

COMMUNICATION FROM THE COMMISSION

on the Treatment of Impaired Assets in the Community Banking Sector

1. INTRODUCTION

- (1) Since mid-2007, the functioning of wholesale credit markets has been severely disrupted. The result has been a drying up of liquidity in the banking sector and a reluctance of banks to lend to each other and to the broader economy. As the disruption of credit markets has intensified over the past eighteen months, the financial crisis has intensified and the global economy has entered a severe recession.
- (2) It is difficult to envisage a resolution of the financial crisis and a recovery in the global economy without assured stability in the banking sector and the broader financial system. Only then will investor confidence return and banks resume their normal lending behaviour. Accordingly, Member States have put measures in place to support the stability of their banking sectors and underpin lending, notably the injection of new capital using public funds and the provision of government guarantees for bank borrowing. These measures were announced in October 2008 and have been gradually implemented over the past months.
- (3) Recently, several Member States have announced their intention to complement their existing support measures by providing some form of relief for impaired bank assets. These announcements, in parallel with a similar initiative in the United States, have triggered a wider debate within the Community on the merits of asset relief as a government support measure for banks. In the context of that debate, this Communication has been prepared by the Commission services, in consultation with the European Central Bank (ECB), and builds on the recommendations issued on 5 February 2009 by the Eurosystem (see Annex 1).
- (4) The Communication focuses on issues to be addressed by Member States in considering, designing and implementing asset-relief measures. At a general level, these issues include the rationale for asset relief as a measure to safeguard financial stability and underpin bank lending; the longer-term considerations of banking-sector viability and budgetary sustainability to be taken into account when considering asset-relief measures; and the need for a common and co-ordinated Community approach to asset relief, notably to ensure a level playing field. In the context of such a Community approach, the Communication also offers more specific guidance on the application of state-aid rules to asset relief, focusing on issues such as (i) transparency and disclosure requirements; (ii) burden sharing between the State, shareholders and creditors; (iii) aligning incentives for beneficiaries with public policy objectives; (iv) principles for designing asset-relief measures in terms of eligibility, valuation and management of impaired assets; and (v) the relationship between asset relief, other government support measures and the restructuring of banks.

2. ASSET RELIEF AS A MEASURE TO SAFEGUARD FINANCIAL STABILITY AND UNDERPIN BANK LENDING

- (5) The immediate objectives of the Member State rescue packages announced in October 2008 are to safeguard financial stability and underpin the supply of credit to the real economy. It is too early to draw definitive conclusions on the effectiveness of the packages, but it is clear that they have averted the risk of financial meltdown and have supported the functioning of important inter-bank markets. On the other hand, the evolution in lending to the real economy since the announcement of the packages has been unfavourable, with recent statistics suggesting a sharp deceleration in credit growth.¹ In many Member States, reports of businesses being denied access to bank credit are now widespread and it would seem that the squeeze on credit goes beyond that justified by cyclical considerations.
- (6) A key reason identified for the insufficient flow of credit is uncertainty about the valuation and location of impaired assets, a source of problems in the banking sector since the beginning of the crisis. Uncertainty regarding asset valuations has not only continued to undermine confidence in the banking sector, but has weakened the effect of the government support measures agreed in October 2008. For example, bank recapitalisation has provided a cushion against asset impairment but much of the capital buffer provided has been absorbed by banks in provisioning against future asset impairments. Banks have already taken steps to address the problem of impaired assets. They have recorded substantial write-downs in asset values², taken steps to limit remaining losses by reclassification of assets within their balance sheets and gradually put additional capital aside to strengthen their solvency positions. However, the problem has not been resolved to a sufficient degree and the unexpected depth of the economic slowdown now suggests a further and more extensive deterioration in credit quality of bank assets.
- (7) Asset relief would directly address the issue of uncertainty regarding the quality of bank balance sheets and therefore help to revive confidence in the sector. It could also help to avoid the risk of repeated rounds of recapitalisation of banks as the extent of asset impairment increases amid a deteriorating situation in the real economy. On this basis, several Member States are actively considering relief for impaired bank assets as a complement to other measures in implementing the strategy agreed by Heads of State and Government in October 2008.

¹ While official data for the euro area suggest that bank lending to businesses is still resilient, the underlying trend is weakening, with month-on-month growth rates in lending slowing markedly toward the end of 2008. In December 2008, bank loans to the private economy (loans to non-MFI excl. governments) fell by 0.4% relative to November.

² From mid-2007 to date, there has been a total of USD 1063 billion in asset write-downs, of which USD 737.6 billion has been reported by US-based banks and USD 293.7 has been reported by European-based banks. Of the latter, USD 68 billion has been reported in Switzerland. Despite the scale of asset write-downs already reported, the IMF currently estimates that the total of bank losses related to asset impairment is likely to reach USD 2,200 billion. This estimate is based on global holdings of U.S.-originated and securitized mortgage, consumer, and corporate debt and has been steadily rising since the beginning of the crisis. Some market commentators suggest that total losses may be substantially higher. For example, Nouriel Roubini who has consistently argued that official estimates are too low now suggests that total losses could be USD 3,600 billion for the United States alone.

