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Does the support of an IPS constitute state aid?

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- **Shareholders in Norddeutsche Landesbank (NordLB) and the German Savings Banks Association (DSGV) have submitted a EUR 3.6 bn restructuring proposal for NordLB to the European authorities for approval.**
- **It seems possible that the European Commission will interpret the plan as state aid, given that it draws solely on public resources.**
- **If it is judged not compatible with the rules of the internal market, the plan could be rejected, opening the way to NordLB being sold (possibly through a privatisation) or put in resolution.**
- **We believe that the criteria for analysing the support provided to NordLB should not be limited just to the nature of the resources used (which are certainly public) but should also include the nature of the contributors (its shareholders and the mutual protection fund S-Group).**
- **Indeed, European legislation (CRR, BRRD) considers the mutual support structures provided by Institutional Protection Schemes (IPS) as recovery measures that are private in nature.**
- **Ultimately, the support plan for NordLB offers, for the first time, an opportunity to question the coherence of European state aid rules and the existence of IPS with state-owned members.**

State-owned Norddeutsche Landesbank (NordLB) is Germany's fourth largest regional bank (see chart). Like its peers, it operates as a commercial and investment bank whilst also playing the role of central institution for the savings banks within its scope of competence. Faced with significant

Halved in ten years

Consolidated balance sheets of Landesbanken at 31 December, EUR bn

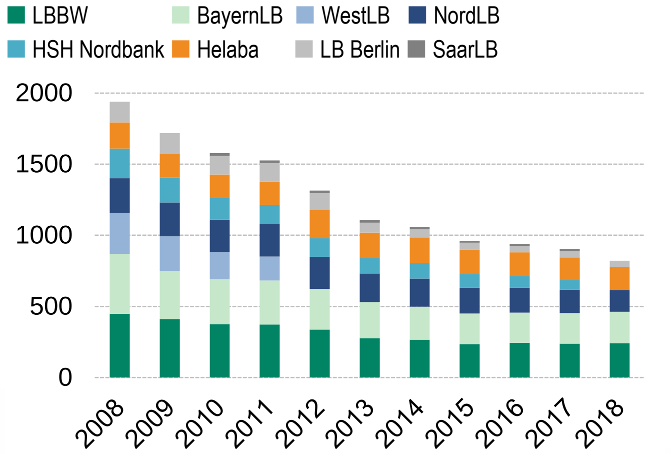

Chart Source: SNL, Bankscope

financial difficulties (resulting mainly from its financing of the shipping sector), NordLB posted a net loss of EUR 2.354 bn in 2018. Its CET1 common equity ratio tumbled from 12.4% at end-2017 to 6.82% at end-2018, well below the minimum requirement[1].

As early as the beginning of 2018, NordLB was considering various options to boost its solvency, including a joint offer by US private equity funds or a merger with Landesbank Helaba. Its shareholders (the state of Lower Saxony with 59.13%, the state of Saxony-Anhalt with 5.57%, Savings Bank Associations of Lower Saxony (26.36%), Saxony-Anhalt (5.28%) and Mecklenburg-Western Pomerania (3.66%))

[1]At 1 March 2019, the SREP capital requirement for NordLB was 10.57%.

finally announced in early February that they would favour a joint solution with the DSGV, the association representing the interests of the German savings bank financial group (S-Group[2]). At the time of publication of its annual results on 4 April, the bank set out the shape of the restructuring plan to be submitted to the European authorities.

The plan

The support plan has a total value of EUR 3.635 bn. This would take the form of a EUR 2.835 bn capital injection, which would represent a virtual doubling of NordLB's core equity[3]. Nearly EUR 1.5 bn would be contributed by the state of Lower Saxony, EUR 200 million by the state of Saxony-Anhalt and EUR 1.135 bn by the S-Group. The bank would also benefit from guarantees from the state of Lower Saxony. These would allow NordLB to make a saving of around EUR 800 million in its capital.

With this support, NordLB intends to reach a common equity ratio of 14% by the end of 2019. The plan also covers a refocusing of NordLB on some of its activities (continuation of financing of SMEs and large customers, withdrawal from ship financing, scaling back of aircraft financing and retail banking) and a reduction in the size of its balance sheet (to EUR 95 bn from EUR 154 bn at end-2018). The bank estimates that the costs associated with its restructuring (notably the sale of portfolios of non-performing loans[4]) will prevent it from returning to profit before 2020.

