EUROPEAN COMMISSION

Brussels, 15.04.2009
C(2009)2890 final

Subject: **State Aid N 193/2009 – UK**
Prolongation of the Financial Support Measures to the Banking Industry in the UK

Sir,

I. Procedure

(1) On 27 March 2009 UK notified a prolongation request for its support measures to the banking industry. The original measures, notified on 12 October 2008, were a package of measures designed to ensure the stability of the financial system, which was approved on 13 October[1]. On 18 December 2008, the UK notified several further changes to the Credit Guarantee and Recapitalisation schemes, which were approved on 23 December 2008[2].

II. Description

1. The Original Scheme

(2) In response to the exceptional turbulence in world financial markets, the UK brought forward a package of measures (hereinafter referred to "the scheme") designed to restore stability to the financial system and to remedy a serious disturbance to the economy of the UK. These measures had as their objective restoring confidence and encouraging healthy inter-bank lending, through the provision of liquidity, the recapitalisation of the financial sector and provision of a state guarantee to new debt issuance.

[1] State Aid N 507/2008 "Financial Support Measure to the Banking Industry in the UK"
[2] State Aid N 650/2008 "Modification to the Financial Support Measure to the Banking Industry in the UK"

The Rt Hon David MILIBAND
Secretary of State for Foreign Affairs
Foreign and Commonwealth Office
King Charles Street
London SW1A 2AH
United Kingdom

Commission européenne, B-1049 Bruxelles – Belgique
Europese Commissie, B-1049 Brussel – België
Telefón: 00-32-(0)2-299.11.11.

(3) The proposed measures fell into three parts:

A. Bank Recapitalisation Scheme (hereinafter "The Recap Scheme").
B. Wholesale Funding Guarantee Scheme (hereinafter "The Guarantee Scheme").
C. Short-Term Liquidity Measures.

2. The modification to the Original Scheme

(4) The first modification to the Credit Guarantee scheme affected the following elements:

A. The spectrum of currencies in which the debt subject to guarantee could be issued was broadened.
B. The fee payable on guaranteed liabilities was lowered.
C. The guarantee period could be extended over two more years, for some individual instruments, subject to limits.
D. The requirement that the balance sheet growth of participating institutions be limited to certain thresholds was removed.

(5) The UK also made changes to the Recap Scheme regarding the reporting requirements of fundamentally sound banks.

3. Operation of the Original Scheme

(6) In its notification of 12 October 2008 the UK undertook to present reports every six months on the operation of the Credit Guarantee Scheme. The first report was received by the Commission on 27 March 2009. The report also provides information in support of an extension of the drawdown window for issuance and the modifications included in the Extension Notification.

(7) According to the UK the Guarantee Scheme has been successful in its first stages and participating institutions are continuing to issue into the market. […][*].

(8) […]. More than 50 institutions have applied and received a certificate to obtain the guarantee, but only [5-20] have issued instruments under the Scheme. Regarding the maturity chosen, 40% of the paper issued is due in 1 year or less from issuance, 8% in 2 years and 52% in 3 years. The majority of issuance has been in sterling (around 60%), while USD and EUR accounts for almost 20 % each.

(9) […]

(10) As regards the Recap scheme, the UK has made available £37 billion of new Tier 1 capital. There have been just 2 beneficiaries of the Recap scheme, RBS and the Lloyds banking Group (the merged Lloyds TSB/HBOS group). The UK has subscribed to both ordinary and preference shares. In the case of ordinary shares, the UK has negotiated the maximum permitted discount (10%) to the share price prior to the placing and open offer. This applies also to the conversion of preference shares to ordinary shares. In the case of preference shares, a return of 12% was imposed, along with a "no dividend policy".

[*] Confidential Information

(11) The Treasury acquired approximately £15 billion of ordinary shares in Royal Bank of Scotland (RBS) and subscribed at the same time to £5 billion of preference shares on 1 December 2008. On 19 January, following further losses by RBS, the Treasury agreed to convert its preference shares into ordinary shares. RBS is now majority owned by the state.

(12) The Treasury acquired approximately £13 billion of ordinary shares in Lloyds banking group and subscribed at the same time to £4 billion of preference shares on 16 January 2009. On 7 March, the Treasury agreed that upon implementation of the Asset Protection Scheme for Lloyds, it would convert its preference shares into ordinary shares.

