Committee of European Banking Supervisors

CEBS

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Analysis of the national plans for the stabilisation of markets

I. Introduction

1. CEBS has analysed the current measures taken in the EU by member states to address the current market situation and the possibility of coordinated solutions. The work has focused on three main areas, namely providing: (i) an overview of the national rescue plans, including the conditions, tools, and supervisory involvement, (ii) an assessment of general measures for the stabilisation of the markets, and (iii) potential areas for further work by CEBS. The report is structured in accordance with these three main areas.

2. The basis of the national rescue plans are the principles agreed by the summit of the Euro area countries on 12 October 2008 and endorsed by the European Council[1] (see extracts from the Declaration on a concerted action plan of the Euro area countries in Appendix 1). In addition, the ECOFIN Council on 7 October agreed that all Member States would, for an initial period of at least one year, provide deposit guarantee protection for individuals for an amount of at least 50.000 euros, acknowledging that many Member States determine to raise their minimum to 100.000 euros. At the same time the Council welcomed the intention of the Commission to bring forward an appropriate proposal to promote convergence of deposit guarantee schemes, which was presented on October 14 and is now being examined by the Council and the European Parliament.[2]

3. The US measures have been discussed by CEBS, looking at the possible effects of the US plan to buy troubled assets on the valuations of such assets and, through this channel, on EU banks. However, the US plan has been significantly revised recently, becoming more similar to the EU ones: it is now envisaged that the US government will directly inject capital in banks instead of buying troubled assets. As a result, CEBS decided that looking into the effect of the US plans on EU banks was not relevant anymore.

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[1] See http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/103441.pdf

[2] See http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/103250.pdf and http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1508&format=HTML&aged=0&language=EN&guiLanguage=fr. The Commission has further suggested submitting, by 31 December 2009 at the latest, a report on the harmonisation of the funding mechanisms of deposit-guarantee schemes and the possible introduction of a Community deposit-guarantee scheme, together with any appropriate proposals to the European Parliament and to the Council. See FSC 4177/08.

4. The aim of the report presented is to provide more insight into the different issues, and to determine whether a possible coordinated action of supervisors on a number of relevant issues is the way ahead. As all the measures taken under the rescue plans are still very much under development, it must be stressed that the information contained in this report should not be interpreted as final. This report was prepared during November-December 2008, therefore the information contained in this report reflects the situation at that time.

II. Executive summary

5. Most Member States have introduced some form of state guarantees, a slightly smaller number have undertaken or foreseen recapitalisation and some are foreseeing various restructuring or special winding up measures. In most of the cases the measures were introduced in combination: guarantees and funding support, capital and liquidity support.

6. While being consistent with the framework agreed at EU level, the national responses show a considerable degree of variation.

7. 17 EEA countries have taken measures aimed at facilitating funding, especially by providing guarantees. In most of these jurisdictions, guarantees are provided by the government directly, but in some cases special purpose vehicles have been set up to provide or facilitate guarantees.

8. Capital support or recapitalisation measures have been explicitly designed in 14 EEA countries; 3 countries have already implemented recapitalisation measures in favour of certain banks without developing any specific general rescue plans. In the case of some countries recapitalisation powers and facilities are given to a state-controlled special purpose vehicle; in one country this vehicle and recapitalisation facility is explicitly designed as a winding-up company.

9. One jurisdiction has set up an asset repurchase programmes, by establishing a fund that will only purchase high quality assets.

10. Member States have responded to the ECOFIN recommendations and raised the level of deposit guarantees to at least 50.000 Euro. In one country the coverage is lower, but an Act adopted in October 2008 provides additional unlimited guarantees for deposits and other claims of unsecured creditors, if a bank has joined and participated in a dedicated rescue scheme. However, despite the common step to increase the level of coverage, different levels of protection (in terms of amounts and types of customers covered) and the absence of a maximum limit leave room for further convergence.

11. In general the involvement of supervisors in rescue plans seems to be satisfactory, although it varies from country to country. National authorities have been assigned tasks that appear to be generally in line with their mandates and responsibilities. Therefore, no major issues have been identified in this area. On the other hand, the differences in national plans, especially for bank recapitalisation, are having effects on the level playing field and on regulatory convergence that might need some action on CEBS'

side - although this is a less pressing concern while banks are retrenching and not pressing any resulting competitive advantage.

12. The differences in the main features regarding recapitalisation measures have various reasons: first, government interventions need to be tailored to the specific conditions of the banks to be supported; second, differences may stem from the position and preferences of the investor. CEBS could find ways to **address level playing field and coordination** issues, especially in those areas that are definitely in the remit of supervisory authorities, such as the quality of capital and the definition of adequate capital buffers to withstand shocks.

13. Relying also on the recommendations put forward by the Eurosystem, **the Commission has set out some general principles that define a common framework for recapitalisation measures**, so that level playing field issues are properly addressed. The application of these principles should ensure that riskier instruments (i.e., higher quality capital) are associated with higher yields and greater conditionality.