3. LONGER-TERM CONSIDERATIONS: A RETURN TO VIABILITY IN THE BANKING SECTOR AND SUSTAINABILITY OF PUBLIC FINANCES

- (8) Asset-relief measures must be designed and implemented in the manner that most effectively achieves the immediate objectives of safeguarding financial stability and underpinning bank lending. An important issue to be addressed in this context is ensuring an adequate participation in the asset-relief measures by setting appropriate pricing and conditions and through mandatory participation if deemed necessary. However, the focus in designing and implementing asset-relief measures should not be limited to these immediate objectives. It is essential that longer-term considerations are also taken into account.
- (9) If asset-relief measures are not carried out in such a way as to ring-fence the danger of serious distortions of competition among banks (both within Member States and on a cross-border basis) in compliance with the State aid rules of the EC Treaty, including where necessary the restructuring of beneficiaries, the outcome will be a structurally weaker Community banking sector with negative implications for productive potential in the broader economy. Furthermore, it could lead to a recurrent need for government intervention in the sector, implying a progressively heavier burden on public finances. Such risks are serious given the likely scale of State exposure. In order to limit the risk of such longer-term damage, government intervention in the banking sector should be appropriately targeted and accompanied by behavioural safeguards that align the incentives of banks with those of public policy. These measures should form part of an overall effort to restore the viability of the banking sector, based on necessary restructuring. The need for restructuring in the banking sector as a counterpart of government support is discussed in more detail in the context of State aid rules later in Sections 5 and 6.
- (10) In considering the design and implementation of asset-relief measures, it is also essential that Member States take account of the budgetary context. Estimates of total expected asset write-downs suggest that the budgetary costs – actual, contingent or both - of asset relief could be substantial - both in absolute terms and relative to GDP in Member States. Government support through asset relief (and other measures) should not be on such a scale that it raises concern about the sustainability of public finances such as over-indebtedness or financing problems. Such considerations are particularly important in the current context of widening budget deficits, rising public debt levels and challenges facing sovereign bond issuance.
- (11) More specifically, the budgetary situation of Member States will be an important consideration in the choice of management arrangement for assets subject to relief, namely asset purchases, asset insurance, asset swap or a hybrid of such arrangements.³ The implications for budgetary credibility may not differ significantly between the various approaches to asset relief, as financial markets are likely to discount potential losses on a similar basis.⁴ However, an approach requiring the

³ These arrangements are discussed in more detail in Annex 2.

⁴ Asset purchases by government need not imply heavy budgetary costs in the longer term if a sufficient portion of the acquired assets can be subsequently sold at a profit (see US and Swedish examples in Annex 2. However, they imply an upfront budgetary outlay which would increase gross public debt and the government's gross financing requirements. An approach based on swapping government debt for

outright purchase of impaired assets would have a more immediate impact on budgetary ratios and government financing. While the choice of management arrangement of impaired assets is the responsibility of each Member State, hybrid approaches whereby bad assets are segregated from the balance sheet of banks in a separate entity (either within or outside the banks) which benefits in some way from a government guarantee could be considered. Such an approach is attractive as it provides many of the benefits of the asset purchase approach from the perspective of restoring confidence in the banking system, while limiting the immediate budgetary impact.

- (12) In a context of scarce budgetary resources, it may be appropriate to focus asset-relief measures on a limited number of banks of systemic importance. For some Member States, asset relief for banks may be severely constrained, due to their existing budgetary constraints and/or the size of their banks' balance sheet relative to GDP.

4. NEED FOR A COMMON AND CO-ORDINATED COMMUNITY APPROACH

- (13) In considering some form of asset-relief measures, there is a need to reconcile the immediate objectives of financial stability and bank lending with the need to avoid longer-term damage to the banking sector within the Community, to the single market and to the broader economy. This can be achieved most effectively by a common and co-ordinated Community approach, with the following broad objectives:

- Boosting market confidence by demonstrating a capacity for an effective Community-level response to the financial crisis and creating the scope for positive spillovers among Member States and on the wider financial markets.
- Limiting negative spillovers among Member States, where the introduction of asset-relief measures by a first-mover Member State results in pressure on other Member States to follow suit and risks launching a subsidy race between Member States;
- Protecting the single market in financial services by ensuring consistency in asset-relief measures introduced by the Member States and resisting financial protectionism.
- Ensuring compliance with state-aid control requirements and any other legal requirements by further ensuring consistency among asset-relief measures, and by minimising competitive distortions and moral hazard.

- (14) Co-ordination among Member States would only be necessary at a general level and could be achieved while retaining sufficient flexibility to tailor measures to the specific situations of individual banks. In the absence of sufficient coordination *ex ante*, many of these objectives will only be met by additional State aid control requirements *ex post*. Common guidance on the basic features of relief measures would, therefore, help to minimise the need for corrections and adjustments as a result of assessment under the State aid rules. Such guidance is provided in the following sections.

impaired assets could be used to ease the operational problems relating to issuance, but would not avoid the impact on the budgetary ratios nor an increase in the supply of government debt in the market.

