructuring period, pursuant to

¹¹⁷ See the CGD Rescue Decision, para. 39.

¹¹⁸ *Ibid.*, para. 29.

¹¹⁹ *Ibid.*, para. 57.

¹²⁰ *Ibid.*, paras 48–63.

¹²¹ Commission Decision C(2012) 9753 final, of 18 December 2012, on State aid SA.35062 – Portugal, Breach of a Dividend Ban by Caixa Geral de Depósitos, S.A. – Misuse of Rescue Aid [2013] OJ C116/13.

¹²² Commission Decision C(2013) 4801 final, of 24 July 2013, on State aid SA.35062 implemented by Portugal for Caixa Geral de Depósitos [2014] OJ L323/19 (CGD Restructuring Decision).

¹²³ See s. 4.2.7.3.2 of the Commitments annexed to the CGD Restructuring Decision.

a schedule that took into account the availability of capital in excess of the applicable capital requirements plus a capital buffer.

The commitments also included a traditional set of behavioural commitments monitored by an independent monitoring trustee.¹²⁴ Specific to the case of CGD, however, was a detailed set of corporate governance commitments, concerning in particular the independence and arms' length management of CGD vis-à-vis the Portuguese authorities and State-owned companies, as well as robust credit and risk policies.

The Commission found that the measures contained in CGD's restructuring plan were geared to restore CGD's viability and to result in a satisfactory level of profitability. The downsizing, cost-cutting measures, adequate remuneration of the CoCos and repayment calendar were also deemed to constitute sufficient contribution and burden-sharing and to limit competition distortions, which were further safeguarded by the behavioural commitments undertaken by CGD and the Portuguese State.

On the other hand, the Commission concluded that CGD did not comply with the dividend ban by paying out dividends totalling €405,415, in breach of the commitments assumed in the CGD Rescue Decision. Although – similar to the BPI case above – CGD argued that such payments were necessary for CGD to be able to repurchase CoCos according to the calendar established in the commitments (and were therefore legally binding), the Commission rejected the argument. In any event, the question was resolved with a commitment by CGD to pay back to Portugal an amount equivalent to the dividend paid, allowing the Commission to conclude that the amount of aid did not exceed the minimum necessary.¹²⁵

CGD has been implementing the restructuring plan since July 2013 but, according to public information, to date the bank has not been able to repay any of the €900 million of CoCos subscribed by the State. In the course of 2016, press reports suggested that the bank would not be able to reimburse the CoCos by the term established in the instrument's contractual conditions, and would need additional capital by the end of 2016 to meet even stricter regulatory capital buffers set by the ECB.¹²⁶ In such a scenario, pursuant to the relevant terms and conditions, the CoCos would be converted automatically into ordinary shares.¹²⁷ While in practice this conversion would not alter the shareholder structure of the bank (since the State was already the sole shareholder), a key element of CGD's restructuring plan, the reimbursement of the CoCos, would not be implemented, which in turn could potentially call into question the 24 July 2013 decision.¹²⁸

¹²⁴ Ibid., s. 6.

¹²⁵ See CGD Restructuring Decision, paras 41–43 and 80–83.

¹²⁶ Diário Económico, 'CGD não vai conseguir pagar os CoCo's ao Estado até Junho de 2017', 19 May 2016 <http://economico.sapo.pt/noticias/cgd-nao-vai-conseguir-pagar-os-cocos-ao-estado-ate-junho-de-2017_249862.html> accessed 31 October 2016.

¹²⁷ See the Terms and Conditions attached to Order 8840-C/2012, of 29 June 2012.

¹²⁸ In particular, and without prejudice to the need to assess all the relevant circumstances of the case, the Commission could argue that a State aid used in breach of a commitment contained in a restructuring plan falls under the category of 'misused aid' in the meaning of art. 1(g) of Regulation (EU) 2015/1589 of the Council, of 13 July 2015 implementing Article 108 TFEU [2015] OJ L248/9, in that it would have been used by the beneficiary in breach of a conditional decision adopted under art. 9(4) of the same Regulation.

On 24 August 2016, the Commission and the Portuguese government announced an agreement in principle for the recapitalization of CGD.¹²⁹ In view of the commitments set out in a comprehensive business plan for CGD, the Commission considered that the recapitalization will take place under market conditions, as the profitability provided to the State was sufficiently high and would be acceptable to a private investor.¹³⁰ According to the Commission, the Portuguese State was to inject up to €2.7 billion in the capital of CGD and convert €900 million of the CoCos in equity. In addition, CGD undertook to issue a total of €1 billion in the form of subordinated debt. The plan was stated to set forth a deep restructuring of the bank with the aim of returning to high long-term profitability by reducing costs, increasing efficiency and risk reduction measures. The plan was to be supported by new rules on corporate governance and implemented by a management team with extensive experience. According to the Commission, this agreement was to be formalized by a decision proposed to the College of Commissioners; as of 31 October 2016 no decision had yet been adopted.

(d) The Resolution of Banco Espírito Santo

(i) Overview

Banco Espírito Santo, S.A. (BES) was one of the oldest banks in Portugal and belonged to one of the largest Portuguese privately owned banking groups; the origins of the Espírito Santo banking family stretched back to 1864.¹³¹ Nationalized in 1975 and reacquired by the Espírito Santo family when it was reprivatized in 1991, by March 2014 BES was the third largest Portuguese banking group, with €76.7 billion in assets, operations in 25 countries and 10,000 employees.

Of the five largest banks in Portugal, BES was the only major bank of Portuguese origin that had not requested recapitalization support from the State in 2012. Over the years BES was able to raise capital in the market through successive capital increases, the last of which was undertaken on 20 May 2014. However, by then BES had become involved in the financial difficulties of the Espírito Santo Group, and on 3 August 2014 was the object of a resolution measure by the Bank of Portugal pursuant to Directive 2014/59/EU (the BRRD).¹³²

¹²⁹ See Press Statement of the Representation of the Commission in Portugal of 24 August 2016, 'Comissão Europeia dá luz verde à recapitalização da Caixa Geral de Depósitos' (only available in Portuguese) <http://ec.europa.eu/portugal/news/margrethe-vestager-green-light-cgd_pt> accessed 31 October 2016.

¹³⁰ *Ibid.*

¹³¹ For an overview of BES and its resolution in 2014, see Mariana Solá de Albuquerque and Luís Branco, 'Resolving Banco Espírito Santo: An Overview of the Application of Recovery and Resolution Measures in Portugal' (2016) 31(10) *JIBLR* 534.

¹³² Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L173/190.

(ii) Events leading to the State intervention

BES came under pressure in May 2014, after it announced that an audit by the Bank of Portugal of Espírito Santo International (ESI, the controlling shareholder in Espírito Santo Financial Group (ESFG), which in turn was the largest shareholder of BES, with 20.1 per cent) had found ESI to be in a critical financial condition.

On 30 July 2014 BES announced its accounts for the first half of 2014, which amounted to €3,577 million in losses, influenced by €4,253 million of impairment and contingency costs of BES, including the creation of provisions related to the exposure of ES Group entities (€2,062 million) and the negative impact of potentially illegal transactions by the bank identified by the external auditor in the second fortnight of July 2014 (€1.5 billion). In addition, debt securities issued by ES group entities and subscribed by BES clients totalled approximately €3.1 billion, of which €1 billion was subscribed by retail customers and €2 billion by institutional investors.

By 30 June 2014 the Common Equity Tier 1 (CET 1) of BES had been reduced to 5 per cent (below the minimum requirement of 7 per cent), and on 1 August the ECB decided to suspend BES's classification as counterparty with effects from 4 August. After assessing the various options, and faced with the impossibility of selling the bank due to an absence of buyers and confronted with the prospect of an imminent bank run on BES,¹³³ on 3 August the Bank of Portugal notified to the Commission the resolution of BES and the immediate creation and capitalization of a temporary credit institution (the Bridge Bank, presently Novo Banco, S.A. (Novo Banco)), which received the 'healthy' part of BES's business activities (such as cash, retail deposits, performing loans, central bank loans, bank bonds and treasury bills), in order to protect depositors and the stability of the Portuguese financial sector.

After receiving a final catalogue of commitments from Portugal, on the same day the Commission adopted a decision authorizing the resolution of BES and the capitalization of Novo Banco under Article 107(3)(b) TFEU,¹³⁴ which was subsequently amended on 19 December 2015.¹³⁵

(iii) Aid measures

With the resolution measure of 3 August 2014 Novo Banco received €64 billion in assets from BES and was capitalized at €4.9 billion by the Resolution Fund¹³⁶ through the subscription of Novo Banco's entire share capital. Given that at the time the Resolution Fund only held €365 million, the Portuguese State made a loan to the Resolution Fund of €3,900 million, financed out of the State budget and the Portuguese banking sector

¹³³ In July BES lost 11–17 per cent of its deposits, without taking the ECB/Bank of Portugal deposits into account.

¹³⁴ Commission Decision C(2014) 5682 final on State aid SA.39250 – Portugal, Resolution of Banco Espírito Santo, S.A., 3 August 2014.

¹³⁵ Commission Decision C(2015) 9762 final on State aid SA.43976 – Portugal, Amendment of the 2014 Resolution of Banco Espírito Santo, S.A., 19 December 2015.

¹³⁶ The Resolution Fund is a public entity created in 2012 by Decree-Law no. 31-A/2012 of 10 February 2012 with the objective of providing financial assistance to the Bank of Portugal for the exercise of its resolution powers. See also the Resolution Fund's Annual Report for 2014 <<http://www.fundoderesolucao.pt/pt-PT/RelatorioContas/Paginas/RelatorioContas.aspx>> accessed 31 October 2016.

contributed a further €700 million (€635 million for the subscription of Novo Banco's capital and €65 million for the first payment of interest on the loan granted by the Portuguese State).

The remainder of BES became a so-called 'bad bank', with a total of €1 billion net assets.

The €4.9 billion capitalization by the Resolution Fund was considered by the Commission as State aid benefitting Novo Banco under Article 107(1) TFEU, in particular since it was a measure imputable to the State and financed with resources under the control of the State.

(iv) The Commission's 2014 assessment

Portugal undertook a number of commitments for Novo Banco, including: caps on loans and on loan and deposit pricing; the sale of Novo Banco within 24 months of the Commission's decision (this date was subsequently extended on 19 December 2015 and is currently confidential) or its subsequent winding-down; and the discontinuation of the brand 'BES' within two months of the decision. Portugal also promised to notify any substantial sale of assets of Novo Banco to the Commission, in order to allow the Commission to verify that no aid would be given to the purchaser.

With regard to the bad bank, Portugal undertook that it would not generate any new business, and that its balance sheet would be gradually decreased. On the sale of Novo Banco, BES's banking licence would be revoked and the bank would be liquidated under normal insolvency procedure.

In addition, a classic set of behavioural commitments common to Novo Banco and the bad bank were submitted by Portugal.

The Commission assessed the resolution of BES and capitalization of Novo Banco under the 2013 Banking Communication rules on the liquidation of financial circumstances,¹³⁷ and concluded that it was compatible with the internal market under Article 107(3)(b) TFEU, since:

- The liquidation cost was limited to the minimum necessary, since the counterfactual scenario (the immediate liquidation or bankruptcy) was estimated by the Portuguese authorities as increasing the resolution costs; for this reason, the creation of a bridge bank and the resolution of the bad bank was found to be the least costly option for Portugal.
- The commitments submitted by Portugal contained sufficient measures limiting the distortion of competition: the banking licence of the bad bank would be revoked no later than the conclusion of the sale process of Novo Banco, and would gradually reduce its activities; the commitments also ensured that the bridge bank did not enter into any aggressive commercial policy, and its existence is limited to a period of two years (since extended).
- The resolution measure included sufficient own contribution and burden-sharing,

¹³⁷ See s. 6 of the Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis [2013] OJ C216 (2013 Banking Communication), 1.

since all shareholders, subordinated creditors and claims by related parties would be left in the bad bank, whose contribution was therefore achieved to the maximum extent possible. In addition, the behavioural commitments ensured adequate burden-sharing by Novo Banco and its management.¹³⁸

(v) The Commission's 2015 assessment

Although a sales process for Novo Banco was opened in December 2014, on 15 September 2015 the Bank of Portugal announced the interruption of the process, as none of the offers received had been satisfactory. In this context, in December 2015 the Portuguese authorities submitted to the Commission a draft restructuring plan setting out the strategy of Novo Banco, from the date of resolution of BES until 2020, as well as a set of revised commitments. Portugal also notified an additional aid measure, in the form of the extension of government-guaranteed bank bonds, originally issued by BES under the State Guarantee Scheme analysed above, and subsequently transferred to Novo Banco.

The Commission adopted a decision on 19 December 2015 authorizing the extension of the guarantees as requested by the Portuguese government under Article 107(3)(b) TFEU, subject to the commitments offered by Portugal, which amended and superseded the commitments of the 2014 decision.