14. As to the quality of capital, CEBS will consider issuing **guidance that states that only instruments that have the highest quality in terms of loss absorbency and flexibility of payments can be classified as core tier 1**[3] **for regulatory purposes**. At the same time, the permanence criteria could be applied in a way that takes into account the temporary nature of government interventions. CEBS guidance could cover: (i) the anticipated application of the new criteria for eligibility of hybrid instruments as defined in the proposal for CRD changes currently being approved; (ii) the development of criteria on the quality of hybrid capital instruments, as requested by the proposal for CRD changes; (iii) further explanation of the proposed CRD definition of core tier 1; and (iv) appropriate consideration of the nature of emergency recapitalisation.

15. As to the quantity of capital, internationally agreed minimum capital requirements should remain the main reference point for supervisors. However, the current economic environment has made abundantly clear that banks may require a buffer above regulatory minimum requirements if they are to survive the coming downturn. Some common criteria for determining the size of such buffers may be therefore be productive, and C**EBS could accordingly strive at developing a common methodology to define adequate capital buffers**.

[3] It should be noted that no definition of core Tier 1 is provided in EU legislation.

III. Detailed overview of the measures under national rescue plans

16. The analysis presented in this note regarding the national rescue plans and their measures encompasses the three major types of measures envisaged in the Action Plan agreed by the Eurogroup on 12 October 2008 (see appendix 1): (i) government guarantees on bank debt; (ii) capital injections; (iii) liquidity support measures. It also covers the expansion of deposit guarantee protection measures. Taking into account the supervisory perspective and involvement, the main focus of the analysis is on the first two sets of measures, which seem to raise a number of complex issues.

III.1 State guarantees regarding refinancing and funding support measures

17. Many countries have set up government guarantees and funding support measures. A more detailed picture can be obtained from CEBS 2008 188 rev 3. The general aim of the guarantees extended by the governments is very similar: facilitating the refinancing of banks through senior debt issuance. The various plans are only different in terms of government guarantees and funding support committed.

18. Some countries have issued different types of guarantees. Most countries (BE, FI, FR, DE, EL, LU, NL, PT, SE) have issued state guarantees, and in most cases these guarantees have a cap, which varies between 15 and 400 bln. Euro depending of the country. In two countries a cap has not been established (Italy, UK)[4]. One country (ES) has designed an asset repurchase programme for high quality assets.

19. Most of the guarantees cover medium term debt issuance with a maturity up to 5 years issued after the entry into force of the respective measure; these measures are generally valid for one year.

Financing and mechanism of plans

20. For all the different plans, participation in these plans is on a voluntary basis and subject to an application made by the bank. The financing of the measures is very similar as well. Examples of such: some member states issue government bonds (EL, NO), the measure is financed from the State Budget and public debt (PT), or the Ministry of Finance is authorised to enter into a temporary swap arrangement between Treasury bills and financial instruments held by national banks (IT). One country (ES) has designed an asset repurchase programme for high quality assets

[4] In addition to the guarantees described above, in one country (FI) a government guarantee has been granted concerning legal risks of financing Kaupthing Finland branch deposit repayment. One country (IT) has different mechanisms in place. Examples of such mechanisms are: (i) the ministry of finance is authorized to enter into a temporary swap arrangement between Treasury Bills and financial instruments held by banks or liabilities of banks, and (ii) issuance of a state guarantee at market conditions on the operations stipulated by banks in order to obtain the temporary availability of securities eligible for refinancing operation with the Eurosystem.

21. Only two countries (DE, AT) have set up a special administration to foresee the clearing and/or funding of the support provided. One country has set up a clearing house for which the Ministry of Finance may assume (i) limited-term liability for loan losses from the clearing house activities and (ii) liabilities for the clearing house itself, such as particular guarantees or sureties for actual obligation; in addition, the Ministry of Finance is authorised to assume liability as guarantor, or as guarantor and payer, or in the form of guarantees for issues of securities by credit institutions.

Type of commitment

22. In most countries the measures have been adopted through a legal decree. In other countries the measures are based upon a contract (NL), political commitment (SI) or Treasury statements (UK).

23. Some countries have in addition issued political statements guaranteeing new debt instruments (BE) and inter-bank credits to specific institutions (LU).

Type of institutions which may apply

24. In all the countries which have governmental guarantees in place, banks that are licensed to operate in that country are eligible to apply for these measures.

Eligibility criteria

25. To be eligible for government guarantees and funding support all countries require that the bank should have an adequate level of own funds and that the business activities have to be designed with a view to sustainability. The guarantees are subject to a fee. In most countries the fee will be at commercial rates. In one country (DE) it has been specified in the by-law that the fee has to reflect the risk of the supported institution and to ensure a reasonable compensation.

26. In most countries the measure is in force until the end of 2009. One member state (FR) has not indicated a definite date.