5. GUIDELINES ON THE APPLICATION OF STATE AID RULES TO ASSET-RELIEF MEASURES

- (15) It is the normal duty of banks to assess the risk of the assets they acquire and to make sure they can cover any associated losses⁵. Asset relief may however be considered to support financial stability. Public asset-relief measures are state aid inasmuch as they free the beneficiary bank from (or compensate for) the need to register either a loss or a reserve for a possible loss on its impaired assets and/or free regulatory capital for other uses. This would notably be the case where impaired assets are purchased or insured at a value above the market price, or if the price of the guarantee does not compensate the State for its possible maximum liability under the guarantee.⁶
- (16) Any aid for asset-relief measures should, however, comply with the general principles of necessity, proportionality and minimisation of the competition distortions. Such assistance implies serious distortions of competition between beneficiaries and non-beneficiary banks and among beneficiary banks with different degrees of need. Non-beneficiary banks that are fundamentally sound may feel obliged to consider seeking government intervention to preserve their competitive position in the market. Similar distortions in competition may arise among Member States, with the risk of a subsidy race between Member States (trying to save their banks without regard to the effects on banks in other Member States) and a drift towards financial protectionism and fragmentation of the internal market. Participation in the asset-relief scheme should therefore be conditioned upon clearly defined and objective criteria, in order to avoid that individual banks take unwarranted advantage.
- (17) The Commission established the principles governing the application of the State aid rules and, in particular, Article 87(3)(b) of the EC Treaty to any support measure for banks in the context of the global financial crisis in its Banking Communication⁷. The Commission subsequently provided more detailed guidance on the practical implementation of these principles to recapitalisation in a recent Communication⁸. In the same vein, the following guidelines, based on the same principles, identify the key features of asset-relief measures or schemes, which determine their effectiveness as well as their impact on competition. These guidelines equally apply to all banks that are granted asset relief irrespective of their individual situation but the practical implications of their application may vary depending on the risk profile and viability of a beneficiary. The principles of these guidelines apply *mutatis mutandis* where two more Member States coordinate measures to provide asset relief to cross-border banks.

⁵ Banks typically hold a variety of assets, including: cash, financial assets (treasury bills, debt securities, equity securities, traded loans, and commodities), derivatives (swaps, options), loans, financial investments, intangible assets, property, plant and equipment. Losses may be incurred when assets are sold below their book value, when their value is decreased and reserves are created on possible loss or ex-post when the revenue streams at maturity are lower than the book value.

⁶ A guarantee is presumed to constitute State aid when the beneficiary bank cannot find any independent private operator on the market willing to provide a similar guarantee. The amount of State aid is set at the maximum net liability for the State.

⁷ Communication from the Commission – *The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, OJ C 270, 25.10.2008, p. 8.

⁸ Communication from the 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*, OJ C 10, 15.01.2009, p. 2.

(18) The present guidance aims at setting coordinated principles and conditions to ensure the effectiveness of asset-relief measures in the single market as far as possible, taking account of the long term objective of a return to normal market conditions, while remaining flexible enough so as to cater for specific features or provide additional measures or procedures at individual or national levels for reasons of financial stability. Effective asset relief measures should have as a consequence the maintenance of lending to the real economy.

5.1. Appropriate identification of the problem and options for solution: full *ex-ante* transparency and disclosure of impairments and an upfront assessment of eligible banks

(19) Any asset relief measure must be based on a clear identification of the magnitude of the bank's asset-related problems, its intrinsic solvency prior to the support and its prospects for return to viability, taking into due consideration all possible alternatives, in order to facilitate the necessary restructuring process, prevent distortion in the incentives of all players and avoid waste of State resources without contributing to resumption in the normal flow of credit to the real economy .

(20) Therefore, in order to minimise the risk of a recurrent need for State interventions in favour of the same beneficiaries, the following criteria should be satisfied as a prerequisite for benefitting from asset relief:

- Applications for aid should be subject to full *ex-ante* transparency and disclosure of impairments by eligible banks on the assets which will be covered by the relief measures, based on adequate valuation, certified by recognised independent experts and validated by the relevant supervisory authority, in line with the principles of valuation developed in section 5.5⁹. Such disclosure of impairments should take place prior to government intervention. This should lead to the identification of the aid amount and of the incurred losses for the bank from the asset transfer¹⁰.
- An application for aid by an individual bank should be followed by a full review of that bank's activities and balance sheet, with a view to assessing the bank's capital adequacy and its prospects for future viability (viability review). This review must occur in parallel with the certification of the impaired assets covered by the asset relief programme but, given its scale, could be finalised after the bank enters into the asset relief programme. The results of the viability review shall be notified to the Commission and will be taken into account in the assessment of necessary follow-up measures (see section 6).

⁹ Without prejudice to the necessity of making public the impact on the balance sheet of an asset relief measure implying appropriate burden-sharing, the terms 'transparency' and 'full disclosure' should be understood as meaning transparency *vis-à-vis* the national authorities, the independent experts involved and the European Commission.