4. Description of the Modifications in the Extended Scheme

(13) The UK is planning to extend the window for issuing new debt that benefits from the government guarantee to 13 October 2009. According to a Bank of England report[3], the uncertainty about the credit risk of individual financial institutions continues to dry up the market of interbank lending and has continued to make access to liquidity difficult for financial institutions across the board. It also reported increased reluctance to lend to banks beyond very short maturities as concerns over the health of banks resurfaced internationally. The report notes that there is little market appetite for banks' unsecured issuance that is longer than a year unless it is guaranteed or paying a high rate of interest. […]. Furthermore, a longer issuance window will allow banks to source their finding from a wider variety of investors, thus giving them the flexibility of using both short and medium term maturities to suit their requirements and market appetite.

(14) The UK considers that the original limit on guaranteed issue of £250 billion remains appropriate. The amount set aside for recapitalization remains £50 billion.

(15) The eligible beneficiaries remain fundamentally sound banks, with eligible (for the Bank of England's Standing Facilities) liabilities of above £500 million. However, a capital injection into a bank that has already accessed the scheme will be subject to an individual notification and approval.[4]

(16) One of the objectives of the UK government's intervention in the financial markets is to underpin lending to the real economy and to help people struggling with mortgage payments to stay in their homes. A Lending Commitment is included in the Extension Notification, aimed at fostering lending to corporations and individuals. Large banks (those banks with sterling eligible liabilities of £25 billion) that issue guaranteed debt after 9 April 2009 will be required to maintain new lending to homeowners and businesses (large, medium and small) at levels set out in their 2009 business plans. Those large banks whose use of the guarantee scheme exceeds their initial allocation ([…] for each institution) will have to increase lending to the real economy. The additional commitment is to be individually negotiated with the participating institutions. All

[3] Bank of England – Quarterly Bulletin, Q1 2009.

[4] Except in the situation where such a bank urgently needs a capital injection to enable it meet the minimum capital requirements to continue operating. This is in line with the Rescue and Restructuring guidelines, which state "An exception may be made in the case of rescue aid in the banking sector, in order to enable the credit institution in question to continue temporarily carrying out its banking business in accordance with the prudential legislation in force"

lending is to be subject to the banks' ordinary course pricing and other terms and their standard credit and acceptance criteria.

(17) All other conditions of the scheme remain unchanged. The UK has not sought to extend the Commission's approval of the Short-Term Liquidity measures in the original scheme, because the window to access the Special Liquidity Scheme, to which the original approval applied, has in any case expired.

III. Position of the UK

(18) The UK submits that the severe stress in the global financial markets and in the UK financial system that necessitated the existing support measures continues to exist and justifies the extension of the notified measures, which have been successful in their early stages. It has provided reports from the Bank of England, as well as the report on the operation of the existing scheme, to justify this.

(19) The UK has committed to seek Commission approval any extension of scheme beyond 13 October 2009.

(20) The UK commits that, in accordance with the commitment given on 13th October 2008 (and having regard to the Commission's communication on the recapitalisation of financial institutions in the current financial crisis) it commits to filing restructuring or viability plans for the banks that have received structural measures within 6 months of their recapitalisation.

(21) The Treasury commits that if it decides after this notification to inject further capital into a Bank which has already been recapitalised under the Recapitalisation Scheme, it will submit an individual notification (except in the case that the recapitalisation is urgently required and is the minimum necessary to remain in accordance with the prudential legislation in force) in respect of that second capitalisation, pursuant to Article 88 EC Treaty.

(22) All other commitments remain unchanged.

IV. Assessment

1. State aid character of the Amended Schemes

(23) As set out in Article 87(1) EC, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

(24) Similar to the original scheme and to the previously approved amendments, the Commission agrees with the position of the UK that the amended scheme for eligible institutions constitutes aid to the institutions concerned pursuant to Article 87 (1) of the Treaty.

2. Compatibility of the Amended Guarantee and Recapitalisation Schemes

a) Applicability of Article 87(3) (b)

(25) The Commission found the original scheme and the previously approved amendments to be compatible with the common market under Article 87(3)(b) EC of the Treaty. The Commission acknowledges that the continuing global financial crisis has led to a credit crunch which constitutes a serious disturbance of the UK economy. In these exceptional circumstances, the extension of the Guarantee and Recapitalisation Schemes can be assessed under article 87 (3) (b), since it aims at solving the serious disturbance and at preventing harmful spill-over effects on the UK financial system and the economy as a whole

b) Compatibility on the basis of Article 87 (3) (b)

(26) The Banking Communication[5] acknowledges that Article 87 (3) (b) may, in the present circumstances, be available as a legal basis for aid measure undertaken to address the current systemic crisis. It lays down conditions which have to be complied with all the aid measures. Paragraph 15 provides that "*all general support measures have to be:*

- *well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy;*
- *proportionate to the challenge faced, not going beyond what is required to attain this effect, and*
- *designed in such a way as to minimize negative spill-over effects on competitors, other sector and other member States"*

Since the scheme is an extension of an existing scheme, it is only necessary to assess whether it continues to be in line with these principles.