27. Regarding the provision of credit to the economy as well as corporate governance most countries have introduced conditions. The support is subject to compliance by the institutions with a code of conduct, which implies restrictions on manager compensation schemes, notably on severance payments and stock-options. Some supervisors will monitor the impact of remuneration policies on risk profiles of banks. Some of the countries have also mentioned that the government has the right to agree with the appointment of new independent non-executive directors.

III.2 Capital support / recapitalisation measures

28. The different capitalisation plans vary from country to country both in terms of capital committed and of conditions to be met in order to qualify for the support.

29. Publicly run funds or companies may distribute capital subject to conditions (see below) and/or capital charges. The charges are either in line with market conditions (AT, FI), set upfront (FR: base rate + 400bp) or decided on a case-by-case basis depending on the entities situation (DE, SI).

30. Capital can be provided in the form of subscription of ordinary and preference shares or equivalent instruments, participation in a rights issue, or covered bonds (AT, BE, IC, EL, IT, LU, NL, PT, SE, ES, UK).

Limits to capital support

31. The table illustrates that there are differences as regards the introduction of limits to the support programs. While some member states have tended to set limits on the amounts they are willing to commit (e.g., DE €80bn, UK £50bn and FR €40bn), other member states have not provided any limit (e.g. BE, IC, LU, SI). Where limits have been set, the amounts vary from member to member.

Availability

32. In almost all cases, the capital support schemes are available to all nationally incorporated credit institutions and, in some cases, other financial institutions.

Conditionality

33. Conditions to be fulfilled by the institutions making use of the capital support vary widely. The conditions can broadly be classified in the following categories:

    - Maintenance of lending to the economy, in particular SME and retail customers (AT, DE, FR, IT, PT, UK);
    - Maintenance of employment level (AT);
    - governance changes including board participation/influence (BE, EL, NL, UK);
    - changes in the remuneration policy (AT,BE, FR, EL, IT, NL, PT, SE, UK);
    - assessment of dividend policy (AT, IT, PT, UK).

34. Some countries (AT, BE, LU and NL) explicitly require that any entity applying for support has an adequate level of own funds prior to receiving the support.

35. The entities receiving the support are in some cases required to change their capital structure and/or achieve a target capital ratio. The detailed plans differ across members and they refer to different capital measures: Tier 1 support (FI, FR, UK), adequate level of core capital (DE), combination of Tier 1 and either Core Tier 1 (BE) or stressed Core Tier 1 (UK), maintenance and support of own funds level (LU). In some jurisdictions, new target ratios (above minimum regulatory requirements) have been established, forcing

healthy institutions to either accept public capital injections or raise capital privately to meet the new requirement. Other jurisdictions that have designed recapitalization plans have not established any additional capital target ratios, and it is up for the institutions to decide whether – and how- to raise additional capital.

Timing

36. Some members have set a strict time limit to applications to their capital support scheme which is some time in Q4 2009. Moreover, all countries are committed to ending the schemes as soon as possible when economic conditions allow.

III.3 Liquidity support measures

37. With respect to liquidity, a few countries have taken liquidity measures. Some of these countries have done this as a stand alone measure, while other countries have provided them together with government guarantees, funding and capital support.

38. The European Central Bank has provided several liquidity measures[5]. In addition, national authorities have taken measures at a national level as well. The mechanics of the liquidity measures are quite different in every member state.

III.4 Expansion of deposit guarantee protection measures

39. With respect to the protection of deposits, in some instances authorities went beyond the ECOFIN conclusions of increasing deposit protection coverage up to 50 000 Euro, and have increased the coverage of the deposit guarantee schemes up to 100 000 Euro. In addition to the increase of the deposit guarantee scheme coverage some countries went for the full guarantee of retail deposits, and in some instances also full guarantee of deposits of certain categories of corporates. One country has guaranteed to the full extent all domestic deposits and another country has guaranteed deposits in full and has extended the coverage to all deposits, creditors and all senior debt (unsecured, unsubordinated) of banks participating in the dedicated rescue scheme. Some jurisdictions have not changed the limits of their deposit guarantee scheme as they are already in compliance or above increased minimums.

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[5] On 29 September the ECB conducted a special term refinancing operation, and in a coordinated action expanded the capacity to provide US dollar liquidity. On 7 October, the ECB increased from EUR 25 billion to EUR 50 billion its allotment amount in the six month longer term refinancing operation. On 8 October the ECB reduced the minimum rate of the main refinancing operations to 3.75%, and also reduced the marginal lending facility and the interest rate on deposit facility to 4.75% and 2.75% respectively. It also decided to reduce the corridor of standing facilities to 100 basis points. On 15 October, the ECB decided to expand the collateral framework and enhance provision of liquidity and provided Swiss francs liquidity in cooperation with SNB. On 16 October the ECB provided liquidity support to MNB. On 17 October the ECB expanded the collateral framework again. On 23 October the ECB made amendments in risk control measures and minimum reserve requirements. On 27 October the ECB and the Danish central bank established a swap line.