¹⁰ The aid amount corresponds to the difference between the transfer value of the assets (normally based on their real economic value) and the market price. In this paper, the incurred losses correspond to the difference between the transfer value and the book value of the assets. Actual losses will normally only be known ex-post.

5.2. Burden-sharing of the costs related to impaired assets between the State, shareholders and creditors

- (21) As a general principle, banks ought to bear the losses associated with impaired assets to the maximum extent. This requires, firstly, full *ex ante* transparency and disclosure, followed by the correct valuation of assets prior to government intervention and a correct remuneration of the State for the asset relief measure, whatever its form, so as to ensure equivalent shareholder's responsibility and burden-sharing irrespective of the exact model chosen. The combination of these elements should lead to overall coherence concerning burden-sharing across various forms of State support, having regard to the specific distinctive features of different types of assistance¹¹.
- (22) Once assets have been properly evaluated and losses are correctly identified¹², and if this would lead to a situation of technical insolvency without State intervention, the bank should be put either into administration or be orderly wound up, according to Community and national law. In such a situation, with a view to preserving financial stability and confidence, protection or guarantees to bondholders¹³ may be appropriate.
- (23) Where putting a bank into administration or its orderly winding up appears unadvisable for reasons of financial stability¹⁴, aid in the form of guarantee or asset purchase, limited to the strict minimum, could be awarded to banks so that they may continue to operate for the period necessary to allow to devise a plan for either restructuring or orderly winding-up. In such cases, shareholders should also be expected to bear losses at least until the regulatory limits of capital adequacy are reached. Nationalisation options may also be considered.
- (24) Where it is not possible to achieve full burden-sharing *ex ante*, the bank should be requested to contribute to the loss or risk coverage at a later stage, for example in the form of claw-back clauses or, in the case of an insurance scheme, by a clause of “first loss”, to be borne by the bank (typically with a minimum of 10%) and a clause of “residual loss sharing”, through which the bank participates to a percentage (typically with a minimum of 10%) of any additional losses¹⁵.
- (25) As a general rule, the lower the contribution upfront, the higher the need for a shareholder contribution at a later stage, either in the form of a conversion of State

¹¹ Asset-relief measures are somewhat comparable to capital injections insofar as they provide a loss absorption mechanism and have a regulatory capital effect. However, with the former the State generally incurs a larger risk, related to a specific portfolio of impaired assets, with no direct contribution of other bank's income generating activities and funds, and beyond its possible stake into the bank. In view of the larger down-side and more limited up-side remuneration for asset relief should normally be higher than for capital injections.

¹² Comparing the book value of the assets with their transfer value (i.e. their real economic value)

¹³ Shareholder protection should, however, normally be excluded. See decisions NN 39/2008 (Denmark, Aid for liquidation of Roskilde Bank) and NN 41/2008 (UK, Rescue aid to Bradford & Bingley).

¹⁴ That may be the case where the bank's size or type of activity would be unmanageable in an administrative or judiciary procedure or via an orderly winding-up without having dangerous systemic implications on other financial institutions or on lending to the real economy. A justification by the monetary and/or supervisory authority would be necessary in this respect.

¹⁵ Other factors, for example higher remuneration, may influence the appropriate level. Moreover, it has to be noted that ex-post compensations may only occur several years after the measure has been introduced and may therefore unsatisfactorily prolong the uncertainty linked to the valuation of the impaired assets. Claw-back clauses based on ex-ante valuation would not have this problem.

losses into bank shares and/or in the form of additional compensatory measures to limit the distortion of competition when assessing necessary restructuring.

5.3. Aligning incentives for banks to participate in asset relief with public policy objectives

- (26) As a general feature, impaired asset relief programmes should have an enrolment window limited to six months from the launch of the scheme by the government. This will limit incentives for banks to delay necessary disclosures in the hope of higher levels of relief at a later date, and facilitate a rapid resolution of the banking problems before the economic downturn further aggravates the situation. During the six-month window, the banks would be able to present eligible assets baskets to be covered by the asset-relief measures, with the possibility of rollover¹⁶.
- (27) Appropriate mechanisms may need to be devised so as to ensure that the banks most in need of asset relief participate in the government measure. Such mechanisms could include mandatory participation in the programme, and should include at least mandatory disclosure to the supervisory authorities. The obligation for all banks to reveal the magnitude of their asset-related problems will contribute to the clear identification of the need and necessary scope for an asset-relief scheme at the Member State level.
- (28) Where participation is not mandatory, the scheme may include appropriate incentives (such as the provision of warrants or rights to existing shareholders so that they may participate in future private capital-raising at preferential terms) to facilitate take-up by the banks without derogating from the principles of transparency and disclosure, fair valuation and burden sharing.
- (29) Participation after the expiration of the six month enrolment window will be possible only in exceptional and unforeseeable circumstances for which the bank is not responsible¹⁷, and subject to stricter conditions, such as higher remuneration to the State and/or higher compensatory measures.
- (30) Access to asset relief should always be conditional on a number of appropriate behavioural constraints. In particular, beneficiary banks should be subject to safeguards which ensure that the capital effects of relief are used for providing credit to appropriately meet demand according to commercial criteria and without discrimination and not for financing a growth strategy (in particular acquisitions of sound banks) to the detriment of competitors.
- (31) Restrictions on dividend policy and caps on executive remuneration should also be considered. The specific design of behavioural constraints should be determined on the basis of a proportionality assessment taking account of the various factors that may imply the necessity of restructuring (see section 6).