In the light of Article 107 of the European treaty and previous decisions by the Commission, it is possible that this support will be interpreted as state aid.

The support of a public shareholder constitutes state aid

Article 107, paragraph 1 of the Treaty on the Functioning of the European Union (TFEU)[5] stipulates that *"save as otherwise provided in the Treaties, 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 internal market."*

In the past, any recapitalisation proposals submitted by shareholders of Landesbanken have been treated as state aid, as they used state resources. German regional banks are, de facto, state-owned banks. They belong to the states (Länder) and the savings banks (Sparkassen), whose supervisory authorities (Träger) are public bodies held by municipalities or counties. Supporting a credit institution with public resources, even in the role of shareholder, represents, in principle, state aid under the TFEU.

Although this support would have provided the Landesbanken with capital to which they would not have had access via the market, the European Commission approved them on the basis of Article 107, paragraph 3, point b) of the TFEU. This allows state aid destined "to remedy a serious disturbance in the economy of a Member State" to be considered as compatible with the internal market. The Commission believes that "persisting stress in financial markets" and the risk of "major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution" justify the prolongation of the conditions of application of the state aid rules in the context of the financial crisis (initially defined in October 2008 and updated on six occasions since then[6]). To be considered as compatible with the internal market, such aid must be limited to the minimum necessary (notably through a burden-sharing) and come with safeguards against undue distortions of competition.

By way of example, in 2012 the Commission came to the conclusion that the EUR 3.3 bn restructuring package granted to NordLB, whilst it constituted state aid, was compatible with European rules[7]. The Commission took the view that the restructuring plan presented guaranteed the viability of the bank over the long term, ensured adequate remuneration of the capital provided and had satisfactory burden-sharing (suspension of dividend payments and payment of hybrid coupons during the restructuring period). The reduction of NordLB's balance sheet (restriction on certain commercial activities, sale of non-essential subsidiaries) and various commitments made by the bank were also likely to mitigate the distortions of competition as a result of the aid. The Commission also stressed that the recapitalisation was the result of the European Banking Authority's capital requirements following a resistance test conducted in 2011 and the Capital Exercise of 2012 rather than an intrinsic problem. Lastly, the Commission judged that the failure of a bank such as NordLB, considered by a Member State as being of systemic importance, could have had damaging effects on the German financial markets and economy.

The unusual nature of this plan

The regional authorities have indicated that they are once again obliged to present a plan that does not contravene European state aid rules. The Länder and the DSGV both hope to avoid the privatisation of NordLB[8] or the triggering of

[2] The S-Group operates on the principle of subsidiarity: local savings banks exercise the main functions of banking branches, whilst the Landesbanken carry out the tasks that local banks themselves can not cover (for example, securities transactions, financing and international support for exporting clients, access to hedging products, treasury management, payment methods, etc.). The network is also characterised by centralised liquidity management: the Sparkassen invest their excess resources with the Landesbanken, which play the role of central banks and clearing houses for the whole network. The local savings banks are traditionally both shareholders in and net creditors of the Landesbanken. One of the specific features of S-Group, as an IPS, which we will return to here, concerns the solidarity commitments linking its members.

[3] NordLB's common equity tier 1 (CET1) capital stood at EUR 3.1 bn at the end of 2018.

[4] NordLB has announced that on 9 April it sold EUR 2.6 bn in non-performing loans (from a total of EUR 7.5 bn at end-2018) to the Cerberus fund.

[5] https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

[6] Communications from the Commission concerning the application of state aid rules in the context of the financial crisis set out the conditions for providing aid to banks in the form of financial guarantees, recapitalisation and impaired asset measures and the requirements for restructuring plans. Aid must satisfy these conditions to be considered compatible with the internal market. The most recent update to the Commission's communication has been in force since 1 August 2013: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2013.216.01.0001.01.ENG&toc=OJ:C:2013:216:TOC

[7] http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_34381

[8] HSH Nordbank is the only Landesbank to have been privatised. In May 2016, the Commission gave its final approval to an increase from

a resolution process, which requires an internal recapitalisation equivalent to at least 8% of liabilities. Given that the bank no longer meets minimal regulatory requirements in terms of capital, in order to be considered compatible with the internal market[9] the bank's restructuring plan must include a partial recapitalisation[10] by requiring a conversion to equity or a reduction in value of subordinated debt instruments[11]. At the end of 2018, NordLB's additional Tier 1 and Tier 2 capital stood at EUR 2.7 bn.