40. Moreover, one country has also reduced the maximum payout period for DGSC (PT).

IV. Assessment of rescue measures: is there a need for coordinated solutions?

41. The rescue measures reviewed in the previous section have proved very effective in breaking the downward spiral that was developing in EU financial markets. There is general agreement that the Eurogroup's Action Plan has been successful in tackling the crisis so far. The aim of this section is not to discuss the effectiveness of the plans or to assess the measures adopted in individual member states, but rather to identify areas where a greater coordination of national solutions might be warranted.

42. The focus of the analysis is on two main areas: (i) the involvement of supervisory authorities in national rescue plans; and (ii) possible level playing field and harmonization issues stemming out of differences in national solutions.

43. In general the involvement of supervisors in rescue plans seems to be satisfactory, although it varies from country to country. The tasks assigned to supervisory authorities have been generally in line with their mandates and responsibilities. Therefore no major issues have been identified in this area. On the other hand, the differences in national plans, especially for bank recapitalisation, are having adverse effects.

IV.1 Supervisory involvement in national rescue plans

44. Supervisory authorities have been extensively involved by national governments in the design and implementation of national rescue plans. Typically, their role has been twofold.

45. First, they contributed with **technical advice** to the policy decisions shaping the rescue plans. Supervisors contributed to identify the funding and capital needs of banks and to select the most appropriate tools to address them. They were generally involved also in the drafting of relevant national legislation and administrative rules.

46. Second, supervisors were assigned important tasks in the **implementation of the plans**, in particular in the assessment of banks' eligibility. This assessment took various forms, which are present to a varying degree in the different national contexts. In general, supervisors were asked to assess the *solvency of the banks* asking for support or included in the scheme and the *sustainability of their strategy*.

47. Supervisors contributed also to the determination of the *instruments to be used and the economic conditions to be applied*: pricing, sometimes linked to the underlying risk as reflected in CDS spreads; quantity of the support to be granted, for instance to achieve a certain target in terms of core tier 1 or tier 1 ratios; quality of assets, in direct purchase programs and in cases in which the granting of the guarantee has been assisted by collateral; incentives and conditions for reimbursement of the funds (step ups, call options, etc.).

48. In most cases government support has been associated with a number of _requirements_. For instance, banks have been asked to maintain or even increase lending to the economy, sometimes with specific targets in terms of credit to certain sectors - typically, households and small and medium enterprises; remuneration of top management and dividend policies have sometimes been subject to constraints. Remuneration policies have sometimes been addressed but only with reference to the banks subject to government support: in several member states supervisors are considering more general guidance to be applied across the board.

49. Requirements have been imposed also by the European Commission with the aim of avoiding banks benefiting from public support unfairly exploiting this advantage through aggressive commercial policies. As a result, national legislation often includes identically drafted provisions requiring no reference to the government support in the commercial contacts with customers and preventing excessive growth of balance sheet totals of beneficiary banks. So far there has been no indication that banks with public support are pressing such commercial advantage to acquire market share in lending, and level playing-field concerns have largely been confined to deposit-taking and funding markets. Supervisors have been asked to contribute to define these conditions and to help with checking compliance on an on-going basis.

50. Supervisors have been attributed a role also on *exit strategies*. Where the capital instruments used are redeemable or include a call option for the issuer, supervisory scrutiny is always envisaged to ensure that the exit of the government from the bank's capital is compatible with the maintenance of adequate capital levels.

51. The exchange of experiences on the involvement of supervisors in the definition and implementation of the rescue plans has *not highlighted any major issue to be addressed*. Supervisors are broadly satisfied with their degree of involvement. No concerns were raised with reference to the possible attribution of improper tasks to supervisors by national legislations or governments. Extensive reliance on supervisors to define the technical features of rescue plans has also ensured that supervisory responsibilities were not overruled by other bodies. Although the degree of involvement may vary across countries, there does not seem to be a need for further convergence in this area. Accordingly, no specific task for CEBS can be envisaged in this area.

IV.2 Differences in national rescue plans

52. While the rescue plans follow the common principles agreed in the concerted action plan agreed on 13 October, differences in the concrete design and practical implementation at the national level are substantial.

53. This report does not directly address differences in **deposit guarantee schemes**. Such differences are well known and have been the object of extensive work by the European Commission. A legislative initiative aimed at enhancing the harmonisation in the level of coverage, addressing the shortcomings of co-insurance clauses and speeding up payments to insured depositors is in the final phases of the approval process.