¹⁶ Case of enrolled assets that may mature afterwards

¹⁷ An 'unforeseeable circumstance' is a circumstance that could in no way be anticipated by the company's management when making its decision not to join the asset-relief programme during the enrolment window and that is not a result of negligence or error on the part of the company's management or decisions of the group to which it belongs. An 'exceptional circumstance' is to be understood as exceptional beyond the current crisis. Member States wishing to invoke such circumstances shall notify all necessary information to the Commission.

5.4. Eligibility of assets

- (32) When determining the range of eligible assets for relief, a balance needs to be found between meeting the objective of immediate financial stability and the need to ensure the return to normal market functioning over the medium term. Assets commonly referred to as "toxic assets" (e.g. US mortgage backed securities and associated hedges and derivatives), which have triggered the financial crisis and have largely become illiquid or subject to severe downward value adjustments, appear to account for the bulk of uncertainty and scepticism concerning the viability of banks. Restricting the range of eligible assets to such assets would limit the State's exposure to possible losses and contribute to the prevention of competition distortions¹⁸. However, an overly narrow relief measure would risk falling short of restoring confidence in the banking sector, given the differences between the specific problems encountered in different Member States and banks and the extent to which the problem of impairment has now spread to other assets. This would plead in favour of a pragmatic approach including elements of flexibility, which would ensure that other assets also benefit from relief measures to an appropriate extent and where duly justified.
- (33) A common and coordinated Community approach to the identification of the assets eligible for relief measures is necessary to both prevent competitive distortions among Member States and within the Community banking sector, and limit incentives for cross-border banks to engage in arbitrage among different national relief measures. To ensure consistency in the identification of eligible assets across Member States, categories of assets ('baskets') reflecting the extent of existing impairment should be developed. More detailed guidance on the definition of these categories is provided in Annex 3. The use of such categories of assets would facilitate the comparison of banks and their risk profiles across the Community. Member States would then need to decide which category of assets could be covered and to what extent, subject to the Commission's review of the degree of impairment of the assets chosen.
- (34) A proportionate approach would need to be developed to allow a Member State whose banking sector is additionally affected by other factors of such magnitude as to jeopardise financial stability (such as the burst of a bubble in their own real estate market) to extend eligibility to well-defined categories of assets corresponding to this systemic threat upon due justification without quantitative restrictions.
- (35) Additional flexibility could further be envisaged by allowing for the possibility for banks to be relieved of impaired assets outside the scope of eligibility set out above without the necessity of a specific justification for a maximum of 10-20% of the overall assets of a given bank covered by a relief mechanism in view of the diversity of circumstances of different Member States and banks. However, assets that cannot presently be considered impaired should not be covered by a relief programme. Asset relief should not provide an open-ended insurance against future consequences of recession.
- (36) As a general principle, the wider the eligibility criteria, and the greater proportion which the assets concerned represent in the portfolio of the bank, the more thorough the restructuring and the remedies to avoid undue distortions of competition will have

¹⁸ This would seem the approach chosen in the US for Citigroup and Bank of America.

to be. In any case, the Commission will not consider assets eligible for relief measures where they have entered the balance sheet of the beneficiary bank after a specified cut-off date prior to the announcement of the relief programme¹⁹. To do otherwise could result in asset arbitrage and would give rise to inadmissible moral hazard by providing incentives for banks to abstain from properly assessing risks in future lending and other investments and thus repeat the very mistakes that have brought about the current crisis²⁰.

5.5. Valuation of assets eligible for relief and pricing

- (37) A correct and consistent approach to the valuation of assets, including assets that are more complex and less liquid, is of key importance to prevent undue distortions of competition and to avoid subsidy races between Member States. Valuation should follow a general methodology established at the Community level and should be closely co-ordinated *ex ante* by the Commission across the Member States in order to ensure maximum effectiveness of the asset-relief measure and reduce the risk of distortions and damaging arbitrage, notably for cross-border banks. Alternative methodologies may need to be employed to take account of specific circumstances relative to, e.g. timely availability of relevant data, provided they attain equivalent transparency. In any case, eligible banks should value their portfolios on a daily basis and make regular and frequent disclosures to the national authorities and to their supervisory authorities.
- (38) Where the valuation of assets appears particularly complex, alternative approaches may be considered such as the creation of a "good bank" whereby the State would purchase the good rather than the impaired assets. Public ownership of a bank (including nationalisation) may be an alternative option, with a view to carrying out the valuation over time in a restructuring or orderly winding-up context, thus eliminating any uncertainty about the proper value of the assets concerned²¹.
- (39) As a first stage, assets should be valued on the basis of their current market value, whenever possible. In general, any transfer of assets covered by a scheme at a valuation in excess of the market price will constitute State aid. . The current market value may, however, be quite distant from the book value of those assets in the current circumstances, or non-existent in the absence of a market (for some assets the value may effectively be as low as zero).
- (40) As a second stage, the value attributed to impaired assets in the context of an asset-relief program (the 'transfer value') will inevitably be above current market prices in order to achieve the relief effect. To ensure consistency in the assessment of the compatibility of aid, the Commission would consider a transfer value reflecting the underlying long-term economic value (the 'real economic value') of the assets, on the basis of underlying cash flows and broader time horizons, an acceptable benchmark