The conditions for a rescue of NordLB would nevertheless be unique.

In contrast to the support packages previously put in place for Landesbanken, the aid provided will not come solely from NordLB's shareholders but also from the mutual cooperation and support network, the S-Group, of which it is a member. Individual contributions from the members of the S-Group have not been fully communicated. The three biggest Landesbanken (LBBW, BayernLB and Helaba) are due to contribute to the recapitalisation of NordLB for a total of EUR 260 million. The association of the savings banks of the state of Lower Saxony, which is both a shareholder in NordLB and a member of S-Group, will inject EUR 320 million alongside the savings banks of Bavaria (EUR 68 million) and Hesse and Thuringia (EUR 37.7 million).

Mutual support structures, the cornerstone of IPS

European legislation recognises the S-Group, to which all German Landesbanken and Sparkassen belong, as an Institutional Protection Scheme (IPS)[12]. The European regulation of June 2013[13] defines an IPS as *"a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary"* (article 113, paragraph 7 CRR). According to the ECB's guide to the approach for recognition of IPS for prudential purposes of July 2016[14], where there is a risk of failure at a member of an IPS and preventative measures are not sufficient, *"the IPS needs to decide on material or financial support."*

The IPS should have a broad range of measures, *"ranging from less intrusive measures, such as closer monitoring of the member institutions on the basis of relevant indicators and additional reporting requirements, to more substantial measures that are proportionate to the riskiness of the beneficiary IPS member institution and the severity of its financial constraints, including direct capital and liquidity support."* Measures to clean up the balance sheet, restructure or adjust the business model may be imposed on the institution in difficulty. In order to minimise the *ex-ante* risks of moral hazard and the *ex-post* risks of contagion, IPS must establish contributions from their members as a function of their risk profiles and must not generally allow for unconditional or unlimited support for their members. Thus, although there must be *"a clear commitment [...] on the part of the IPS to provide support when – despite previous monitoring of risks and early intervention measures – an IPS member is or is likely to become insolvent or illiquid"*, this remains conditional: an IPS is a system of mutual commitments and obligations. The opportunity to help a member financially must be evaluated in the light of its financial position and its past risk-taking, available funds and the capacity of other members to replenish funds afterwards. Conditions for the use of funds are even more tightly restricted when the IPS has the double function of a mutual protection system and a deposit guarantee system (as is the case for the S-Group). The need for prior approval of members of the decision-making committee (with a 75% qualified majority) before any activation of mutual support illustrates this conditionality. As far as we are aware, this system has never been used to help a Landesbank since the financial crisis of 2008.

The decision in the Banca Tercas case cannot be extrapolated

The Commission's communication on state aid does not set out any particular regime for intervention by an IPS. It does however stipulate that *"interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes do not constitute State aid. However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State."* On 19 March, the European Court of Justice overturned the Commission's 2015 ruling that the support measures to the Italian savings bank Banca Tercas, by the Italian deposit guarantee fund (FITD), were state aid. The Court considered that the Commission was not able to demonstrate that this was state aid on behalf of the state and financed with state resources. The Commission did not provided sufficient evidence that the Italian public authorities exerted a substantial influence on the decision to set up support measures. Moreover, the funds used came from voluntary contributions (FITD's mandate allows for protective measures in favour of its members) rather than mandatory contributions to FITD[15].

However, we do not believe that the Banca Tercas case can be applied to NordLB. Granted, the S-Group also has the role of a deposit guarantee fund. It could also claim that any decision to intervene to help NordLB would not be attributable to the state (IPS preventative measures, internal vote) and that the funds used would correspond to voluntary contributions (over and above the minimum required for deposit guarantees). The fact remains that the resources

EUR 7 bn to EUR 10 bn in the asset guarantee provided by the states of Hamburg and Schleswig-Holstein to HSH. This decision was based on new undertakings by German authorities, which covered the separation of HSH into two entities and the sale of the operating business without further state aid. In November 2018, the Commission approved the sale of HSH to a consortium of private equity funds led by J.C. Flowers and Cerberus. An agreement was reached to maintain its membership to the S-Group for three years.