54. Measures which are directly intended to provide liquidity to the banking system, such as **purchases of good quality bank assets and asset swaps**, have posed no major issue in their implementation. Only a limited number of countries are making use of this category of measures. *Choice of instruments* and *pricing*[6] are relatively simple. The asset purchases plans are generally targeted to assets listed in regulated markets and bought at market prices following standard bidding procedures. Also asset swaps are rather straightforward, as banks are provided with securities that are eligible for monetary policy operations against collateral of lower quality, against a fee. Both the choice of the instruments and the conditions applied have been determined along lines broadly consistent with the recommendations issued by the Eurosystem in the field of government guarantees on bank debt.

55. The **issuance of government guarantees** on bank debt generated serious competitive concerns before the Eurogroup's Action Plan (Action Plan). Countries where these guarantees had been put in place were able to attract funding from other jurisdictions, thus aggravating the liquidity situation of banks that couldn't benefit from such measures. The lack of ex ante coordination was a serious source of concern, as the move of some member states may have left little room for others but to follow suit. However, the issue has been addressed by the Action Plan, which stated that "Governments would make available for an interim period and on appropriate commercial terms, directly or indirectly, a Government guarantee, insurance or other similar arrangements of the new medium term (up to 5 years) bank senior debt issuance".

56. Differences in the pricing of the guarantees and in the definition of the eligible liabilities were not directly addressed and this represented a source of concern from the level playing field point of view. However, the Eurosystem issued recommendations that brought about substantial convergence in this area. According to the recommendations no liabilities with a maturity shorter than three months can be guaranteed - retail deposits are under different insurance schemes; guarantees on interbank deposits should not be provided; instruments with maturity below one year should be charged a common flat fee, while a variable fee geared to CDS spreads is applied for those beyond one year – with specific guidance for instruments issued by banks for which reliable CDS data are not available. Non-euro countries followed a similar approach. For example, the pricing for the UK government guarantee is a flat fee plus a spread based on the bank's average CDS spread over recent years.

57. On the other hand, some issues arise with reference to the design and implementation of **recapitalisation measures**. The following areas of concern can be singled out:

    - ***Choice of instruments***: *preferred shares* or similar instruments have been used in a number of jurisdictions: they rank behind bank debt and thus do not reduce the ability of banks to borrow from other sources; however, they dilute shareholder earnings and can therefore

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[6] Market prices for collateralized (good quality assets) financing operations.

hamper efforts to raise capital from other sources. As an alternative, less immediately dilutive[7] instruments, such as convertible notes or other hybrid instruments without voting rights, have been selected. As a consequence, the effects of government intervention on share prices have differed according to the instrument used. Convertibility features are also different across countries, ranging from mandatory convertibles to trigger ratios linked to the position with respect to minimum capital requirements, to a possibility for the issuer to convert into ordinary shares at certain dates.

- ***Pricing***: the differences in the main features of the instruments make it difficult to compare their pricing. However, the wide range of conditions suggest that in some cases banks have been able to access the government facilities only at a costly rate, while in other instances the instruments have been more favourably priced. In some cases, a call option for the issuer is included with the possibility to repay at 100% of the nominal value, while in others a fixed premium (e.g. 150% of the issue price) or the maximum between the issue price and the market price are referred to.

- ***Quality of capital***: under present market conditions, lower quality capital is not perceived as a sufficient safeguard. In most cases the features of the instruments have been designed so as to be included in tier 1 or core tier 1 capital. This has sometimes been done through changes in the eligibility criteria and in ways that increase divergence in the definition of capital within the EU. For instance, in some countries capital instruments have been classified under the current national rules, while in other countries some provisions of the proposals from the CRD review have been already referred to. In other member states, the law itself or a statement of the supervisory authority recognise as core capital financial instruments that would not qualify as such under either the current or the future definition.

- ***Determination of the amounts***: the amount of capital injected by national governments has in some cases brought the core tier 1 and tier 1 ratios of the beneficiary banks to very high levels. It is not unusual now to witness tier 1 ratios two or three times higher than the regulatory minimum. These capital targets defined by the authorities differ considerably across the EU.

- ***Criteria for selecting banks***: stigma issues may induce banks not to resort to the government facilities until it is too late. Governments tried to address this issue through authoritative measures, moral suasion or coordination mechanisms agreed with the industry. For instance, in the UK the FSA conducted tailored stress tests to determine the amounts of core tier 1 capital needed, thus bringing banks towards a broadly similar risk of insolvency; in France more emphasis has been put on the objective of ensuring sustained lending

[7] Conversion options dilute the equity base only when exercised, while participation certificates dilute shareholders' earnings but not their voting rights.

to the economy and all banks are being recapitalised *pro quota*, i.e. bringing their tier 1 capital ratio up by the same percentage.