¹⁹ Generally, the Commission considers that a uniform and objective cut-off date, such as the end of 2008, will ensure a level playing field among banks and Member States.

²⁰ Where necessary, State support in relation to the risks of future assets can be tackled on the basis of the guarantee notice and the temporary framework.

²¹ This would be the case, for example, if the State swapped assets for government bonds in the amount of their nominal value but received contingent warrants on bank capital, the value of which depends on the eventual sales price of the impaired assets.

indicating the compatibility of the aid amount as the minimum necessary. Uniform hair-cuts applicable to certain asset categories will have to be considered to approximate the real economic value of assets that are so complex that a reliable forecast of developments in the foreseeable future would appear impracticable.

- (41) Consequently, the transfer value for asset purchase or asset insurance²² measures should be based on their real economic value. Moreover, adequate remuneration for the State shall be secured. Where Member States deem it necessary –notably to avoid technical insolvency- to use a transfer value of the assets that exceeds their real economic value, the aid element contained in the measure is correspondingly larger. It can only be accepted if it is accompanied by far-reaching restructuring and the introduction of conditions allowing the recovery of this additional aid at a later stage, for example through claw-back mechanisms.
- (42) The valuation process both with regard to the market value and the real economic value, as well as the remuneration of the State, should follow the same guiding principles and processes listed in Annex 4.
- (43) When assessing the valuation methods put forward by Member States for asset-relief measures, and their implementation in individual cases, the Commission will consult panels of valuation experts²³. The Commission will also build on the expertise of existing bodies organised at EU level in order to ensure the consistency of valuation methodologies.

5.6. Management of assets subject to relief measures

- (44) It is for Member States to choose the most appropriate model for relieving banks from assets, from the range of options set out in section 4, in light of the extent of the problem of impaired assets, the situation of the individual banks concerned and budgetary considerations. The objective of State aid control is to ensure that the features of the selected model are designed so as to ensure equal treatment and prevent undue distortions of competition.
- (45) While the specific pricing arrangements for an aid measure may vary, their distinctive features should not have an appreciable impact on the adequate burden-sharing between the State and the beneficiary banks. On the basis of proper valuation, the overall financing mechanism of an asset management company, an insurance or a hybrid solution should ensure that the bank will have to assume the same proportion of losses. Claw-back clauses can be considered in this context. In general, all schemes must ensure that the beneficiary banks bear the losses incurred in the transfer of assets (see further para. 50 and footnote 10).
- (46) Whatever the model, in order to facilitate the bank's focus on the restoration of viability and to prevent possible conflicts of interest, it is necessary to ensure clear functional and organisational separation between the beneficiary bank and its impaired assets, notably as to their management, staff and clientele.

²² In the case of an insurance measure, the transfer value is understood as insured amount

²³ The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may have recourse to external expertise.

5.7. Procedural aspects

- (47) Detailed guidance on the implications of these guidelines on State aid procedure with regard to both the initial notification of aid and the assessment of restructuring plans, where necessary, is provided in Annex 5.

6. FOLLOW-UP MEASURES – RESTRUCTURING AND RETURN TO VIABILITY

- (48) The above principles and conditions set the framework for designing asset-relief measures in compliance with State aid rules. State aid rules aim, in the present context, at ensuring the minimum and least distortive support for a removal of risks related to a separate category of assets from the beneficiary banks in order to prepare a solid ground for return to long-term viability without State support. While the treatment of impaired assets along the above principles is a necessary step for a return to viability for the banks, it is not in itself sufficient to achieve that goal. Depending on their particular situation and characteristics, banks will have to take appropriate measures in their own interest in order to avoid a recurrence of similar problems and to ensure sustainable profitability.
- (49) Under State aid rules and notably those for rescue and restructuring aid, such asset relief amounts to a structural operation and requires a careful assessment of three conditions: i) adequate contribution of the beneficiary to the costs of the impaired assets programme; ii) appropriate action to guarantee the return to viability; and iii) necessary measures to remedy competition distortions.
- (50) The first condition should normally be achieved by fulfilling the requirements set in the previous chapters, notably disclosure, valuation, pricing and burden-sharing. This shall ensure a contribution by the beneficiary of at least the entirety of the losses incurred in the transfer of assets to the State. Where this is materially not possible, aid may still be authorised, by way of exception, subject to stricter requirements as to the other two conditions.
- (51) Requirements to return to viability and the need for remedies for competition distortion will be determined on a case-by-case basis. As regards the second condition, the need to return to long term viability, it should be noted that asset relief may contribute to this objective. The viability review should certify the actual and prospective capital adequacy of the bank after a complete assessment and consideration of the possible factors of risk²⁴.
- (52) The Commission's assessment of the extent of necessary restructuring, following the initial authorisation of the asset-relief measures, will be determined on the basis of the following criteria: criteria outlined in the Commission's communication on recapitalisation of banks²⁵, proportion of the bank's assets subject to relief; the transfer price of such assets compared to the market price; the specific features of the impaired asset relief granted; the total size of State exposure relative to a bank's risk-weighted