[9] The plan will be assessed against the Commission's 2013 communication (which increased burden-sharing requirements), which would be a first for a plan submitted by a Landesbank.

[10] http://europa.eu/rapid/press-release_MEMO-09-441_en.htm

[11] To the extent that this is legally possible and on condition that the principle that no creditor may be disadvantaged more than in the event of a liquidation without state aid.

[12] C. Choulet (2017), *Institutional protection systems: are they banking groups?* BNP Paribas, Conjoncture, January 2017

[13] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02013R0575-20180101

[14] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/institutional_protection_guide.en.pdf

[15] T. Humblot (2019), *The FITD's support measures adopted for the benefit of Banca Tercas did not constitute State aid*, BNP Paribas, EcoFlash, to be published

mobilised in favour of NordLB would be, in contrast to those used for Banca Tercas, state resources in the sense of Article 107(1) of the TFEU.

Ultimately, a private solution?

European legislation is more favourable to IPS in the texts setting out the prudential framework (CRR, BRRD). Thus the BRRD directive[16] treats support measures put in place by IPS in the same way as private support packages, reducing the risk that the institution being helped be put into resolution. To this extent, an IPS can meet the BRRD's requirements for recovery plans, and its members exempted as a result[17].

The BRRD allows a bank to be put into resolution only under three conditions: 1. *"the institution is failing or is likely to fail"*; 2. *"there is no reasonable prospect that any alternative private sector measures, including measures by an IPS, or supervisory action, including early intervention measures or the write down or conversion of relevant capital instruments [...] would prevent the failure of the institution within a reasonable timeframe*"; and 3. *"a resolution action is necessary in the public interest".* The mutual support structures of an IPS are in some ways a sort of private bailout: the bailout of a Landesbank could be taken on by counterparties external to the group in difficulty but that are members of the same IPS (Landesbanken or perhaps even Sparkassen of other German Länder or Landesbausparkassen) and this offers protection to creditors from outside this network (deposit-holders and other creditors who are not members of the IPS).

We believe that the conditions for the rescue of NordLB represent, at the very least, evidence of the existence of a 'real' mutual support structure within the S-Group. Without an intervention from the DSGV, the credibility of the solidarity undertakings between S-Group members would have been called into question[18].

In the end, as far as state aid is concerned, NordLB's restructuring plan should be considered only in terms of the public resources committed by the two Länder. To interpret any support provided by the S-Group as qualifying under the terms of the 2013 communication (without taking account of the specific nature of this support) would deny the possibility of IPS being composed of public sector members. In other words, it would imply that any intervention by the S-Group would be incompatible with state aid rules.

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[16] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0059

[17] Under Article 4, paragraph 8 b) of the BRRD, lending establishments that are members of an IPS (other than establishments under the direct supervision of the ECB, such as the Landesbanken) can be exempted from the requirement to draw up a recovery plan. Where such an exemption is granted, the IPS must draw up a plan of cooperation with each of its exempt members and ensure that its members meet regulatory requirements for capital and liquidity on an individual basis. According to a survey by the EBA in 2017, 89% of German lending establishments (with total banking assets of EUR 1,793 bn, corresponding roughly to the aggregated assets of German savings banks and credit cooperatives) were eligible for such a waiver thanks to their membership of an IPS, but, at the time of the survey in April 2017, no waivers had been formally requested. 9% of establishments met the conditions required to benefit from simplified obligations. Regarding resolution plans, 98% of German lending establishments (with a combined EUR 2,320 bn in assets) are under simplified obligations. However no bank can be exempted from drawing up a resolution plan (such waivers are reserved to establishments that are members of a central body under Article 4.8.a). Link to the study: https://eba.europa.eu/documents/10180/1720738/EBA+Report+on+the+Application+of+Simplified+Obligations+and+Waivers+in+Recovery+and+Resolution+Planning.pdf

[18] It is worth remembering that IPS status gives rights to prudential exemptions and waivers. In addition, ratings agencies take account of these links in their assessment of the credit risk associated with Landesbanken.

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