58. These differences give rise to a number of risks that could be categorized in two broad groups:

    i. Level playing field issues:

    a. Although capital ratios are not the only factor in determining the competitive position of an institution, there are potential competitive advantages for banks that have benefited from capital injections from their national governments. Even though this potential depends on the conditions attached to the public injection of capital (price, restrictions on dividends, etc.), banks that have received these injections could be in a more favourable position to obtain market funding, grant loans and develop future plans, even when the general crisis situation is resolved. Banks are still repairing balance sheets, and aggressive competition for market share does not yet appear a pressing concern.

    b. The recapitalisation schemes developed by Member States may trigger a competition to raise capital to the highest levels: market analysts and rating agencies consider capital ratios well above the internationally agreed minimum to be insufficient as "the bar has now been raised"; banks unable to raise capital on the market and unwilling to call for official support may be induced to prop up capital ratios by tightening credit, thus contributing to a negative spiral with cyclical conditions (procyclicality).

    ii. Harmonization of capital standards:

    a. The capital targets pursued by some authorities are sometimes perceived as new regulatory floors, conveying the impression that capital requirements vary across the EU.

    b. This step back in the degree of harmonization is made more evident by the increasing importance attributed to variously defined "core tier 1" instruments, which has made the existing regulatory categories of capital instruments appear obsolete.

59. These competitive effects called for action from the European Commission, which under the Treaty provisions on State aid published a Communication on the application of State aid rules to the support measures for financial institutions.[8] The Communication covers general features of the recapitalisation plans and aims at limiting aid to the minimum necessary and at safeguarding against undue distortions of competition. Also the Eurosystem has developed recommendations on the pricing condition of

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[8] European Commission, "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", Communication of 5 December 2008

recapitalisation measures which define a price corridor for the rate of return of the capital injected by governments.

60. Supervisors need to build on this framework to collectively avoid that key instruments in their toolbox, such as the definition of capital, the level of minimum capital requirements and target capital buffers, are applied inconsistently,

61. CEBS intends to address the level playing field and coordination issues highlighted above, especially in those areas that are definitely in the remit of supervisory authorities, such as the definition of capital and the definition of appropriate capital buffers to withstand possible shocks.

V. Potential areas for further work by CEBS

62. There are a number of reasons why the main features of recapitalisation measures may differ.

63. The main reason is that, as recognized in the Eurogroup's Action Plan, recapitalisation plans can fulfil two different goals: (i) providing financial institutions with additional resources so as to continue to ensure a proper financing of the economy, and (ii) allowing for an efficient recovery of distressed banks. As recognised in the Communication of the European Commission, this distinction will be reflected in the amount and quality of capital that needs to be injected in individual institutions, in the risk for the investor and the corresponding return, and in the kind of conditionality that is applied.

64. In addition to the different goals described above, the differences in the main features of recapitalisation measures may stem from the debt levels and budgetary constraints of national governments and from the political willingness to put taxpayers' money at risk or to get involved in the running of banks.

65. Even though recapitalisation plans need to differ, there should be consistency between quality of capital, conditionality and pricing, in order to avoid competitive distortions, and there should be a common prudential criterion for the capital levels to be achieved, in order to preserve effective harmonization of rules. Therefore there may be some important areas within the remit of CEBS where further work could be done in order to promote convergence.

V.1 Choice of the instrument, pricing and requirements

66. In principle, one would expect that when a capital injection aims at restoring confidence in the bank ability to withstand adverse market developments instruments with high loss absorbency features (core tier 1) should be used, while lower quality (tier 2) instruments could be sufficient (or even preferable, to minimize government involvement) if alleviating constraints to lending is the main concern. In practice, it is difficult to apply a clear-cut distinction, because the two motives could both be present, to a different extent, in a specific rescue measure. In fact, in several cases lending to the economy was supported by tier one capital injections.

67. However, it seems reasonable to assume that the higher the risk for the investor – which of course is closely related to the quality of the capital instrument required for the intervention – the higher should be the required rate of return, and the more extensive should be the conditionality of the capital injection. A level playing field could therefore be established by defining criteria for consistency across these three dimensions: risk, price and conditionality.

68. On the relationship between the quality of capital instruments and pricing the Communication of the Commission provides a useful reference point. Building upon the recommendations of the Eurosystem on the pricing conditions of recapitalisation measures, the Communication distinguishes between temporary recapitalisations of fundamentally sound banks, aimed at supporting lending to the economy, and operations involving distressed institutions It refers to a "price corridor" defined by a lower bound corresponding to the return on subordinated debt and an upper bound corresponding to ordinary shares; intermediate, hybrid, instruments would fall in between.

69. At one end of the spectrum we would have instruments of the highest quality ensuring the maximum loss absorbency and flexibility of payments. Such instruments would carry the maximum risk for the government and should therefore be linked to a rather high required rate of return, to ensure a proper remuneration of taxpayers' money. With reference to the corridor recommended by the Eurosystem, the remuneration should be near the upper bound, which on average for euro area countries is at around 9.3%[9]. Of course, the benchmark should vary according to differences in government bond yields and could be increased if the government intends to apply conditions to managers and shareholders. Such instruments could also carry the greatest conditionality so as to ensure a proper upside for taxpayers and reflect the higher risk of losses. For instance, the government may require, where needed, that a restructuring plan is implemented, or limits could be imposed on dividend policies and on management remuneration.