²⁴ Compliance with the criteria set in paragraph 40 of the Commission communication on recapitalisation of banks would also need to be ensured as far as applicable.

²⁵ Communication from the 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*, OJ C 10, 15.01.2009, p. 2.

assets; the nature and origin of the problems of the beneficiary bank; and the soundness of the bank's business model and investment strategy. It will also take into account any additional granting of State guarantee or State recapitalisation, in order to draw a complete picture of the situation of the beneficiary bank²⁶.

- (53) Long term viability requires that the bank is able to survive without any State support, which implies clear plans for redeeming any State capital received and renouncing State guarantees. Depending on the outcome of this assessment, restructuring will have to comprise an in-depth review of the bank's strategy and activity, including, for example, focussing on core business, reorientation of business models, closure or divestment of business divisions/subsidiaries, changes in the asset-liability management and other changes.
- (54) The need for in-depth restructuring will be presumed where an appropriate valuation of impaired assets according to the principles set out in section 5.5 and Annex 4 would lead to negative equity/technical insolvency without State intervention. Repeated requests for aid and departure from the general principles set out in earlier sections will normally point to the need for such in-depth restructuring.
- (55) In-depth restructuring would also be required where the bank has already received State aid in whatever form that either contributes to coverage or avoidance of losses, or altogether exceeds 2% of the total bank's risk weighted assets, while taking the specific features of the situation of each beneficiary in due consideration.²⁷
- (56) The timing of any required measures to restore viability will take account of the specific situation of the bank concerned, as well as the overall situation in the banking sector, without unduly delaying the necessary adjustments.
- (57) Thirdly, the extent of necessary compensatory measures should be examined, on the basis of distortions of competition resulting from the aid. This may involve downsizing or divestment of profitable business units or subsidiaries, or behavioural commitments to limit commercial expansion.
- (58) The need for compensatory measures will be presumed if the beneficiary bank does not fulfil the conditions set in the previous paragraphs and notably those of disclosure, valuation, pricing and burden sharing.
- (59) The Commission will assess the scope of the compensatory measures required, depending on its assessment of competition distortions resulting from the aid, and notably on the basis of the following factors: total amount of aid, including from guarantee and recapitalisation measures; volume of impaired assets benefiting from the measure; proportion of losses resulting from the asset; general soundness of the bank; risk profile of the relieved assets; quality of risk management of the bank; level of solvency ratios in the absence of aid; market position of the beneficiary bank and

²⁶ For those banks already subject to the obligation of a restructuring plan, following the granting of previous State aid, such a plan would need to duly take into consideration the new aid and envisage all options from restructuring to orderly winding-up.

²⁷ Participation in an authorised credit guarantee scheme, without the guarantee having had to be invoked to cover losses, shall not be taken into consideration for the purposes of the present paragraph.

distortions of competition from the bank's continued market activities; and impact of the aid on the structure of the banking sector.

7. FINAL PROVISION

- (60) This Communication applies from 25 February 2009, the date on which the Commission agreed its content in principle, having regard to the financial and economic context that required immediate action.

Annex 1

EUROSYSTEM GUIDANCE ON ASSET SUPPORT MEASURES FOR BANKS

The Eurosystem has identified seven guiding principles for bank asset support measures:

- *eligibility of institutions*, which should be voluntary, with possible priority for institutions with large concentrations of impaired assets in case of constraints;
- relatively broad *definition of assets* eligible for support;
- *valuation of eligible assets* which is transparent, preferably based on a range of approaches and common criteria to be adopted across Member States, based on independent third-party expert opinions, use of models which use micro-level inputs to estimate the economic value of, and probabilities attached to, the expected losses, and of asset-specific haircuts on book values of assets when the assessment of market value is particularly challenging, or when the situation requires swift action;
- an adequate degree of *risk sharing* as a necessary element of any scheme in order to limit the cost to the government, provide the right incentives to the participating institutions and maintain a level playing field across these institutions;
- sufficiently long *duration* of the asset-support schemes, possibly matching the maturity structure of the eligible assets;
- *governance of institutions* which should continue to be run according to business principles, and favouring of schemes that envisage well defined exit strategies; and
- *conditionality* of public support schemes to some measurable yardsticks, such as commitments to continue providing credit to appropriately meet demand according to commercial criteria.