In the detailed commitment catalogue annexed to the decision, the main changes concerned the split of Novo Banco into a core unit (to be sold within a confidential deadline, pursuant to an open, non-discriminatory and competitive process, to be launched by 15 January 2016) and a non-core unit, which would either be sold or run down. Portugal committed not to provide any additional capital or liquidity support to any of the entities, and to comply with the necessary capital requirements set by the supervisor by 1 January 2016, including by raising the necessary capital on market terms from private parties. In the event that Novo Banco was not sold by the date set in the decision, it would cease new business and be put in wind-down in the following month.

Finally, the Commission also took into account in its State aid compatibility assessment whether the extension of the guarantees was contrary to any provision of the BRRD that was 'indissolubly linked' to the object of the aid measure, in light of the existing case law of the European courts.¹³⁹ The Commission assessed the relevant provisions of the BRRD, and analysed in particular whether the additional proposed aid measure triggered the resolution of Novo Banco under the Directive. The Commission reached the preliminary conclusion that Novo Banco was a solvent institution and that the conditions for considering it as failing or likely to fail were not met.¹⁴⁰

¹³⁸ An appeal and interim measures request against the Decision of 3 August 2014 were lodged with the EU General Court (see Case T-812/14 *BPC Lux 2 a.o. v Commission*, action brought on 12 December 2014 and related interim measures request, in case T-812/14 R). The interim measures request was dismissed by order of the President of the General Court of 25 February 2015 (ECR I-000), since the applicants did not establish that they would suffer serious and irreparable harm if the application for suspension of the resolution of BES were not granted. The main annulment action is pending as of 31 October 2016.

¹³⁹ Case 74/76 *Ianelli v Meroni* [1977] ECR I-000, para. 14 and Case T-289/03 *BUPA et al v Commission* [2005] ECR I-000, paras 313 and 314.

¹⁴⁰ See Decision of 19 December 2015, paras 96–103.

As of 31 October 2016, the sale process of Novo Banco was ongoing, with revised terms of reference having been recently published by the Resolution Fund.¹⁴¹

(e) The Recapitalization and Resolution of Banco Internacional do Funchal, S.A.

(i) Overview

Originally incorporated in 1991 as a small bank on the island of Madeira, by 2012 Banco Internacional do Funchal, S.A. (Banif) had grown into a full-service bank and insurance financial group, with 312 branches and activities in Azores and Madeira (where it held a leading position), mainland Portugal and abroad.

In 2013 Banif was the eighth-largest commercial bank in Portugal by asset value, with average market shares of 3.8 per cent in loans and 4 per cent in deposits. Conversely, in Madeira its market share was 23.2 per cent for loans and 36 per cent for deposits, whereas in Azores the share was 31 per cent for loans and 37.1 per cent for depositors. Banif's main client groups were individuals and SMEs.

(ii) The reasons for the State intervention

Banif's difficulties resulted not only from the deterioration of the Portuguese economy in the context of the financial crisis, but also by serious deficiencies in price setting and risk management, which led to exceptionally high levels of credit risk.

Over the first three-quarters of 2012, Banif presented a negative net result of €250 million. In November 2012 the bank's Core Tier 1 capital was significantly below the minimum capital requirements, meaning that the bank would have failed in the absence of a significant State recapitalization.

(iii) The 2013 recapitalization and the Rescue Decision

In order to comply with the applicable capital requirements, in January 2013 Banif received recapitalization measures totalling €1.1 billion from the Portuguese State (which amounted to 10 per cent of the Bank's RWA):

- the subscription by the State of a capital increase for Banif of €700 million (Measure 1);
- the subscription by the State of CoCos amounting to €400 million, the terms of which were closely aligned with those of the New Recapitalization Scheme analysed above (Measure 2).¹⁴²

In view of Banif's high market shares in Madeira and Azores, the bank had systemic importance even though it was only a small-sized institution. For this reason, the

¹⁴¹ Terms of Reference for the Novo Banco market sale process (amended), of 11 October 2016 <http://www.fundoderesolucao.pt/en-US/ofundo/Documents/AlienacaoNB/20161010_Market%20Sale%20Process%20Terms%20of%20Reference.pdf> accessed 31 October 2016.

¹⁴² Order No. 1527-B/2013, of 23 January 2013, DR II No. 17, 3 24 January 2013, 3454-(4). Banif also benefitted from the State Guarantee Scheme, pursuant to which as of the end of 2012 Banif had a total of €1,175 million government-guaranteed bonds, which were redeemed by October 2014.

Commission agreed that the recapitalization measures should be assessed under Article 107(3)(b) TFEU.

On 9 November 2012, Portugal committed to presenting a full restructuring plan for Banif, which would provide a significant balance sheet reduction by carrying out a deep transformation of the group to focus on core profitable activities and areas, with particular focus on Madeira and the Azores leading the Commission to provisionally authorize the recapitalization measures of Banif on 21 January 2013 under Article 107(3)(b) TFEU.¹⁴³

(iv) The opening of the formal investigation procedure

Although an initial restructuring plan was submitted by Portugal in early April 2013, until October 2014 several versions of Banif's restructuring plan were submitted by the Portuguese authorities, without an agreement being reached. The Commission was also concerned that Banif did not meet the deadline to repay the outstanding €125 million of CoCos by the end of 2014, as foreseen in the terms and conditions.¹⁴⁴

On 24 July 2015 the Commission adopted a decision opening the formal investigation procedure under Article 108(2) TFEU.¹⁴⁵ The Commission had serious doubts as to whether the latest draft restructuring plan of Banif: (i) ensured its long-term viability as a whole within the restructuring period and the repayment of the State aid; (ii) contained adequate burden-sharing by the beneficiary (the plan did not provide any information on potential remuneration for the State aid received); and (iii) provided for measures substantial enough to address the distortions of competition.

(v) The Resolution Decision

Following the decision opening the formal investigation procedure, several contacts took place between the Portuguese authorities and the Commission.

Events evolved quickly after reports of Banif's impending closure or resolution appeared in the media over the weekend of 13–14 December 2015, further to which the liquidity situation of Banif deteriorated quickly due to significant withdrawals of clients' deposits.¹⁴⁶ On 18 December 2015 the Portuguese authorities informed the Commission that a sale would not be possible outside the resolution framework, as State aid would have to be granted.

Finally, on 19 December, the Bank of Portugal as the Resolution Authority adopted a resolution measure regarding Banif, applying the 'asset separation tool' together with the 'sale of business tool', as described in Article 37 of the BRRD. This resulted in two groups of assets: a 'clean bank', which was sold to Banco Santander Totta, S.A. on 20 December 2015, after a one-day tender process, and a 'remaining bank', which remained

¹⁴³ Commission Decision C(2013) 333 final on State aid SA.34662 – Portugal, Recapitalization of Banif – Banco Internacional do Funchal, S.A. – rescue aid, 21 January 2013.

¹⁴⁴ Order No. 1527-B/2013, of 23 January 2013, DR II No. 17, 3 24.01.2013, 3454-(4).

¹⁴⁵ Commission Decision C(2015) 5199 final on State aid SA.36123 – Portugal, Recapitalization of Banif – Banco Internacional do Funchal, S.A., 24 July 2015.

¹⁴⁶ TVI, the broadcasting channel in question, was later fined by ERC, the media regulator, for infringing the Journalists' Statute and Code of Practice (see Decision ERC/2012/202, of 31 August 2016 <www.erc.pt> accessed 31 October 2016).

in Banif, to be managed by a newly created Asset Management Company (AMC). After the submission of commitments by Portugal, the Commission approved the aid measures on 21 December 2015.¹⁴⁷

Besides the recapitalization measures of 2013, which were analysed as liquidation aid, the Commission assessed the following additional measures as State aid within the meaning of Article 107(1) TFEU:

- capital aid amounting to €2,579 million, to be contributed by the Resolution Fund and directly by the Portuguese State into the clean bank, in order to comply with the buyer's offer (Measure 3);
- transfer of impaired assets to the AMC, estimated at €422 million (Measure 4).

The Commission also analysed whether the sale process entailed any aid to the buyer, but concluded that there was no indication that the sales process had not been fair, open and transparent.

As in the BES resolution decision discussed above, the Commission assessed the State aid measures under the rules of the 2013 Banking Communication applicable to the liquidation of financial institutions, concluding that Measures 1, 2 and 3 were compatible with the internal market under Article 107(3)(b) TFEU, since:

- the amount of costs incurred in the resolution (€3,486 million) was lower than the estimated losses in liquidation (€3,987 million), meaning that the orderly resolution aid could be considered to be limited to the minimum necessary;
- distortions to competition were limited, in particular by the choice of the sale of business as primary resolution tool, by the sale of the clean bank in a competitive tender, by the reduction of commercial presence of the clean bank compared with Banif, by the absorption of the business of Banif into the buyer's in a short time frame and by the disappearance of the Banif brand;
- shareholders and subordinated debt holders of Banif contributed to the resolution in the maximum extent possible; and
- there was no reason to doubt the viability of the Buyer or its ability to integrate the clean bank it acquired, considering the dimension of Santander Totta.

The Commission also concluded that the transfer of impaired assets to the AMC (Measure 4) complied with the requirements of the Impaired Assets Communication¹⁴⁸ on eligibility, transparency and disclosure, management and burden-sharing, as adapted and complemented by the 2013 Banking Communication. In addition, while the *ex ante* valuation requirements of the Impaired Assets Communication were not met, the very short timeframe within which the sale of the business tool was usually conducted meant that the Commission was able to grant the temporary approval of Measure 4 on the basis of a very conservative transfer value for a period of three months, reserving final approval for a second decision.

¹⁴⁷ Commission Decision C(2015) 9763 final on State aid SA.43977 – Portugal, Resolution of Banif – Banco Internacional do Funchal, S.A., 21 December 2015.

¹⁴⁸ Communication from the Commission on the treatment of impaired assets in the Community banking sector [2009] OJ C72/1.

PART III SPAIN

1. THE SPANISH BANKING LANDSCAPE

(a) Introduction

The first comprehensive measures taken to strengthen the financial sector in Spain in the context of the financial crisis can be traced back to late 2008, although the restructuring process only began in 2009.¹⁴⁹

The uncertainty affecting credit risk for both sovereign and financial bonds, and for counterparts, disrupted interbank lending and caused severe liquidity restrictions affecting the economy as a whole. The financial crisis and the fall of the real estate market in Spain affected the Spanish credit market in two ways. On one hand, credit growth slowed significantly. As a result of substantial growth during the pre-crisis period, some parts of the Spanish credit system were oversized, decreasing its efficiency.¹⁵⁰ A number of credit institutions needed to revamp their business and recover their historically high efficiency levels. On the other hand, with the outbreak of the crisis, the performance of outstanding credit deteriorated and delinquency rose sharply from previously very low levels. This fact had negative fallout for credit institutions, hindering some from access to capital markets.

The obvious link between credit activity and economic growth made it necessary to repair and refit some parts of the credit system to prop up lending to the real economy through fundamentally sound banks in the context of general distrust of markets towards EU sovereigns.

(b) The Financial Assistance Program

(i) Overview

On 25 June 2012, the Spanish government formally requested external financial assistance from Eurozone Member States in the context of the restructuring and recapitalization of the Spanish banking sector initiated under the aid schemes discussed below.

On 23 July 2012, Spain and the Commission signed a Memorandum of Understanding (MoU) on Financial-Sector Policy Conditionality (2012 MoU).¹⁵¹ The financial assistance provided by the European Financial Stability Facility and later by the ESM was meant to provide an effective backstop for all possible capital requirements estimated by the stress test completed by mid-September 2012, with an additional safety margin.

Unlike other financial assistance programs, Spain's rescue money was targeted and scaled to the financial sector alone without seeking a full bailout for the country. In return

¹⁴⁹ See Edurne Navarro Varona, 'The Spanish Financial Sector Restructuring from a State Aid Law Perspective', in Moniz and de Gouveia e Melo 2015, 89.

¹⁵⁰ See Commission Decision in Case N28/2010 – Spain, Recapitalization Measures in favour of the Banking Sector in Spain, 28 January 2010.

¹⁵¹ See <http://ec.europa.eu/economy_finance/eu_borrower/mou/spain-mou_en.pdf> accessed 2 September 2016.

for the funds, Spain committed to solving the problems of the banking sector but was not required to undertake major austerity or economic reforms.

The duration of the program was 18 months, although the restructuring of the banks receiving public support under State aid rules was to take up to five years.

The loan was granted directly to the *Fondo de Reestructuración Ordenada Bancaria* (FROB) – Fund for Orderly Bank Restructuring created by Royal Decree-Law No 9/2009 of 26 June – and it was the FROB, acting as the agent of the Spanish government, that channelled the funds to the financial institutions concerned.

The FROB was established in the context of the financial crisis to provide public support for the consolidation of the Spanish banking sector, namely by strengthening the capital buffers of credit institutions and managing their restructuring. The FROB is funded by the State budget and by the Deposit Guarantee Funds of credit institutions.