70. At the other end of the spectrum would be lower quality capital instruments – e.g., hybrid capital instruments close to subordinated debt – with a fixed remuneration, not redeemable before a certain period and redeemable at par. The lower risk of these instruments would position them close to the lowest bound of the corridor (i.e., at around 7%)[10]. Accordingly, these

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[9] This benchmark should apply to preferred shares (ordinary shares have no required rate of return). The benchmark is obtained by adding up the risk free rate (i.e., a government bond yield), a historic equity risk premium of 500 basis points and an add on of 100 basis points to cover for operational costs and to provide the banks with adequate incentives (i.e. discouraging excessive demand and favouring an early exit of the government from the bank's capital).

[10] It is calculated by adding to the risk-free yield over a 5 year horizon the bank specific CDS spread on the same maturity (if the bank has no CDS or the prices are not reliable enough, the appropriate spread could be calculated with reference to the CDS spreads for banks in the same rating class), plus an add on to cover for the discrepancies with the observed average yield on subordinated debt.

instruments should also carry the lowest degree of conditionality. Any government intervention would be driven by the concern that capital constraints might lead to a tightening in lending standards and to a credit crunch. Therefore, also these lower quality instruments could carry some conditions, for instance in terms of requirements to ensure proper lending to the economy or to specific classes of borrowers that are most likely to suffer from credit rationing.

71. Application of the criteria defined by the European Commission should ensure that the consistency between risk, price and conditionality is achieved across the board. Therefore, high quality instruments absorbing losses *pari passu* with ordinary shares, convertible in ordinary shares when the capital ratio falls below a certain threshold and ensuring flexibility of payments should ensure a rate of return close to the upper bound defined by the Eurosystem and could still require the fulfilment of some conditions (e.g., some degree of restraint in dividend policies). Going down the ladder we should find hybrid instruments and preferred shares that under the proposals for the CRD review would fall into the different buckets: from the higher to the lower quality, instruments eligible in tier 1 up to a limit of 50%, those eligible up to a limit of 35% or 15%, instruments eligible in upper and lower tier 2.

V.2 Quality of capital

72. The criteria to ensure an appropriate matching between risk, price and conditionality can contribute to a level playing field only if a common definition of capital applies throughout the EU. As we have seen in previous sections, at present this is not the case.

73. With a view to the proposed CRD amendments to be adopted in spring 2009, CEBS will consider issuing guidance to state that only instruments that have the highest quality in terms of loss absorbency and flexibility of payments can be classified as core tier 1 for regulatory purposes (and priced accordingly). This guidance could cover: (i) the anticipated application of the new criteria for eligibility of hybrid instruments as defined in the proposal for CRD changes currently being approved; (ii) the development of criteria on the quality of hybrid capital instruments, as requested by the proposal for CRD changes; (iii) further explanation of the proposed CRD definition of core tier 1, (iv) appropriate consideration of the nature of emergency recapitalisation measures and the different nature of institutions that are not joint stock companies.

74. The application of the new limits to the eligibility of hybrid instruments would provide for a more transparent setting, allowing comparison of the conditions of different plans. It would also avoid that some banks would be facing tighter limits on the issuance of hybrid instruments, and being therefore less able to access to the recapitalisation plans with cheaper and less conditional instruments.

75. However, there are some areas in which it might be desirable to recognise the peculiar nature of the current emergency recapitalisation plans, allowing some departure from the standard supervisory rules. Capital instruments subscribed by governments often include redemption clauses or call options,

so as to allow for exit from banks’ capital once market conditions have stabilised. The temporary nature of government interventions could justify the classification of these instruments amongst those of the highest quality, even though the permanence criterion would not be met, provided some additional conditions are met. For instance, supervisors should be endowed with tools to prevent buy backs of the instruments if they would lead to an excessive weakening of the capital position of the bank.

V.3 Amounts of capital

76. Capital injections may have conveyed the impression that the internationally agreed minimum capital requirements have been replaced by higher, country specific requirements, mostly focused on core tier 1 or tier 1 ratios. Supervisors should send a clear message that minimum requirements are still the main reference point for their action.

77. At the same time, capital buffers might need to be reviewed in light of a significant upward shift in risk, stemming from the breakdown of markets for structured financial instruments, adverse developments in financial markets, tense conditions in the markets for bank funding and an overall deterioration in the macroeconomic outlook. CEBS intends to define a common methodology to define adequate capital buffers.