(27) As far as the *appropriateness* is concerned, the extension of the Guarantee and Recapitalisation Schemes, similar to the existing scheme, aims at providing liquidity to the banking sector and at promoting lending to business and households. According to the UK Treasury, the severe stress in the global financial markets and in the UK financial system continues to exist and justifies the proposed extension to the schemes. It is a response to the continuing international market failure, where banks have difficulties to get access to the liquidity due to the loss of confidence in the credit market. The position of the UK Treasury is also endorsed by the Bank of England[6]. Since the extension of the schemes is targeted at filling a funding gap in the UK, the aid is therefore well targeted.

(28) As regards *proportionality,* the extended Guarantee and Recapitalisation Schemes, similar to the existing scheme, is proportionate to addressing the continuing funding problems facing the financial institutions, as set out in the Treasury and Bank of England reports on the financial situation. The Commission accepts that medium term liquidity conditions for banks remain challenging. Regarding the duration of the extension itself, the proposed measure will be temporary in nature, lasting for six months from the date of

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[5] Commission Communication on the application of State aid rules to measures taken in relation to financial institution, in the contest of the current global financial crisis (2008/C270/02), p. 10

[6] See http://www.bankofengland.co.uk/publications/quarterlybulletin/f09qbcon.htm

Commission's approval. The Commission accepts, in line with the view of the UK Authorities, that these challenging conditions are likely to continue throughout 2009. Therefore it considers that a six month extension is the minimum necessary in scope and time, which is in line with Commission practice in the aid schemes approved since the start of the crisis, and also with the extension of the Danish Guarantee scheme.[7] .

(29) Regarding the *minimisation of negative spill-over effects on competitors and other Member States,* the Commission observes that the extension of the scheme is a response to the continuing financial difficulties that most Member States continue to experience. Given that the UK was one of the first Members States to implement financial support schemes, it is normal that their scheme is one of the first to be extended. Furthermore, it is strictly limited in time, so that if the conditions justifying its existence change it will expire. The fact that the guarantee fee is priced higher than the ECB recommendations which are applied in most Member States guarantee schemes is another factor limiting the potential negative spill-over on competitors and other Member States.

(30) Furthermore, the requirement that banks seeking a second and subsequent recapitalisation would require an individual notification also minimises the distortive effect of the aid. It ensures that the Commission has the opportunity to assess whether repeat beneficiaries remain fundamentally sound, and look at any repeat capital injection in the context of the restructuring/viability plan that they must supply. In the situation where such a bank needs an urgent capital injection to ensure that it continues to meet the minimum capital level required to continue operations, the Commission considers that such an exception could be permitted on the grounds that it contributes to maintaining financial stability. However, the Commission would regard such a measure as evidence that this bank should be regarded as distressed, and thus subject to stricter requirements, as set out in points 43, 44 and 45 of the Recapitalisation Communication.

(31) As regards the lending commitments, it is appropriate that banks accessing the measures are committed to continuing lending to the real economy. This is in line with the recent Commission decision on the UK's Working Capital Guarantee Scheme[8].

(32) The UK authorities must present, within 6 months (or earlier, if they intend to seek a further prolongation), a report on the operation of the scheme to the Commission. They must also submit, in line with the previous decisions, restructuring plans, or a report showing that the bank remains fundamentally sound, for the banks which have benefitted from any structural measures (such as recapitalisations or a call upon the guarantee), within 6 months of these measures taking effect. Any additional structural measures granted under other schemes (such as the Asset Protection Scheme) will be assessed in the context of this restructuring plan

(33) On the basis of the above, the extension of the Guarantee and Recapitalisation Schemes of the UK can be considered compatible with the Common market and it is approved for six months from the adoption of the Decision.

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[7] See N31a/2009 point 85

[8] This is consistent with previous Commission's decisions taken within art. 87(3)(b) of the Treaty (e.g. Aid N. 11/2009 – UK- Working Capital Guarantee Scheme, para. 67-70)

V. Decision

The Commission concludes that the notified amended schemes are compatible with the Common market and has accordingly decided not to raise objections against it, since it fulfils the conditions to be considered compatible with the EC Treaty.

The Commission's approval will apply until 13 October 2009.

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European Commission
Directorate-General for Competition
State Aid Greffe
Rue de la Loi/Wetstraat, 200
B-1049 Brussels
Fax No: +32-2-296 12 42

Yours faithfully,

For the Commission

Neelie Kroes
Member of the Commission