(ii) Underlying objectives

When the 2012 MoU was signed, the borrowing capability of Spanish banks had been strongly limited. The intensification of the sovereign debt crisis and the consequent impact of rating downgrades on collateral availability rendered access to wholesale markets practically impossible on affordable terms for a number of institutions. Also, the lowering of credit rating of Spanish banks themselves posed a further strain on Eurosystem funding.

Given the nature of the financial support provided to Spain, the 2012 MoU addressed issues specific to the financial sector and included both bank-specific conditionality and horizontal conditionality.

The bank-specific conditionality had three main components:

- a comprehensive diagnostic of the capital needs of individual banks, based on a comprehensive asset quality review and evaluation process, and bank-by-bank stress tests;¹⁵²
- the segregation of impaired assets from the balance sheet of banks receiving public support and their transfer to an external Asset Management Company (SAREB);¹⁵³
- the recapitalization and restructuring of viable banks and an orderly resolution of ultimately non-viable banks, with private sector burden-sharing as a prerequisite.

Horizontal conditionality applied to the entire banking sector and included measures aimed, inter alia, at strengthening the regulatory, supervisory and bank resolution frameworks, enhancing the governance structure of the severely-hit savings banks (known as *cajas de ahorros*)¹⁵⁴ and of commercial banks controlled by them, and improving consumer protection legislation as regards the sale by banks of subordinated debt instruments.

¹⁵² These tests were conducted by the independent consultant Oliver Wyman, results <http://www.bde.es/f/webbde/SSICOM/20120928/informe_ow280912e.pdf> accessed 2 September 2016.

¹⁵³ *Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria*.

¹⁵⁴ *Cajas* are credit institutions governed by their members. Their legal form is that of a private charity that holds a banking licence and is entitled to provide banking services. Profits are partially used to strengthen capital and the remainder is used to fund the charitable, cultural and social activities that each *caja* carries out through a dedicated institution called *Obra Benéfico-Social*.

(iii) Roadmap to recapitalization and restructuring

The 2012 MoU provided that on the basis of the 2012 stress test results, the largest Spanish banks – covering 90 per cent of the system – would be split into four main categories according to their capital needs:

- Group 0 – banks for which no capital shortfall is identified and no further action is required;
- Group 1 – banks already owned by the FROB;
- Group 2 – banks with capital shortfalls identified by the stress test and unable to meet those capital shortfalls privately without having recourse to State aid;
- Group 3 – banks with capital shortfall identified by the stress test with credible recapitalization plans and the ability to meet those capital shortfalls privately without recourse to State aid.

The program money was destined to strengthen the resources of credit institutions that showed a capital shortfall in the stress test which could not be covered by private resources until 30 June 2013. Additionally, and in order to accommodate urgent capital needs that could materialize before the stress test was completed, the 2012 MoU contained an emergency backstop facility that was available to banks finding themselves at risk regardless of the groups to which they belonged.

Both before and after the stress test, applicants had to meet the requirements set out in the 2012 recapitalization scheme for credit institutions in Spain, approved by the Commission together and in the framework of the 2012 MoU with the aim of facing the capital deficits requiring State aid.¹⁵⁵ The budget of the scheme was equal to that of the assistance program (€100 billion) but the part of the budget that could be used for the contingency line was limited to €30 billion. The recapitalization scheme expired on 31 December 2012, so no further recapitalization under its framework was made after that date.

Except for the emergency situations that might occur prior to recapitalization, the scheme was essentially tailored to credit institutions belonging to Group 3. For credit institutions in Groups 1 and 2, the FROB was only allowed to provide financial support *after* individual restructuring plans were approved by the Commission.

Any capital injection under the 2012 MoU and the recapitalization scheme had to be subject to burden-sharing requirements with losses allocated to equity, hybrid capital and subordinated debt holders.

Restructuring plans for the institutions making use of the funds had to be submitted to the Commission within six months. A number of customary behavioural constraints (e.g., prohibitions on dividend payments, buy-backs) applied until the Commission approved the plan.

The preferred instruments available for recapitalization by the FROB were convertible contingent bonds (CoCos) eligible as Core Tier 1, with an envisaged investment period of five years (extendable in certain cases for up to seven years). At the end of this period the

¹⁵⁵ Commission Decision in Case SA.35069 (2012/N) – Spain, Recapitalization Scheme for Credit Institutions, 25 July 2012.

CoCos were to be bought back and redeemed by the beneficiary or converted into ordinary shares held by the FROB. Remuneration on the CoCos would be, as a minimum, 8.5 per cent for the first year and would increase through annual step-ups to reach an average of 9 per cent over the first five years.

In the emergency situations discussed earlier the FROB might subscribe for discounted ordinary shares if the purpose of the intervention could not be achieved by CoCos. In such cases, burden-sharing by existing equity owners must be ensured upfront.

Spain successfully exited the financial assistance program in January 2014 and used only €39 billion of funds for bank recapitalization, under restructuring and resolution plans approved by the Commission under State aid rules, and €2.5 billion for capitalizing SAREB.¹⁵⁶

Figures recently disclosed by the Bank of Spain covering the pre-bailout period show that, between 2009 and the end of 2015, public financial assistance committed in various forms of capital amounted to €61 billion, €53 billion of which was provided by the FROB and €8 billion by the banking industry through the Deposit Guarantee Fund.¹⁵⁷

2. AID SCHEMES

(a) Fund for the Acquisition of Financial Assets

(i) Overview

In November 2008, the European Commission approved a State aid scheme for the creation of a Fund for the Acquisition of Financial Assets (the Fund) financed by €30 billion worth of public debt.¹⁵⁸ The main purpose of the Fund (which was managed by the government) was to provide credit institutions – as a complement to interbank lending – with liquidity in exchange for the acquisition of their high quality assets, and thus encourage them to grant more credit to businesses and households resident in Spain.

(ii) Scope of the scheme

The scheme was available to all credit institutions established in Spain (including subsidiaries and branches of EU institutions).

The assets to be purchased by the Fund were selected by means of an auction whereby the State acted as the sole buyer, and credit institutions offered pre-specified asset classes

¹⁵⁶ See <http://ec.europa.eu/economy_finance/assistance_eu_ms/spain/index_en.htm> accessed 2 September 2016.

¹⁵⁷ For a detailed breakdown of the public financial assistance provided to the various bank recapitalization processes, see the Bank of Spain's Background note on public financial assistance in the restructuring of the Spanish banking sector (2009-2016), 6 September 2016 <http://www.frob.es/es/Documents/presbe2016_41en.pdf> accessed 6 September 2016.

¹⁵⁸ Commission Decision in Case NN54/A/2008 – Spain, Fund for the Acquisition of Financial Assets, 4 November 2008 (as amended by Commission Decision of 8 April 2009 in the same case).

with triple or double A ratings¹⁵⁹ issued in the same period. Eligible assets were limited to covered bonds and asset-backed securities, which reduced the credit risk for the Fund in case of default. There was also a minimum interest rate specified in the auction, which could not be inferior to the government bond yield, i.e., the cost of resources for the Spanish government.

The divestments made by the Fund were subject to same criteria, i.e., the Fund was able to sell assets before their maturity expired and could accomplish as many *reverse* auctions as necessary to achieve it.

In order to secure a certain asset diversification and avoid privileging large institutions over smaller ones, each participating entity could not sell more than 10 per cent of the total amount to be purchased by the Fund at each auction.

(iii) Commission's assessment and conditions for approval

Spanish authorities argued that the scheme did not amount to State aid, as the auctions were open to every credit institution in Spain and the price of the assets was driven by a competitive mechanism of supply and demand. The State would therefore act as a market economy investor. Conversely, the Commission regarded the measure as State aid since there was little appetite in the market for the assets concerned and the State was assuming the role of a buyer of last resort in providing liquidity to the bidders. There was thus no indication that profit maximization played any role whatsoever in the State's intervention. The Commission also found that the scheme benefitted the banking sector in general as all credit institutions were able to record a higher-than-otherwise mark-to-market valuation for asset classes accepted in the auctions, using the latter as a valuation benchmark.

At the initial stage, approval of the Fund by the Commission came with certain restrictions on the benefitting entities, which could not expand aggressively nor advertise on account of the aid. However these behavioural constraints were subsequently removed to take account of the revised guidance of the Commission at the time, according to which, given the objective of ensuring lending to the real economy, balance sheet growth restrictions would not be necessary in recapitalization and guarantee schemes of fundamentally sound banks, unless there was a serious risk of displacement of capital flows between Member States.¹⁶⁰

This scheme was set up as a transitory measure with a limited lifetime. It was put into effect on November 2008, following the Commission's approval, and was extended on a subsequent occasion.¹⁶¹

In any event, Spanish legislation prevented the Fund from holding auctions after 31 December 2009. According to publicly available information, there have been four auc-

¹⁵⁹ As assessed by a recognized rating agency.

¹⁶⁰ Commission Decision in Case NN54/B/2008 (ex-CP 277/2008) – Spain, Guarantee Scheme for Credit Institutions, 23 December 2008 (as amended by Commission Decision of 23 April 2009 in the same case) (Commission Decision in Case NN54/B/2008), para. 15, which referred to fn. 4, on p. 7 of the 2009 Recapitalization Communication.

¹⁶¹ Commission Decision in Case N337/2009 – Spain, Prolongation of the Fund for the Acquisition of Financial Assets, 7 August 2009, which extended the scheme until 31 December 2009 (Commission Decision in Case N337/2009).

tions to date with an allotted amount of approximately €20 billion invested by the Fund.¹⁶² Approximately 98 per cent of the assets purchased were assigned AAA rating. Although no accurate data is available, it appears that the average yield of the assets acquired was higher than the yield on government bonds for the same period and the remuneration realized was sufficiently high to also cover an insurance component to compensate for credit risk, as would be requested by a prudent investor.¹⁶³

(b) Original Guarantee Scheme for Credit Institutions (2008–11)

(i) Overview

In late 2008 Spanish authorities notified to the Commission Real Decreto-ley 7/2008 de Medidas Urgentes en Materia Económico-Financiera en relación con el Plan de Acción Concertada de los Países de la Zona Euro (Real Decreto-ley 7/2008), which established a guarantee scheme for new senior debt issued by credit institutions in Spain. This was the first guarantee scheme adopted by Spain during the international financial crisis. It was in force until 31 December 2011 and was replaced shortly after by an amended regime, which we will tackle in the next section.

The purpose of the original scheme was to mitigate systemic risks and restore confidence in the financing mechanism of credit institutions by institutional lenders so as to foster lending to the Spanish economy.

(ii) Scope of the scheme

The scheme was open to credit institutions registered in Spain, including subsidiaries of foreign banks but not their branches.

In order to access the guarantees, and in addition to the place of registration requirement, beneficiaries had to meet the following criteria: (i) be adequately capitalized; (ii) have a share of at least 0.1 per cent of the Spanish credit market according to data provided by the Bank of Spain; and (iii) the instruments covered by the scheme had to be issued in the five years preceding the entry into force of Real Decreto-ley 7/2008.

With the purpose of allowing small credit institutions to take part in the guarantee scheme, credit institutions, consolidated groups and pools of credit institutions were able to cumulate their market shares to reach the threshold, provided there was prior agreement between the participants. Each eligible credit institution, consolidated group or pool was then entitled to obtain the maximum amount that could be guaranteed in direct proportion to its market share, unless that amount was limited to prevent solvency risks.

The guaranteed financial instruments included notes, bonds and obligations admitted to the official secondary markets in Spain. Hence, only senior debt was admitted (no securitization notes or subordinated instruments), which obviously facilitated the perception of risk by the guarantor towards the principal of the credit and the interest.

Initially, the overall maturity of the instruments ranged from three months to three

¹⁶² See the results of each auction <<http://www.fondoaf.tesoro.es/EN/Subastas.html>> accessed 1 February 2016.

¹⁶³ Commission Decision in Case N337/2009, paras 11, 20–25, 42–43.

years and longer maturities could only be guaranteed in exceptional circumstances justified by the Bank of Spain and subject to an individual notification to the Commission. In one of the revisions of the scheme, the Commission authorized an extension of such maturity up to five years to allow banks to source their funding from a wider variety of investors and hence arbitrage between short- and medium-term issuances to better suit market appetite and avoid excessive concentration over shorter maturities. Still, the amount of debt with maturities exceeding three years and up to five years was limited to an aggregate amount of one-third of the total budget that could be guaranteed under the scheme.¹⁶⁴

The amount of new issuance covered by State guarantees was initially set at €100 billion and later increased to €164 billion. During the issue window of the scheme, each beneficiary was only entitled to apply for guarantees once and the minimum nominal value of each emission had to be greater than €10 million.

A market-oriented premium was charged for each guarantee. The fee structure was devised on the basis of the ECB recommendations regarding government guarantees on bank debt¹⁶⁵ and comprised a fixed annual premium and, for emissions with a maturity of over one year, a variable fee indexed to the relevant CDS. The guarantee fee was adjusted upwards after 1 July 2010 to accommodate developments in financial markets and the scheme's effectiveness.