78. While a methodology to assess the adequacy of capital buffers throughout the cycle is being developed by CEBS, an ad hoc approach could be used to define capital needs at this particular juncture. More analysis is needed to develop a reliable methodology. One possible way forward would be to determine the capital buffer as the sum of two components. The first could be equal for all banks in a member state, and might be defined by running in all countries the same system-wide macro-stress test, simulating rather harsh recessionary scenarios. The second component could be institution specific and be determined as a result of tailored stress tests. As a result, all banks would have a common buffer to shelter the upcoming recession, while those showing additional fragility should maintain additional capital buffers. Of course, those banks that already operate with sufficient buffers would not need to tap government-sponsored recapitalisation plans. But as this would be the result of a common methodology, they should not be under pressure from market analysts and rating agencies to raise additional capital. The whole process should operate in a transparent fashion and would facilitate communication with private investors.

Appendix 1

Extracts from the Declaration on a concerted action plan of the Euro area countries of 12 October 2008

Agreed principles for action

a. ensuring appropriate liquidity conditions for financial institutions;

b. facilitating the funding of banks, which is currently constrained;

c. providing financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy;

d. allowing for an efficient recapitalisation of distressed banks;

e. ensuring sufficient flexibility in the implementation of accounting rules given current exceptional market circumstances ;

f. enhancing cooperation procedures among European countries.[11]

Ensuring appropriate liquidity conditions for financial institutions.

6) We welcome the recent decision by the European Central Bank and other Central Banks in the world to cut their interest rates.

7) We also welcome the decisions by the European Central Bank to improve the conditions for the refinancing of banks and to provide more longer-term funding. We look forward to Central Banks considering all ways and means to react flexibly to the current market environment. We welcome the intention of the ECB and the Eurosystem to react flexibly to the current market environment, in particular in considering to improving further its collateral framework with regard to the eligibility of commercial paper.

Facilitating the funding of banks, which is currently constrained.

8) With a view to complementing the actions taken by the European Central Bank in the interbank money market, the governments of the Euro area are ready to take proper action in a concerted and coordinated manner to improve market functioning over longer term maturities. The objective of such initiatives should be to address funding problems of liquidity constrained solvent banks.

We welcome the initiatives put forward in some Member States to facilitate medium term funding of banks notably through purchase of high quality assets or through swaps of government securities.

[11] See http://register.consilium.europa.eu/pdf/en/08/st14/st14239.en08.pdf

The worsening of financial conditions in the last four weeks requires additional coordinated actions.

To this aim, Governments would make available for an interim period and on appropriate commercial terms, directly or indirectly, a Government guarantee, insurance, or other similar arrangements for new medium term (up to 5 years) bank senior debt issuance. Depending on domestic market conditions in each country, actions could be targeted at some specific and relevant types of debt issuance.

In all cases, these actions will be designed in order to avoid any distortion in the level playing field and possible abuse at the expense of non beneficiaries of these arrangements. As a consequence:

− the price of those instruments will reflect at least their true value with respect to normal market conditions;

− all the financial institutions incorporated and operating in our countries and subsidiaries of foreign institutions with substantial operations will be eligible, provided they meet the regulatory capital requirements and other non discriminatory objective criteria;

− Governments may impose conditions on the beneficiaries of these arrangements, including conditions to ensure an adequate support to real economy;

− the scheme will be limited in amount, temporary and will be applied under close scrutiny of financial authorities, until December 31 2009.

While acting quickly as required by circumstances, we will coordinate in providing these guarantees as significant differences in national implementation could have a counter-productive effect, creating distortions in the global banking markets. We will also work in cooperation with the

European Central Bank so as to ensure consistency in the management of liquidity by the Eurosystem and compatibility with the operational framework of the Eurosystem.

Providing financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy.

9) So as to allow financial institutions to continue to ensure the proper financing of the Eurozone economy, each Member State will make available to financial institutions Tier 1 capital, e.g. by acquiring preferred shares or other instruments including non dilutive ones. Price conditions shall take into account the market situation of each institution involved. Governments commit themselves to provide capital when needed in appropriate volume while favouring by all available means the raising of private capital. Financial institutions should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non beneficiaries.

10) Given the exceptional market circumstances, we urge national supervisors, in accordance with the spirit of Basel 2 rules, to implement prudential rules also with a view to stabilising the financial system.

Allowing for an efficient recapitalisation of distressed banks.

11) Governments remain committed to support the financial system and therefore to avoid the failure of relevant financial institutions, through appropriate means including recapitalization. In doing so, we will be watchful regarding the interests of taxpayers and ensure that existing shareholders and management bear the due consequences of the intervention. Emergency recapitalisation of a given institution shall be followed by an appropriate restructuring plan.

Ensuring sufficient flexibility in the implementation of accounting rules given current exceptional market circumstances.

12) We welcome the recent initiatives of the Commission regarding conclusions of the 7th October Ecofin regarding the classification of financial instruments by banks between their trading and banking books, notably to ensure a level playing field with our competitors.

Under the current exceptional circumstances, financial and non-financial institutions should be allowed as necessary to value their assets consistently with risk of default assumptions rather than immediate market value which, in illiquid markets, may no longer be appropriate.

We ask the competent authorities to take the next steps within the coming days.