(iii) Commission's assessment and conditions for approval

In its original framework, the Commission approved the scheme until 1 July 2009¹⁶⁶ and subsequently extended it on five occasions, the last being in June 2011, until 31 December 2011.¹⁶⁷ However, such extensions did not involve an increase in the scheme's overall budget.

In case of activation of the guarantees, Spanish authorities were bound to notify to the Commission a restructuring plan for the beneficiary within six months. Under domestic law, in that scenario the State would also recover from the institution concerned all costs involved with the award of the guarantee. Spanish authorities further committed to monitoring that the beneficiaries maintained a credit policy towards businesses and households.

In the decision originally approving the scheme, the Commission included a number of behavioural constraints preventing the beneficiaries from pursuing an aggressive commercial conduct under the measure. Such restrictions were later removed as the Commission

¹⁶⁴ Commission Decision in Case N336/2009 – Spain, Prolongation of the Guarantee Scheme for Credit Institutions in Spain, 25 June 2009.

¹⁶⁵ Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, 20 October 2008 <https://www.ecb.europa.eu/pub/pdf/other/recommendations_on_guaranteesen.pdf> accessed 15 July 2016.

¹⁶⁶ Commission Decision in Case NN54/B/2008.

¹⁶⁷ Commission Decisions in Case N336/2009, *op. cit.*; Case N588/2009 – Spain, Prolongation of the Guarantee Scheme for Credit Institutions in Spain, 1 December 2009; Case N263/2010 – Spain, Extension of the Guarantee Scheme for Credit Institutions in Spain, 28 June 2010; Case SA.31921 (N530/2010) – Spain, Extension of the Guarantee Scheme for Credit Institutions in Spain, 29 November 2010; and Case SA.32990 (2011/N) – Spain, Fifth Prolongation of the Spanish Guarantee Scheme for Credit Institutions, 1 June 2011.

accepted there were no indications that the absence thereof would lead to undue distortions of fund flows between Member States.¹⁶⁸

Periodic reports submitted by the Spanish authorities to the Commission on the operation of the scheme suggest that, by reducing risk premium, it contributed positively to easing the impact of the crisis on the beneficiaries' funding and the banking sector in general. The final figures on implementation of the measure (up to 31 December 2011, when the original scheme ceased to apply) indicated that beneficiaries applied for and issued debt instruments worth a total of €69.66 billion, with an aggregate take-up rate of 47.48 per cent of the global ceiling. Furthermore, every guarantee requested under the scheme was granted, there have not been any solvency issues and no guarantee has been called in.¹⁶⁹

However, to facilitate the phasing out of the scheme and prevent over-reliance by its beneficiaries in a way that could be detrimental to restoration of normal functioning of financial markets, a number of amendments were introduced from 1 July 2010 concerning the amount of fees to be paid to the State and reporting obligations by Spanish authorities.

In its decision of 28 June 2010 extending the guarantee scheme for the third time, the Commission observed, on the basis of information provided by the Spanish authorities, that 'lower-rated credit institutions have become the prime users of the Scheme, whereas a gradual alignment with market conditions has provided an exit incentive for sounder institutions'.¹⁷⁰ This conclusion was essentially supported by the fact that, at the time, an increasing number of larger institutions were able to obtain term financing through issues outside the scheme. The relatively low take-up rate of the scheme (below 50 per cent) compared to its budgeted ceiling could also be a sign that at least part of the Spanish financial market could be gradually returning to normality.

The Commission therefore considered it necessary to make adjustments to the terms on which banks could retain the possibility of accessing the government guarantees in order to incentivize credit institution to scale down or terminate their State aid dependence and to prevent the risk of the scheme benefitting to non-viable beneficiaries with structural weaknesses in their business models. The viability review was to be communicated within three months and should comply with the requirements set out in the 2009 Restructuring Communication.¹⁷¹

(c) Second Guarantee Scheme for Credit Institutions (2012–13)

(i) Overview

The original guarantee scheme expired on 31 December 2011. On 16 January 2012, Spain notified to the Commission a request to introduce a new debt guarantee scheme to be in

¹⁶⁸ In line with fn. 4, p. 7 of the 2009 Recapitalization Communication.

¹⁶⁹ Commission Decision in Case SA.34224 (2012/N) – Spain, Reintroduction of the Spanish Guarantee Scheme, 9 February 2012.

¹⁷⁰ Commission Decision in Case N263/2010, note 167 above, para. 23.

¹⁷¹ *Ibid.* The viability review did not replace the need to submit a restructuring plan for beneficiaries undergoing a restructuring at the time the new guarantees were granted.

force until 30 June 2012.¹⁷² The new scheme was prolonged twice and terminated on 30 June 2013.¹⁷³

(ii) Scope of the scheme

The main terms and conditions of the second scheme were the same as those of the original scheme, except for the introduction of an upfront fee and the pricing of the fees.

The new guarantee scheme included a remuneration that was computed differently from that of the original scheme, in order to meet the conditions set forth in the Commission's 2011 Prolongation Communication.

(iii) Commission's assessment and conditions for approval

After the termination of the original scheme, access to wholesale market funding was still affected by the international financial crisis and the sovereign debt crisis experienced throughout 2011. Moreover, a significant number of the securities issued under the original scheme were about to mature in 2012. For these reasons, the Commission authorized the reintroduction of a debt guarantee scheme as a way to ensure that the beneficiaries would have access to funding and could promote credit to the Spanish economy.

In approving the new scheme, the Commission conditioned its green light on fulfilment of the commitments assumed by the Spanish authorities under the original one, stressing in particular that periodic reviews would allow the Commission to assess the appropriateness, necessity and proportionality of the required extensions thereof.

However, during the course of execution of the new scheme there was a shift in the way guarantees were allocated. As a result of the environment of austerity and fiscal consolidation experienced in 2012, Spanish authorities decided that new guarantees would be granted only upon individual request of the beneficiaries, thus discontinuing the across-the-sector allocation that had resulted in significant outstanding contingent liabilities for the State posing further stress on the sovereign risk. In June 2012, the exposure of Spanish authorities under both the original and the new scheme was around €71 billion.

Throughout the new scheme, the beneficiaries issued debt instruments for a total of €41.2 billion, with an aggregate take-up rate of 41.2 per cent of the budget. Similar to the previous scheme, every guarantee asked for was granted but none was called upon by the holders of the guaranteed instruments.

(d) Recapitalization Scheme for Credit Institutions (2010)

(i) Overview

Before the 2012 recapitalization scheme approved contemporaneously with the 2012 MoU, in 2010 Spain endorsed its first public capital support to the consolidation and

¹⁷² The legal basis for the new scheme was art. 49(2)b) of the General Budget Law for 2011, as amended by Real Decreto-ley 20/2011, of 30 December 2011, and Ministerial Order ECC/149/2012, of 30 January 2012.

¹⁷³ Commission Decision in Case SA.34904 (2012/N) – Spain, Extension of the Reintroduced Spanish Guarantee Scheme for H2 2012, 29 June 2012, and Commission Decision in Case SA.36020 (2013/N) – Spain, Prolongation of the Spanish Guarantee Scheme for Credit Institutions, 6 February 2013.

restructuring of the banking sector. On 19 January 2010 the Spanish authorities notified to the Commission the country's initial recapitalization scheme, which was initially valid until 30 June 2010 but later extended until 31 December 2010.¹⁷⁴

The recapitalization scheme was governed by the FROB.¹⁷⁵

In spite of being enacted by Royal Decree-Law No 9/2009, the FROB's prerogatives went beyond the mere application of the recapitalization scheme and presiding over the mergers and acquisitions of Spain's failing savings banks. It also acted as the Spanish resolution authority for the purposes of Directive 2014/59/EU.

(ii) Scope of the scheme

The beneficiaries of the recapitalization scheme were credit institutions established in Spain. Both fundamentally sound and non-fundamentally sound institutions were eligible. For these purposes, beneficiaries were deemed fundamentally sound if they did not present any drawbacks that could affect their viability¹⁷⁶ and the result of dividing the sum of their share capital plus reserves and generic provisions by the RWA was greater than 6 per cent.

In order to benefit from the scheme, beneficiaries were required to draw up a plan, setting out the specific measures and commitments to be implemented in order to achieve increased efficiency and solvability. This plan was later approved by the Bank of Spain, which would assess the risk profile of the applicant. The FROB would then communicate to the Commission the results of such assessment so that the Commission would also examine the proposed subscription of securities and the need to provide a restructuring plan.

The acquisition of securities by the FROB was only of the scale required to reach a solvency ratio of 8 per cent taking into account potential economic losses in a two-year time frame.

The securities purchased by the FROB were perpetual convertible preference shares and formed part of the non-Core Tier 1 capital of the beneficiaries. The remuneration was equal to the minimum of: (i) 7.75 per cent annual yield; or (ii) five-year Treasury bonds issued by Spain plus 500 bp. In both cases, an additional 15 bp was added annually as a step-up clause from the first to the fifth year of issuance to incentivize an early redemption. For the securities outstanding after the fifth year, an additional 100 bp per year would apply. In case of breach of the behavioural safeguards mentioned below, the remuneration would lift by 200 bp.

The beneficiaries were bound to buy-back the securities as soon as they were in a position to do so or they would convert into ordinary shares at maturity (five years as a rule or seven years in exceptional circumstances authorized by the Bank of Spain).

Upon conversion – which had to be notified to the Commission – should the beneficiary find itself in a weak position, a restructuring process would be triggered. In this case, the FROB would be appointed as the beneficiary's interim manager and, within one

¹⁷⁴ Commission Decision in Case N317/2010 – Spain, Extension of the Recapitalization Measures in favour of the Banking Sector in Spain, 23 July 2010.

¹⁷⁵ The legal basis for this scheme was Royal Decree-Law No 9/2009 of 26 June and a Resolution approving the FROB.

¹⁷⁶ According to the Bank of Spain.

month, would submit a plan to the Bank of Spain detailing its merger with another credit institution and/or the transfer of its business to another institution.

(iii) Commission's assessment and conditions for approval

The scheme enabled the beneficiaries to secure capital that would hardly be possible in the light of the conditions prevailing at the time in the financial markets. The Commission reported in its decision that, according to the Spanish authorities, there was an excess of installed capacity in the banking sector.¹⁷⁷ The FROB was intended to provide the beneficiaries with the means necessary to undertake the reorganization process required to adjust their size and practices to the new market conditions. This was done through integration and rationalization of credit institutions and by strengthening their capital position.

The scheme required that beneficiaries went through some degree of restructuring during their integration so that the resulting credit institution was stronger and more efficient.

In order to benefit from the FROB support all credit institutions agreed to:

- refrain from non-organic growth;
- not use the State support for advertising, marketing or commercially aggressive purposes;
- restrict management remuneration; and
- cap dividend payment to 30 per cent of annual profits.

Should the FROB subscribe securities in excess of 2 per cent RWA of a beneficiary that was nevertheless considered fundamentally sound, the following additional commitments would apply:

- reduce the balance sheet by 10 per cent;
- refrain from increasing the branch footprint in Spain;
- a ban on dividends; and
- maintain the staff productivity ratio between the revamped branch network and the central services during a five-year time span.

Finally, in case the FROB subscribed securities issued by beneficiaries that were non-fundamentally sound, a number of supplementary conditions were required:

- a reduction of 20 per cent in the balance sheet;
- three years after subscription, the aggregate total assets could not exceed 95 per cent of the sum of the total assets of the institutions taking part in the merger; and
- a ban on discretionary coupon and interest payments on hybrid instruments.

For beneficiaries needing a second recapitalization, Spanish authorities further committed to notify each additional measure individually. In addition, in cases where FROB

¹⁷⁷ Commission Decision in Case N317/2010, note 174 above, para. 43.

intended to subscribe securities in excess of 2 per cent RWA in beneficiaries that were not fundamentally sound, there was a need to notify the conditions of the recapitalization as well as a restructuring plan.

Spanish authorities were also to present to the Commission a report every six months on the operation of the scheme.

Although the scheme was opened to all types of credit institutions in Spain, only savings banks (*cajas*) applied. Under the scheme seven integration projects were completed in 2010, involving 26 *cajas* and aggregate assets of €768 billion, benefitting from a €10 billion capital injection from the FROB.¹⁷⁸ These projects gave rise to the following institutions: Unnim, Catalunya Caixa, Caja España de Inversiones, Salamanca y Soria, BFA/Bankia, Banko Mare Nostrum, NovaCaixaGalicia and Banca Cívica.

3. INDIVIDUAL AID

(a) CajaSur

(i) Overview

On 22 May 2010 the Spanish authorities notified to the Commission their intention to provide a capital injection and liquidity support to Caja de Ahorros y Monte de Piedad de Córdoba (CajaSur) through the FROB. On the following day, the Commission approved the rescue measures for CajaSur for a period of six months, pending notification of a restructuring plan.¹⁷⁹

(ii) Events leading to the State intervention

CajaSur was the 20th-biggest savings bank in Spain, founded in the nineteenth century by the Catholic Church of Córdoba. Its loan portfolio enlarged considerably between 2002 and 2007, especially in the real estate sector. Such exposure inflicted great losses on CajaSur and decreased its equity. On 30 June 2010, the equity was €24 million, leaving the solvency ratio at 0 per cent, and the reported delinquency rate (8.3 per cent) at among the highest in the sector.

From the funding viewpoint, historically CajaSur obtained the funds to finance its loan portfolio from wholesale markets but, on the back of successive downgrades to non-investment level in April 2009, access to wholesale markets became nearly impossible. Also, the deposit base eroded rapidly, aggravating the liquidity position, together with the recorded distressed solvency levels.

(iii) Aid measures

In May 2010 the Bank of Spain replaced the management of CajaSur with FROB and adopted two rescue measures: (i) the subscription, by the FROB, of €800 million of

¹⁷⁸ See <http://www.frob.es/en/Lists/Contenidos/Attachments/301/nota_bde_30_junio_2010_English_prot.pdf>; and <http://www.frob.es/en/Lists/Contenidos/Attachments/318/20101222_english.pdf> accessed 2 September 2012.

¹⁷⁹ Commission Decision in Case N202/2010 – Spain, Recapitalization of CajaSur, 23 May 2010.

cuotas participativas – an equity-like security available to *cajas de ahorro* and qualified as Core Tier 1 capital – awarding to the FROB 100 per cent of the voting rights; and (ii) a €1.5 billion credit facility granted by the FROB against an adequate collateral and with an interest of 100 bp on top of the ECB’s marginal credit facility (1 per cent at the time). The mix of the two measures allowed CajaSur to meet the minimum capital requirement of 8 per cent and its liabilities during the restructuring period.

Conditional upon the submission of a restructuring plan, the Commission temporarily authorized the recapitalization and the credit facility in favour of CajaSur as emergency aid to prevent the institution’s insolvency. According to the Commission, this conceivable scenario would have an adverse impact on the Spanish financial system, and particularly on other savings banks, which would likely experience a run on the deposits at a sensitive juncture.

(iv) Commission’s assessment and conditions for approval

Given the situation and prospects of CajaSur at the time of the aid, the Commission considered that the institution was not in a position to adequately remunerate the capital injection. The reason was that the support was being granted through an equity-like instrument, the remuneration of which was based and dependent on distributable proceeds, i.e., chances were that if CajaSur could not pay out dividends, the FROB would not receive any remuneration. Hence, according to general principles this lack of return to the State at the rescue stage had to be reflected in the subsequent restructuring plan.¹⁸⁰

Having asserted that the orderly wind-down of CajaSur would be very expensive and time-consuming, Spanish authorities (with the Commission’s acquiescence) focused on promoting a competitive open-market tender procedure to gauge market interest for the acquisition of CajaSur’s business. In the end, Bilbao Bizkaia Kutxa (BBK) was selected.

The restructuring plan put together by the Spanish authorities and approved by the Commission contemplated a number of measures, some of them including additional aid measures. However, having regard to the features of the tender process and considering that no other participant made an offer requesting less public support, the Commission was satisfied that this was a proxy for the establishment of a market price and certified that BBK received no aid.¹⁸¹

- CajaSur transferred all its assets and liabilities to a wholly-owned subsidiary of BBK. As a result, both CajaSur and its *Obra Benéfico-Social* were liquidated, although BBK kept CajaSur’s brand and branches (in the absence of an overlap with those of BKK). As CajaSur’s equity was negative, BBK paid the symbolic price of €1;
- in turn, the FROB afforded to the transferred business, for five years, an asset protection scheme (APS) of €392 million covering a portfolio of €5.5 billion. Under

¹⁸⁰ Communication from the Commission on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2, paras 15 and 44.

¹⁸¹ Commission Decision in Case N392/2010 – Spain, Restructuring of CajaSur, 8 November 2010.

the APS, the FROB would compensate BBK for 90 per cent of losses arising from such book up to the €392 million limit;

- CajaSur repaid the rescue aid prior to completion of the deal (to this end, it received a credit line of €800 million from the FROB to pay back the *cuotas*);
- the new entity was not to carry out new economic activities and engage in aggressive commercial practices;
- a ban on coupon payments and buy-backs for hybrid securities;
- Spanish authorities were to report yearly on the evolution of the APS.

In June 2010, before implementation of the restructuring plan, CajaSur held 0.6 per cent of the Spanish financial system total assets. Following the takeover of its business by BBK, the new entity increased the size of its balance sheet by 60 per cent and became Spain's seventh-largest saving bank at the time.

(b) Caja Castilla-La Mancha

(i) Overview

In March 2009 Spain granted a guarantee on emergency liquidity assistance (ELA) provided to Caja Castilla-La Mancha (CCM). Furthermore, a capital injection in favour of CCM was made by the Deposit Guarantee Fund for Cajas de Ahorro (savings banks) in April 2009.¹⁸² None of these measures were notified to the Commission prior to implementation, and thus were deemed illegal aid for the purposes of Article 108(3) TFEU.¹⁸³

(ii) Events leading to the State intervention

CCM was a Spanish *caja de ahorro* (savings bank) established in 1992, with activities limited to Spanish territory and the retail banking sector. In 2009 it had roughly 1 per cent of the deposits, loans and total assets of the Spanish financial system.

Between 2000 and 2008 CCM experienced high growth rates of investment credit (from €4 billion to €19 billion) and invested in real estate projects. When the effects of the global crisis intensified after 2008, property demand declined sharply and this impacted on real estate developers and constructors, which were the most relevant debtors of CCM.

This situation caused successive reductions in its financial ratings, which further hampered the bank's access to wholesale funding. Between 2008 and February 2009, Fitch downgraded CCM from A+ to BB+ (below investment grade or junk bond).

Consequently, the main source of potential funding had to be the financing facilities

¹⁸² The Deposit Guarantee Fund for Cajas de Ahorro was created by Royal Decree 2860/1980, of 4 December, as amended. The Fund guarantees the amounts deposited in its affiliates but can also perform all necessary pre-emptive actions to avoid the deposits guarantees from being triggered. The fund concerned only covered savings banks; commercial and cooperative banks had two separate deposit funds until October 2011 (when the three were merged). In the context of the 2008 financial crisis, CCM was the only *caja* benefitting from a direct intervention of its respective Deposit Guarantee Fund. After CCM's rescue, Royal Decree-Law No 9/2009 of 26 June instituted the FROB, which centralized these procedures.

¹⁸³ Commission Decision in Case NN61/2009 – Spain, Rescue and Restructuring of Caja Castilla-La Mancha, 29 June 2010.

of the ECB but these were not available due to CCM's lack of eligible collateral and its inability to sell off assets without incurring large losses. On the other hand, the small annual operating profit of CCM (about €150 million) was not enough to absorb the impairments. At the end of 2008 its capital ratio was of 1.26 per cent, well below the 8 per cent required.

Under these circumstances, it was in urgent need of assistance to meet its outflows.

(iii) Aid measures

In March 2009, as a consequence of the impossibility of CCM raising capital on its own, the Bank of Spain provided CCM with a €9 billion ELA guaranteed by the State up to €3 billion, out of which €1.15 billion was effectively used.

In parallel, the Bank of Spain placed CCM under administration, replacing its previous management with interim directors. After assessing the institution's situation, the new directors confirmed that the only solution would be to integrate CCM with a solvent credit institution.

In April 2009, the Deposit Guarantee Fund injected €1.3 billion of capital in the form of preference shares (regarded as Tier 1 capital).

(iv) Commission's assessment and conditions for approval

The restructuring of CCM basically consisted of integrating its banking activities with a solvent credit institution. To that end, CCM's interim board launched a competitive auction process in September 2009 to search for a buyer. Ultimately CajAstur presented the best and highest offer and acquired CCM's banking business through its subsidiary, Banco Liberta. The main terms of the deal were:

- The net assets of CCM transferred into Banco Liberta were worth €23 billion (including branches, staff, IT, mortgages, debt and deposits). This already entailed, on the asset side, a reduction of approximately 20 per cent of the existing branches.
- CCM would receive a share of 25 per cent in Banco Liberta's capital in exchange for the assets transferred.
- The new entity would have to reach an 8 per cent Tier 1 ratio. This implied that CajAstur would inject €410 million into Banco Liberta and CCM would transfer assets for a net value of €442 million. To this end, the Deposit Guarantee Fund for Cajas de Ahorro would make an additional liquidity contribution of €350 million for the reimbursement of certain banking liabilities that could not be contractually transferred to Banco Liberta.
- The Deposit Guarantee Fund would provide a five-year guarantee of €2.47 billion on a €7.7 billion portfolio of impaired assets (consisting mainly of real estate loans). All losses above the guaranteed amount would be assumed by Banco Liberta.
- Once CCM's banking activities were transferred to Banco Liberta, the remaining assets would be transferred to the Deposit Guarantee Fund, which would sell them. Losses incurred after completion of the sale, if any, would be shared between CCM and the fund.
- To limit the State aid involved, the ELA would be fully reimbursed to the Bank of Spain and the capital injection was to be offset by the transfer of CCM's non-banking assets to the Deposit Guarantee Fund.

- The combined entity was prevented from expanding to new businesses, adopting an aggressive commercial policy and using the State support throughout its duration.

As a combined result of the support and restructuring measures applicable, CCM received very significant amounts of State aid: the €1.15 billion guarantee on the ELA and the €1.3 billion capital injection in preference shares granted by the Deposit Guarantee Fund, both awarded as rescue aid to keep the institution afloat before its restructuring; and a €2.47 billion guarantee awarded by the Deposit Guarantee Fund as an asset relief measure and a further €350 million liquidity contribution made by the same fund as conditions attached to the restructuring.

Conversely, the Commission considered that the sale process of CCM to CajAstur was open and non-discriminatory and resulted in the best bid winning the tender. For these reasons, the Commission concluded that the acquirer did not receive aid.

The total aid amount (approximately €5.3 billion) was very high in terms of total assets (21 per cent) and RWA (51.7 per cent). Although one might discuss whether adequate burden-sharing was ensured at the rescue stage of CCM, it appears that it was compensated at a subsequent phase with the far-reaching restructuring just described and the early redemption of the previous State supports.

Furthermore, on 30 June 2010 CCM surrendered its banking licence, ceased its banking activities and turned into a charitable foundation – Fundación Caja Castilla-La Mancha¹⁸⁴ – aimed only at supporting charitable, cultural or social projects in the area of Castilla-La Mancha. It is the foundation that holds the 25 per cent stake in Banco Liberta, currently known as Banco de Castilla-La Mancha, S.A. (now a subsidiary of Liberbank, S.A.), although it still operates under the commercial brand CCM.¹⁸⁵ Dividends stemming from this participation in Banco Liberta are employed to fund the abovementioned projects existing at the time, subject to a yearly cap of €11 million. Any revenues above that amount should be pledged to guarantee any subsequent liabilities towards the Deposit Guarantee Fund arising from the realization of the non-banking activities.

(c) **Caja de Ahorros de Mediterráneo**

(i) **Overview**

Caja de Ahorros del Mediterráneo (CAM) was a savings bank operating mainly in the regions of Valencia and Murcia with local market shares around 15 per cent in deposits and 3 per cent nationwide.

CAM was bailed out by the Spanish authorities in July 2011. It received recapitalization aid of €2.8 billion through the issuance of ordinary shares (representing 5.8 per cent of the institution's RWA) subscribed by the FROB, which became the sole shareholder. CAM was also the recipient of a €3 billion credit facility granted against adequate collateral and subject to the ECB's marginal credit facility (1.75 per cent then) plus an interest of 100 bp.

¹⁸⁴ See <<http://www.fundacioncajastillalamancha.es/>> accessed 3 September 2016.

¹⁸⁵ See <<http://www.ccm.com.es>>, <<https://www.cnmv.es/Portal/verDoc.axd?t={7f936bc0-6279-47bb-8d91-4781a2185949}>> accessed 3 September 2016.

The Commission authorized the rescue aid on 24 July 2011 under the condition that a restructuring plan would follow.¹⁸⁶

(ii) Events leading to the State intervention

The reasons why CAM had run into difficulties do not follow clearly from the Commission's decisions approving the emergency aid and the restructuring plan. It appears though that one of the foremost reasons for the institution's failure lies in the low quality of its assets. CAM's loan portfolio presented very high default rates (above 22 per cent in 2011) and had a high concentration in risky sectors (particularly real estate). Additionally, the Commission noted that CAM had frequently refinanced its operations, avoiding a haircut in problematic assets.

This also posed a liquidity issue. Following successive downgrades of its credit rating, CAM was barred from accessing wholesale markets, had limited assets eligible for liquidity at the ECB and the deposit base decreased considerably.

In 2011 CAM failed the EU wide stress test exercise run by EBA, showing a Core Tier 1 ratio of 3 per cent under adverse scenario (the minimum was 5 per cent at the time). For that same year, losses of €2.4 billion reduced CAM's solvency ratio to 7.8 per cent.

(iii) Aid measures

In July 2011 the Commission gave its green light for a period of six months to the two rescue measures in favour of CAM mentioned above. In August 2011, the Spanish authorities initiated an open and competitive tender for the sale of CAM, which was won by Banco Sabadell, S.A. (Banco Sabadell). The final bid included an offer of €1 for CAM and a number of aid measures provided by the Spanish Deposit Guarantee Fund.¹⁸⁷

(iv) Commission's assessment and conditions for approval

Given the bank's distress level, the size of the aid and the absence of an adequate return for the State – the recapitalization measure had no fixed remuneration to it (but was rather dependent on the availability of profits to hand out) and the liquidity facility was being paid at a low interest – it was clear that CAM would have to be subject to a strict restructuring plan.

The restructuring plan reflected the conditions presented by Banco Sabadell in the final offer and its main elements were as follows:

- CAM's entire assets and liabilities were transferred to Banco Sabadell for €1.¹⁸⁸
- An additional recapitalization of €2.45 billion in the form of ordinary shares (on

¹⁸⁶ Commission Decision in Case SA.33402 (2011/N) – Spain, Recapitalization of the CAM Group, 24 July 2011, and Commission Decision in Case SA.34255 (2012/N) – Spain, Restructuring of CAM and Banco CAM, 30 May 2012.

¹⁸⁷ The initial intention of the Spanish authorities was to channel the aid through FROB but, at a later stage, it decided to use the Deposit Guarantee Fund as the vehicle for the restructuring measures. Although that fund was financed by banks' contributions, the Commission considered that State resources were mobilized for the purposes of art. 107(1) TFEU since those contributions were mandatory and determined by law and, in the case at issue, the measures were made available by the Spanish authorities to potential buyers in the tendering process.

¹⁸⁸ According to the Spanish authorities, Banco Sabadell had the best bid for CAM considering

top of the €2.8 billion afforded during the rescue stage) was provided by the Spanish Deposit Guarantee Fund, allowing the merged entity to reach the minimum regulatory capital requirement of 10 per cent.¹⁸⁹

- The same fund granted an APS to cover losses on an impaired assets pool of €24.6 billion, supporting 80 per cent of the losses between €3.9 billion and €24.6 billion (against a symbolic annual fee of 0.01 per cent). The remaining loss was borne by CAM.
- A contingent tax relief measure of €724 million was to be triggered if, after the acquisition by Banco Sabadell, CAM could not benefit from deferred tax assets accumulated as of 31 December 2011.
- The liquidity facility of €3 billion granted by the FROB in July 2011 was repaid once the transfer was completed.
- Banco Sabadell was entrusted with managing CAM's portfolio of 70 subsidiaries exposed to real estate development with the goal of reducing it in an orderly fashion while maximizing their net present value.
- A ban on coupon payments and buy-backs for hybrid securities and subordinated debt, as well as a ban on aggressive commercial policies, were in place.
- There was an integration of the branches of Banco Sabadell and CAM where they overlapped, to the extent that approximately 28 per cent of the former's branches were phased-out in the core area of Valencia and Murcia and circa 86 per cent outside those regions. There was also a downsizing in the headcount by 2,231 bringing the total number of former CAM employees to 4,448.
- CAM's credit portfolio for the duration of the restructuring plan (1 January 2012–31 December 2015) in its core regions was limited. Annual growth rates were of 2.5 per cent for consumer credit, 6 per cent for SMEs and corporate clients and 0 per cent for residential mortgages; in the real estate development segment an annual reduction of 15 per cent was imposed.
- CAM was converted into a special foundation (Fundación Caja Mediterráneo) whose main goal is to manage its Obra Benéfico-Social with substantially fewer resources. The foundation is a charitable institution that operates in regions where Banco Sabadell carries out banking activities.¹⁹⁰
- Spanish authorities reported yearly to the Commission on the evolution of the APS and a monitoring trustee was appointed by Banco Sabadell throughout the restructuring period.

All measures combined represented aid of approximately €14 billion, amounting to more than 30 per cent of CAM's RWA. These figures were used to justify the thorough restructuring undertaken, comprising a change of CAM's ownership and its disappearance as a standalone banking entity.

inter alia that other participants were asking for greater public support. Since the offer was submitted in the context of a competitive tender, the Commission concluded that Banco Sabadell received no aid.

¹⁸⁹ There was neither an obligation to repay the principal amount of this second recapitalization nor any form of remuneration.

¹⁹⁰ See <<http://www.cajamediterraneo.es/>> accessed 27 October 2016.

Spanish authorities also ran alternative liquidation scenarios to assess the impact of an orderly winding-down of CAM. However, data presented by Spain suggests that a winding-up option, entailing a discounted asset disposal to private investors in three to five years, would cost an estimated €16.5 billion to €19.5 billion, and a liquidation scenario based on a good bank/bad bank split would cost around €19 billion. For these reasons, the restructuring and sale of CAM to Banco Sabadell was considered the alternative involving the least use of public resources with the extra advantage of avoiding the risk of negative spillovers on confidence in the banking industry.

The full merger of CAM into Banco Sabadell increased the former's balance sheet by 70 per cent and established the new entity among the top five largest banks in Spain back in 2011.

(d) Group 1 Banks: NCG, Catalunya Banc, BVA and BFA/Bankia

(i) Overview

As indicated before, Spain's MoU contained a strict timeline for recapitalization and restructuring of the different groups of banks established on the basis of stress test results. In particular, for banks controlled by the FROB, additional capital would only be provided once individual restructuring plans had been approved by the Commission by the end of November 2012.

As a result, four credit institutions were classified in Group 1: NovaCaixaGalicia, which later transferred its banking business to NCG Banco, S.A. (NCG); CatalunyaCaixa, which also transferred its activities to a newly established banking entity, Catalunya Banc, S.A. (Catalunya Banc); Banco de Valencia, S.A. (BVA); and Banco Financiero y de Ahorro, S.A. (BFA) and its subsidiary Bankia, S.A. (Bankia; together BFA/Bankia or BFA Group).

As a result of: (i) the significant capital shortfall revealed by all such banks in the 2012 MoU stress test; (ii) the considerable amount of aid received since they were first nationalized by the FROB; and (iii) the impossibility of restoring these banks' standalone viability, the four Group 1 institutions were placed under resolution and subject to a comprehensive rebalancing under new ownership.

(ii) Events leading to the State intervention

Following the outbreak of the financial crisis in 2008, Spanish authorities laid down, via Royal Decree-Law No 9/2009, the foundations for restructuring the country's financial sector. According to the Commission, some of the banks presented structural limitations and, in some instances, complex and weak corporate governance systems that prevented those institutions from detecting problems at an early stage.¹⁹¹

¹⁹¹ Commission Decisions of 28 November 2012 in Cases SA.33734 (2012/N) – Spain, Restructuring of NCG, para. 13, SA.33735 (2012/N) – Spain, Restructuring of Catalunya Banc S.A., para. 17 [as amended in Case SA.39402 (2014/N) – Spain, Restructuring of Catalunya Banc S.A. through its Acquisition by BBVA, para. 21], SA.34053 (2012/N) – Spain, Recapitalization and Restructuring of Banco de Valencia, S.A., para. 17, and SA.35253 (2012/N) – Spain, Restructuring and Recapitalization of the BFA Group, para. 18.

Banks categorized in Group 1 had in common a high exposure to the real estate sector, which had driven up their non-performing loans, and a large reliance on wholesale funding. For these reasons, all four Group 1 institutions were bailed-out by the FROB under the 2010 recapitalization scheme mentioned above.

Furthermore, on February 2011 Spanish authorities adopted more stringent regulatory capital requirements for the entire banking sector, which obliged all credit institutions to meet, by 30 September 2011, a 10 per cent capital solvency ratio over their RWAs. All Group 1 banks concerned failed to satisfy that requirement with their own resources. This was aggravated by the fact that the 2012 MoU stress test detected significant capital shortage for the three-year horizon (2012–14) of that exercise.

(iii) Aid measures

NCG *NCG* was a savings bank operating mainly in Galicia, where it had a market share of 44 per cent (3 per cent at national level). *NovaCaixaGalicia* (the predecessor of *NCG* to which *NovaCaixaGalicia* transferred its business in early September 2011) benefitted from a first capital injection in December 2010 in the form of a convertible preference amounting to €1,162 million from the FROB to support the said merger pursuant to the 2010 recapitalization scheme.

As a result of the new regulatory solvency levels approved in February 2011, *NCG* received a second capital injection from the FROB through the subscription of €2,465 million of ordinary shares. This emergency recapitalization was temporarily approved by the Commission on 30 September 2011 to allow *NCG* to meet the 10 per cent capital principal ratio prescribed by the Spanish authorities.¹⁹² As a result of this capital injection, the FROB obtained more than 90 per cent of *NCG*'s share capital (including the conversion into equity of the preference shares bought in 2010), the remaining being largely at the hands of *NCG*'s charitable foundation.¹⁹³

On 28 September 2012, the results of the bottom-up stress test and asset quality review conducted by Oliver Wyman in the context of Spain's MoU revealed that *NCG* had a capital deficit of €7,176 million under an adverse scenario and €3,966 million in the base case. To tackle this, *NCG* required an additional capitalization of €5,425 million subscribed by the FROB as ordinary shares.

Also, under the MoU, assets related to real estate of banks needing State aid were to be transferred to the asset management company (*SAREB*) in charge of managing and divesting the portfolio received maximizing its recovery over 15 years. The volume of assets to be transferred to *SAREB* by Group 1 institutions was around €45 billion. *NCG* transferred assets to *SAREB* worth €10–20 billion.¹⁹⁴

Between 2010 and 2012 *NCG* received State aid through capital injections and impaired

¹⁹² Commission Decision in Case SA.33096 (2011/N) – Spain, Recapitalization of *NCG* Banco, 30 September 2011.

¹⁹³ See <<http://www.afundacion.org/es/>> accessed 5 September 2016.

¹⁹⁴ The aid amount of the impaired asset measure was estimated by the Commission to be of €1.3 billion (the difference between the market price and the transfer price of the assets).

asset measures in excess of €10 billion (22 per cent of RWA), on top of €7.5 billion in guarantees.

Catalunya Banc On March 2010, the FROB participated in the merger of three savings banks (Caixa Catalunya, Caixa Tarragona and Caixa Manresa) creating Caixa Catalunya, a saving bank operating mainly in Catalonia. The capitalization was awarded under the 2010 recapitalization scheme through the purchase of €1,250 million of convertible preference shares.

At the time, Catalunya Caixa ranked eighth among its Spanish peers, with a market share of approximately 12 per cent in its core region and 3 per cent nationwide. In July 2011, Catalunya Caixa transferred its banking business to Catalunya Banc, a new institution through which the former exercised its financial activities.

On 30 September 2011 the Commission authorized as rescue aid an additional injection by the FROB into Catalunya Banc of €1,718 million in the form of ordinary shares.¹⁹⁵ This allowed Catalunya Banc to comply with the 10 per cent reinforced capital threshold applicable to banks operating in Spain. As a result thereof, the FROB acquired around 90 per cent of Catalunya Banc's capital.

In September 2012, the MoU stress test showed a capital gap of €10.83 billion under adverse scenario and €6.49 billion in the base case. Hence, Catalunya Banc had to receive an additional capitalization from the FROB of €9.08 billion and the preference shares of 2010 were converted into equity. In parallel, pursuant to the MoU, Catalunya Banc transferred to SAREB a portfolio of €10–20 billion in terms of gross book value.¹⁹⁶

In sum, the combination of measures attributed between 2010 and 2012 amounted to €13.35 billion, equivalent to 32 per cent of the bank's RWA, in addition to guarantees worth €10.76 billion.

BVA BVA was a listed commercial bank essentially active in Valencia and Murcia where it focused on retail banking for individuals and SMEs with local market shares of 5–10 per cent and residual at a national glance.

BVA's management was taken over by the FROB in November 2011 and the bank received, roughly six months later, a rescue injection of €1 billion in equity and a liquidity line of up to €2 billion from such fund.¹⁹⁷ As a result, the FROB obtained a controlling 91 per cent stake in BVA.

Subsequently, in the outcome of a competitive tender procedure, the Spanish authorities decided to sell BVA to CaixaBank, S.A. (CaixaBank) for €1, under the following assumptions:¹⁹⁸

¹⁹⁵ Commission Decision in Case SA.33103 (2011/N) – Spain, Recapitalization of Catalunya Banc, 30 September 2011.

¹⁹⁶ The aid amount of the impaired asset measure was estimated by the Commission at €1.6 billion (the difference between the market price and the transfer price of the assets).

¹⁹⁷ Commission Decision in Case SA.33917 (2011/N) – Spain, Recapitalization and Liquidity Support for Banco de Valencia, S.A., 21 November 2011.

¹⁹⁸ Apart from the Commission Decision SA.34053, note 191 above, see also the FROB's press release <http://www.frob.es/en/Lists/Contenidos/Attachments/268/20121127_Venta_BV_nota_de_prensa_eng_PROT.pdf> accessed 5 September 2016.

- a capital injection of €4.5 billion by the FROB into BVA;
- an asset protection scheme for a portfolio of €5–10 billion over a ten-year period, according to which the FROB would absorb 72.5 per cent of losses above €404 million, while CaixaBank would cover the rest;
- the previous transfer to SAREB of BVA's assets belonging to the credit portfolio and real estate amounting to €5–10 billion; and
- a previous liability management exercise regarding hybrid instruments and subordinated debt issued by BVA to secure the contribution of the holders of such securities.

On the basis of the above, BVA received State aid in the form of equity and impaired-asset measures in the amount of €7,225 million and accounting for an impressive 64 per cent of RWA, in addition to the liquidity facility of €2 billion.¹⁹⁹

BFA/Bankia BFA was created in 2010 as a result of the merger of seven Spanish savings banks.²⁰⁰ The FROB participated in this consolidation, subscribing €4,465 million in the form of convertible preference shares under the 2010 recapitalization scheme.

The BFA Group is a large universal retail bank, with a presence in all main business segments. At its peak (mid-2010) the group ranked fifth among the biggest banks in Spain, with more than €340 billion in assets and a national market share of approximately 9 per cent. Bankia was a subsidiary of BFA to which the latter transferred 85 per cent of the assets and liabilities received from the seven founding savings banks. It is listed on the Madrid stock exchange.

In May 2012, BFA Group reported a loss of €4,952 million in 2011 and Bankia was suspended from trading in the official markets. In the following month the Spanish authorities announced that the preference shares acquired by the FROB would be converted into ordinary shares to restore the group's regulatory capital levels, together with a liquidity guarantee of up to €19 billion to BFA in the context of that conversion.²⁰¹ The Commission approved both measures as rescue aid on 27 June 2012.²⁰² Accordingly, the FROB became the sole shareholder of BFA.

In September 2012, BFA and Bankia were in need of a new recapitalization of €4.5 billion to tackle its precarious capital position under the more demanding regulatory

¹⁹⁹ The amount of aid under the impaired asset measure was estimated by the Commission at €500 million (the difference between the market price and the transfer price of the assets). The aid element of the asset protection scheme was evaluated at €1,225 million, corresponding to the sum of the expected losses covered by the FROB, the capital relief and the difference to an appropriate remuneration of the scheme.

²⁰⁰ Caja de Ahorros y Monte de Piedad de Madrid, Caja de Ahorros de Valencia, Castellón y Alicante, Caja Insular de Ahorros de Canarias, Caixa D'Estalvis Laietana, Caja de Ahorros Monte de Piedad de Avila, Caja de Ahorros y Monte de Piedad de Segovia and Caja de Ahorros de la Rioja.

²⁰¹ See <http://www.frob.es/en/Lists/Contenidos/Attachments/286/20120514_Nota_prensa_con_version_preferentes_BFA_EN_prot.pdf> accessed 5 September 2016.

²⁰² Commission Decision in Case SA.34820 (2012/N) – Spain, Rescue Aid to BFA/Bankia, 27 June 2012.

requirements approved by Spain,²⁰³ which the Commission authorized anew as an emergency aid in anticipation of the final recapitalization by the FROB.²⁰⁴

Following the 2012 MoU stress test, a massive capital shortfall of €24,743 million in the adverse scenario and €13,230 million under the base case were identified in respect of the BFA Group, requiring an additional capitalization of €17,959 million, an impaired asset measure involving a non-identified amount and averted potential losses linked to credit lines from the BFA Group to BVA (a former subsidiary of BFA) amounting to €1,759 million.

Following the capital injection of €17,959 million, BFA transferred the funds received from the FROB to Bankia through the subscription of CoCos in order to allow the BFA Group to comply with the regulatory solvency ratio by 1 January 2013.

Consequently, up until its restructuring, BFA/Bankia received aid in the form of capital injections, capital relief and impaired asset measures in the amount of €36.2 billion (22 per cent of RWA) and State guarantees of €53.9 billion.

(iv) Commission's assessment and conditions for approval

NCG In view of the bank's situation, the considerable amounts of aid received and the low probability of repaying the public funds granted, NCG was resolved and subject to an in-depth restructuring with a view to selling it within a maximum of five years, failing which it would be wound-up.

According to the restructuring plan approved by the Commission on 28 November 2012, the foremost measure to achieve the required deep structural change was the splitting of NCG's activities into two parts: a core unit and a non-core unit, managed separately. The first formed the basis of a sound and viable bank focused on retail businesses. The legacy unit contained the assets and liabilities not included in the core activities and regions which were to be discontinued, sold, closed or held to maturity.

During the restructuring period (2012–17), NCG's balance sheet was to shrink by 30–40 per cent, mainly due to a downsizing in the loans portfolio of 20–30 per cent, a reduction in Eurosystem funding of 60–70 per cent and a decline in deposits of 20–30 per cent. If added to the restructuring efforts undertaken between 2010 and 2012, this represents a total reduction of the balance sheet by 50–60 per cent.

NCG was also under the obligation to close and/or sell its business outside the core regions.²⁰⁵ The intended branch and staff adjustments were to lead to a reduction

²⁰³ See <http://www.frob.es/en/Lists/Contenidos/Attachments/274/20120903_FROB%20Nota%20prensa%20recapitalizacion%20BFA%20Bankia%20EN%20prot.pdf> accessed 5 September 2016.

²⁰⁴ Commission Decision in Case SA.35369 (2012/N) – Spain, Urgent Recapitalization of BFA Group, 7 September 2012.

²⁰⁵ On 18 April 2013, Banco Sabadell was selected to buy NCG's subsidiary Banco Gallego, S.A., subject to several support measures from the FROB approved by the Commission under State aid rules on 25 July 2013 [Case SA.36500 (2013/N) – Spain, Recapitalization and Restructuring of Banco Gallego, S.A.]. Furthermore, on 9 September 2013 NCG announced its intention to sell its subsidiary EVO Banco (that operated outside of Galicia) to the American private equity firm Apollo Global Management for €60 million. See <<http://www.lavozdegalicia.es/noticia/economia/2013/09/09/fondo-apollo-compra-evo-banco-60-millones-euros/00031378713451114770176.htm>> accessed 5 September 2016.

of 40–50 per cent, between 2012 and 2017, and 60–70 per cent, considering 2010 onwards.²⁰⁶

Following this deep restructuring, the volume of RWA in NCG was predicted to fall by 30–40 per cent by 31 December 2017. For the same date NCG projected post profits of €200–300 million (compared to €7,966 million in 2012), a cost-to-income ratio of 50–60 per cent (compared to 60–70 per cent in 2012) and capital ratios according to EBA (Core Tier 1) and Basel III (common equity tier 1) of 10–20 per cent (compared to 5–10 per cent in 2012).

Following a competitive tender process conducted by the FROB and in accordance with the restructuring plan, on 18 December 2013 the FROB announced the sale of NCG to Banco Etcheverría, S.A, a Venezuelan-owned Spanish bank part of the Bransco Group, for €1,003 million.²⁰⁷ In the meantime, NCG changed its brand name to Abanca Corporación Bancaria, S.A.²⁰⁸

Catalunya Banc For the same reasons as NCG, Catalunya Banc was also placed under resolution and put up for sale following deep restructuring.

Catalunya Banc's activities were severed into a core and a non-core unit. Its banking business was 'cleaned-up' and focused among retail, SMEs and the public sector in Catalunya. The legacy unit included the most risky asset classes emanating from the burst of the Spanish real estate bubble, which was to be discontinued.

Despite the fact that the restructuring period is predicted to last from 2012 to 31 December 2017,²⁰⁹ the Commission only provided financial projections until the end of 2016. During this period, Catalunya Banc's balance sheet was expected to reduce 20–30 per cent as a result of a 20–30 per cent decrease in loans, an increase in ECB funding of 100–200 per cent and a cut in deposits of 20–30 per cent.

Catalunya Banc was also bound to dispose of its entire businesses (including stakes) outside Catalonia, motivating a reduction in branches and staff of 30–40 per cent (or around 50 per cent contemplating the restructuring efforts began in 2010).

Accordingly, until the end of 2016, the RWAs should reduce by 20–30 per cent (which represented a decline of 60–70 per cent comparing to 2010), profits should be of €200–300 million, the cost-to-income ratio should achieve 60–70 per cent and the EBA capital ratio should stay above 10 per cent²¹⁰).

Once the restructuring plan was approved, the FROB initiated the sale process of Catalunya Banc through a competitive tender. Since the initial stage of the process did not attract sufficient interest, the FROB designed a dual sale of: (i) a carved-out portfolio

²⁰⁶ The restructuring plan also contained typical behavioural commitments banning acquisitions, commercial aggressive practices, aid advertising and dividends and coupons, restricting remuneration and the appointment of a monitoring trustee.

²⁰⁷ See <http://www.frob.es/en/Lists/Contenidos/Attachments/257/20131218_ingles.pdf> and <http://www.frob.es/en/Lists/Contenidos/Attachments/256/20131218_INFORME_INGLES.pdf> accessed 5 September 2016.

²⁰⁸ See <<https://www.abanca.com/es/>> accessed 5 September 2016.

²⁰⁹ See para. 3.3 of the commitments term-sheet annexed to the Commission Decision SA.33735, note 191 above.

²¹⁰ The restructuring plan also contained typical behavioural commitments banning acquisitions, commercial aggressive practices, aid advertising and dividends and coupons, restricting remuneration and appointing a monitoring trustee.

of poorer quality loans (mainly mortgages) with a nominal value of €6,392 million and provisions of €2,205 million; and (ii) the rest of Catalunya Banc without distressed assets.

On 17 July 2014, the FROB announced the sale of the credit portfolio to the international investment firm Blackstone for €3,615 million, with the FROB contributing to the remainder €572 million. According to the FROB, this was the biggest sale of a portfolio of mortgage loans to date in Europe.²¹¹

A few days later, the FROB announced the sale of Catalunya Banc to Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), a Spanish-based international banking group, for a price of €1,187 million.²¹² The terms of the sale agreement essentially followed the package of basic assurances offered by the FROB in the process, except for the granting of an asset protection scheme.²¹³

In December 2014 Spain approached the Commission with a proposal for a new and modified restructuring plan reflecting the sale of the credit portfolio to Blackstone and the sale of Catalunya Banc to BBVA. The Commission approved the new restructuring plan on 17 December 2014, authorizing slight adjustments to the initial targets for the downsizing of the bank in terms of branches and staff, as well as an anticipation of the term of restrictions for acquisitions, aggressive practices, advertising and remunerations.²¹⁴ The Commission was satisfied that the new figures preserved the objectives of the original commitments while factoring properly the integration of Catalunya Banc into BBVA. The Commission also took account of the significant headway recorded by Catalunya Banc over the first 18 months of the original plan.²¹⁵

The Commission was also of the view that neither the participation of the FROB in the sale of the credit portfolio nor the guarantees awarded in the sale process entailed State aid because both aspects resulted from open, competitive and transparent tender processes and were available to all bidders. Moreover, to the Commission, the absence of such involvement by the FROB would have been reflected in a lower price.

BVA The restructuring of BVA was made in the context of its sale to CaixaBank. The plan covered the period from the Commission's clearance decision (28 November 2012) to 31 December 2015.

As a result of the said integration, 80–90 per cent of the network was closed and 40–50 per cent of BVA's employees were made redundant. Considering that the takeover of BVA by CaixaBank resulted in the wiping-out of former share and hybrid capital holders and in the disappearance of BVA as a standalone entity, that the sale process was conducted

²¹¹ See <http://www.frob.es/en/Lists/Contenidos/Attachments/252/20140721FROB_sale_portfolioCX.pdf> accessed 5 September 2016.

²¹² See <http://www.frob.es/en/Lists/Contenidos/Attachments/251/20140721FROBconcludes_sale_CX.pdf> accessed 5 September 2016.

²¹³ In addition to customary representations and warranties, the FROB provided all potential buyers with a number of guarantees should specific contingencies materialize, such as negative adjustments and tax charges arising from the asset transfer to SAREB and 85 per cent of the net amounts resulting from court rulings adverse to Catalunya Banc.

²¹⁴ Commission Decision in Case SA.39402, note 191 above.

²¹⁵ As of 30 June 2014 Catalunya Banc achieved 60–70 per cent of the target for balance sheet reduction, 80–90 per cent of the target for RWA reduction, 60–70 per cent of the target for branches and 80–90 per cent of the personnel goals.

in a competitive manner and the proceeds of the sale revert to the State and that there was a strong deleveraging of the territorial presence of the former BVA, the Commission concluded that the scale and nature of the aid measures concerned were compatible with Article 107(3)(b) TFEU.

BFA/Bankia In view of the systemic nature of BFA/Bankia within the Spanish and European financial sector, for exceptional reasons the Commission accepted the restructuring of the BFA Group on a standalone basis, instead of its sale to a third party.²¹⁶

To that end, BFA/Bankia were divided into a core and a non-core unit. The first encompassed retail, SMEs and public sector banking businesses in its core areas and a limited number of branches in selected main economic centres in other Spanish regions. The legacy unit was used as a run-off vehicle to allow for the disposal or wind-down of the remaining businesses, assets, liabilities and stakes.

Between 2012 and the end of the restructuring period (31 December 2017), the BFA Group is expected to reach a decrease of 40–50 per cent in the balance sheet, 10–20 per cent in the RWAs and 30–40 per cent in branches and staff.²¹⁷

The holders of preference shares and subordinated debt instruments also contributed to the capitalization and restructuring of the BFA Group by means of a buy-back of such securities at their net value, thus implying deep discounts to the nominal value of the instruments. The proceeds of the buy-back were essentially converted into equity stakes in Bankia.²¹⁸

(e) Group 2 Banks: Cajatres, Liberbank, Banco Mare Nostrum and Banco CEISS

(i) Overview

Under the MoU, banks with capital deficits identified in the September 2012 stress test that were unable to meet those shortages without having recourse to State aid were classified in Group 2. For these banks, the FROB would only provide financial support once individual restructuring plans had been approved by the Commission by December 2012.

There were four Spanish credit institutions in this situation: Banco Cajatres, S.A. (Cajatres), Liberbank, S.A. (Liberbank), Banco Mare Nostrum, S.A. (Banco Mare Nostrum) and Banco CEISS, S.A. (Banco CEISS).

Unlike Group 1 banks – that were put under resolution due to their structural constraints – the restructuring of Group 2 institutions was considered viable by the Commission on account of the lighter measures contained in the individual plans.²¹⁹

²¹⁶ Commission Decision SA.35253, note 191 above, para. 67.

²¹⁷ In respect of the terms under which redundancy of employees should be approached in the light of the BFA Group's restructuring plan, see the judgment of the ECJ in joined cases C-352/14 and C-353/14 *Iglesias Gutiérrez* [2015] ECR I-000.

²¹⁸ The restructuring plan also contained typical behavioural commitments banning acquisitions, commercial aggressive practices, aid advertising and dividends and coupons, restricting remuneration, a capital repayment mechanism to ensure that any extra capital not needed for prudential reasons is paid to the shareholders of the BFA Group and appointing a monitoring trustee.

²¹⁹ Commission Decisions of 20 December 2012 in Cases SA.35489 (2012/N) – Spain, Restructuring of Banco Grupo Cajatres, S.A., SA.35490 (2012/N) – Spain, Restructuring of Liberbank, S.A., SA.35488 (2012/N) – Spain, Restructuring of Banco Mare Nostrum, S.A. and

(ii) Events leading to the State intervention

Banks included in the Group 2 category revealed a capital shortfall following the MoU stress test. The main source for their shortcomings was driven by operational challenges stemming from an excessive exposure to the real estate development sector and poor asset quality, but still with a less concerning level of non-performing loans when compared to Group 1 institutions.

(iii) Aid measures

Cajatres Cajatres was set up in 2010 by three savings banks²²⁰ that transferred all their assets and liabilities to the institution, with the exception of assets related to their Obra Benéfico-Social. Cajatres operated with a business profile based on retail banking located in the three regions of incumbency of its founding *cajas*.

The MoU stress test identified a capital shortfall for Cajatres of €779 million under adverse scenario and €188 million in the base case.

Between 2009 and 2012 Cajatres benefitted from government guarantees worth €654 million. In the context of its recapitalization and restructuring, and with a view to meet the required solvency levels, it received a further capital injection of €407 million and transferred to SAREB impaired assets amounting to €0–5 billion.

The capitalization was provided by the FROB in the form of CoCos, with a maturity of five years. The remuneration was set at 8.5 per cent per annum for the first year, with annual step-ups of 25 bp in the second year and 50 bp from the third year onwards. In case of default from Cajatres or should it fail to amortize the CoCos at the end of the restructuring period (31 December 2017), the CoCos would automatically convert into ordinary shares.

The volume of assets to be transferred to SAREB by Group 2 institutions was around €16 billion. Cajatres alone transferred assets worth €0–5 billion.²²¹

Hence, Cajatres received State aid in the form of capital injection and impaired asset measures in the amount of €1.097 million (8.6 per cent of RWA), in addition to the €654 million guarantee.

Liberbank Liberbank was created as a result of the integration between Caja de Ahorros de Asturias, Caja de Ahorros y Monte de Piedad de Extremadura and Caja de Ahorros de Santander y Cantabria.

Liberbank focuses on retail banking in Asturias, Cantabria, Extremadura and Castilla la Mancha where it holds regional market shares ranging between 20 and 40 per cent (leading positions in some cases) and a national share of 2–3 per cent.

The capital needs of Liberbank subsequently to the MoU stress test were covered

SA.34536 (2012/N) – Spain, Restructuring and Recapitalization of Banco CEISS [as amended in Cases SA.36249 (2013/N) – Spain, Restructuring of Banco CEISS through Integration with Unicaja Banco, and SA.36249 (2014/N-3) – Spain, Amendment of the Restructuring of CEISS through Integration with Unicaja Banco].

²²⁰ Caja Badajoz, Caja Circulo de Burgos and Caja Inmaculada de Aragón.

²²¹ The aid amount of the impaired asset measure was estimated by the Commission to be €690 million (the difference between the market price and the transfer price of the assets).

by a €124 million support granted by the FROB through the subscription of CoCos and a transfer of real estate development assets amounting to €5–10 billion to SAREB. Together, the two measures approved by the Commission on December 2012 represented an aid amount of €1,124 million, 4.06 per cent of RWAs. Since 2009, Liberbank also benefitted from State guarantees of €3,875 million.

Banco Mare Nostrum Banco Mare Nostrum is the result of a merger in 2010 between Caja Murcia, Caja Penedès, Caja Granada and Sa Nostra. It operates essentially in the Spanish Mediterranean coast with local market shares up to 12 per cent and a national market share of approximately 3 per cent. Its focus is on retail banking mainly to SMEs and individuals.

The initial merger required the granting of State aid by the FROB under the 2010 recapitalization scheme for an amount of €915 million in the form of preference shares. This amount was converted into equity to reinforce the bank's capital position in response to the new regulatory requirements set forth by Spain in 2011.

Nevertheless, Banco Mare Nostrum also presented a capital shortfall in the results of the MoU stress test. To this end, it received an additional capital injection of €730 million from the FROB through the subscription of 25 per cent-discounted ordinary shares, and transferred to SAREB assets amounting to €10–20 billion.

Altogether, Spain provided Banco Mare Nostrum with capital totalling €1,645 million and an impaired asset measure valued by the Commission in €2,100 million (9.4 per cent of the RWAs), on top of guarantees of €4,424 million.

Banco CEISS Banco CEISS is a commercial bank to which Caja CEISS transferred its banking business in late 2011. It is particularly active in the regions of Castilla y León and Caceres. Caja CEISS was a savings bank created from the merger in 2010 of Caja Duero and Caja España.

Since 2010 Banco CEISS and its predecessor Caja CEISS have received several aid measures consisting of: capital injections by the FROB totalling €1,129 million (4.8 per cent of RWA), out of which €525 million was to support the merger of the founding savings banks and €604 million was in the form of CoCos following the MoU stress test; impaired assets transferred to SAREB concerning a portfolio of €6.5 billion and an aid element of €700 million (3 per cent of RWA); and State guarantees of €3,193 million.

(iv) Commission's assessment and conditions for approval

Cajatres On November 2012 Cajatres and IbercajaBanco, S.A.U. (Ibercaja) agreed to merge Cajatres' business with that of Ibercaja, in consideration of which the shareholders of Cajatres received a stake of up to 20 per cent in the new entity. The merger created the tenth-largest credit institution by asset volume in Spain, positioned as a regional entity focused on retail banking and sustained by a self-funding structure.

As a result of the envisaged restructuring, Cajatres committed to closing 30–40 per cent of its branches, reducing its workforce by 20–30 per cent and divesting its equity portfolio. The combined entity was also to decrease its exposure to the real estate sector through the transfer of a portion of assets to SAREB and a decrease in the relative weight of such sector in the balance sheet.

The mixture of these measures was expected to result in a reduction of 5–10 per cent of the new entity's balance sheet and of 10–20 per cent for RWAs.²²²

Liberbank The restructuring plan approved for Liberbank states that the institution is able to fully repay the aid with its own funds. To accomplish that, Liberbank concentrated on its core business lines in its traditional regions and closed down risky and loss-making businesses.

By the end of the restructuring period (31 December 2017) the balance sheet was to have shrunk by 20–30 per cent, mainly due to a decrease of 10–20 per cent in the loan portfolio and a significant reduction of 50–60 per cent in wholesale funding. The envisaged branch and staff adjustments were to lead to a deleveraging of 5–10 per cent and 0–5 per cent, respectively. Consequently, the volume of RWAs was expected to fall by 5–10 per cent by 2017.

Furthermore, prior to the concession of the aid, Liberbank carried out a subordinated liability management exercise whereby the holders of preference shares and subordinated debt instruments were called to contribute to the recapitalization and restructuring. Retail holders received CoCos and institutional creditors got ordinary shares.²²³

Banco Mare The restructuring plan of Banco Mare Nostrum foresaw the ability of the bank returning to viability and fully repaying the public funds through various measures.

The main measures were the refocusing of the institution's business in its core activities and areas, the hiving-off of the real estate development loans to the SAREB, the closing-down of businesses outside that scope, the adjustment of the loan book to match the available funding through deposits and the divestment of the large majority of subsidiaries and equity participations.

During the restructuring period (due to end on 31 December 2017), Banco Mare Nostrum's balance sheet was expected to have been reduced by 40–50 per cent and its RWAs to have dropped by 50–60 per cent. The geographical reach was also to have decreased significantly with a forecasted shrinkage of 40–50 per cent both in terms of franchise and headcounts.

The holders of preference shares and subordinated debt instruments were also called upon to contribute to the recapitalization and restructuring, by means of a buy-back of their securities at net value, thus implying a deep discount to the nominal value of the instruments. The proceeds of the buy-back were essentially converted into equity.

During the restructuring period, Banco Mare Nostrum became a listed institution.²²⁴

Banco CEISS On 20 December 2012 the Commission approved a restructuring plan for Banco CEISS based on the concept of a standalone restructuring. The plan was amended

²²² The restructuring plan also contained a number of behavioural commitments banning dividends and coupons, restricting remuneration and advertising and appointing a monitoring trustee.

²²³ The restructuring plan also contained behavioural commitments, such as a ban on acquisitions, commercial aggressive practices and aid advertising, remuneration restrictions and the appointment of a monitoring trustee.

²²⁴ The restructuring plan also contained a ban on acquisitions, commercial aggressive practices and aid advertising, restrictions to remuneration and the appointment of a monitoring trustee.

on 13 May 2013, 25 July 2013 and 12 March 2014 to accommodate a takeover of that bank by Unicaja Banco (Unicaja) through a market process.

Unicaja is a credit institution resulting from the combination of several savings banks and is present in 18 Spanish provinces.

Following several amendments to Banco CEISS' restructuring plan, the bank was to concentrate its business activities in its core regions of Castilla y León and Caceres and cut costs leading to a reduction of 30–40 per cent in branches and staff until 31 December 2017. Furthermore, its balance sheet was to be reduced by 20–30 per cent and RWAs by 30–40 per cent.

The updated restructuring plan also included the abandonment of real estate development, large corporates and capital market activities and the divestment of its equity portfolio.

In the version in force at the time of writing, the restructuring plan also reflected an additional guarantee issued by the FROB up to a maximum of €241 million with the aim of covering possible litigation costs associated with former investors of Banco CEISS that had not accepted Unicaja's offer and may have decided to claim before Spanish courts that the securities they held were originally mis-sold. According to this measure, 29 per cent of the litigation costs were shouldered by Banco CEISS and 71 per cent by the FROB up to €241 million.

This litigation measure accrues to another linked to the transfer of assets to SAREB aimed at covering possible errors stemming from the categorization, perimeter or accounting valuation of the assets transferred. The guarantee foresaw possible compensation by the FROB to Banco CEISS for the negative effect of the aforementioned adjustments in excess of €40 million up to a maximum of €200 million. This guarantee also covered potential claims of mis-selling of securities by Banco CEISS resulting from an arbitration mechanism set up by the FROB for retail holders of hybrid and subordinated securities in Banco CEISS who accepted the Unicaja offer.²²⁵

From a behavioural viewpoint, the plan's latest version contained a ban on acquisitions, coupon and dividend payments and advertising of State aid, a prohibition on engaging in aggressive commercial strategies and restrictions on remuneration and the appointment of a monitoring trustee.

Finally, burden sharing was also imposed on holders of preference shares and subordinated debt instruments through the conversion of their securities into equity.

²²⁵ See <<http://www.frob.es/en/Lists/Contenidos/Attachments/258/20131126ingles.pdf>> accessed 5 September 2016.