Annex 2

The different conceivable approaches to asset relief and experience with the use of bad-bank solutions in the United States, Sweden, France, Italy, Germany and Switzerland

I. Possible approaches

In principle, two broad approaches to managing assets subject to relief measures can be considered:

- The segregation of impaired assets from good assets within a bank or in the banking sector as a whole. Several variants of this approach can be considered. An asset management company (bad bank or risk shield) could be created for each bank, whereby the impaired assets would be transferred to a separate legal entity, with the assets still managed by the ailing bank or a separate entity and possible losses shared between the good bank and the State. Alternatively, the State could establish a self-standing institution (often called an "aggregator bank") to purchase the impaired assets of either an individual banks or of the banking sector as a whole, thereby allowing banks to return to normal lending behaviour unencumbered by the risk of asset write-downs. This approach could also involve prior nationalisation, whereby the State takes control of some or all banks in the sector before segregating their good and bad assets.
- An asset insurance scheme whereby banks retain impaired assets on their balance sheets but are indemnified against losses by the State. In the case of asset insurance, the impaired assets remain on the balance sheet of banks, which are indemnified against some or all losses by the State. A specific issue concerning asset insurance is setting the appropriate premium for heterogeneous and complex assets, which should in principle reflect some combination of valuation and risk characteristics of the insured assets. Another issue is that insurance schemes are technically difficult to operate in a situation where the insured assets are spread across a large number of banks rather than concentrated in a few larger banks. Finally, the fact that the insured assets remain on the balance sheets of banks will allow for the possibility of conflicts of interest and remove the important psychological effect of clearly separating the good bank from the bad assets.

II. Experience with bad banks

In the United States, the Resolution Trust Corporation (RTC) was created as a government-owned asset-management company in 1989. The RTC was charged with liquidating assets (primarily real estate-related assets, including mortgage loans) that had been assets of savings and loan associations ("S&Ls") declared insolvent by the Office of Thrift Supervision, as a consequence of the Savings and Loan crisis (1989-1992). The RTC also took over the insurance functions of the former Federal Home Loan Bank Board. Between 1989 and mid-1995, the Resolution Trust Corporation closed or otherwise resolved 747 thrifts with total assets of \$394 billion. In 1995, its duties were transferred to the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation. Overall, the cost to the taxpayers was estimated at \$124 billion in 1995 dollars.

The RTC operated via so-called 'equity partnership programs'. All equity partnerships involved a private sector partner acquiring a partial interest in a pool of assets. By retaining an interest in asset portfolios, the RTC was able to participate in the extremely strong returns

being realized by portfolio investors. Additionally, the equity partnerships enabled the RTC to benefit by the management and liquidation efforts of their private sector partners, and the structure helped assure an alignment of incentives superior to that which typically exists in a principal/contractor relationship. The various forms of equity partnerships are the following: Multiple Investment Fund (limited and selected partnership, unidentified portfolio of assets), N-series and S-series Mortgage Trusts (competitive bid for identified portfolio of assets), Land fund (to take profit from longer-term recovery and development of land), and JDC Partnership (selection of general partner on a "beauty-contest" basis for claims unsecured or of questionable value).

In Sweden, two bank asset management corporations (AMCs), *Securum* and *Retriva*, were set up to manage the non-performing loans of financial institutions as part of the resolution policy for the financial crisis in 1992/1993. The assets of an ailing bank were split into "good" and "bad" assets, with the bad assets then transferred to one of the asset management corporations, mainly to *Securum*.²⁸ An important feature of the Swedish programme was to force banks to disclose expected loan losses in full and assign realistic values to real estate and other assets. For this, the Financial Supervisory Authority tightened its rules for the definition of probable loan losses as well as for the valuation of real estate. In order to obtain uniform valuation of the real estate holdings of banks applying for support, the Authority set up a Valuation Board with real estate experts. The low market values assigned to the assets in the due diligence process, effectively helped setting a floor for asset values. As market participants did not expect prices to fall below this level, trading was maintained.²⁹ In the long run, the two bank asset management corporations turned out to be successful in the sense that the budgetary cost of supporting the financial system was roughly balanced by the revenues received by the bank asset management corporations from the liquidation of their asset holdings.

In France, a public body enjoying an institutional unlimited State guarantee was created in the 1990s to take over and liquidate over time the bad assets of Credit Lyonnais. The bad bank financed the acquisition of the assets by means of a loan from Credit Lyonnais. The latter, therefore, could avoid recording losses on the assets and free capital for an equivalent amount of risk-weighted assets, as the loan to the bad bank could enjoy a 0% risk weight in view of the State guarantee. The Commission approved the bad bank as restructuring aid. A feature of the model was the neat separation between the good and the bad bank in order to prevent conflicts of interest and the clause "de retour à meilleure fortune" on the good bank's profit to the benefit of the State. After a few years, the bank was successfully privatised. However, transfer of the assets to the bad bank at book value sheltered the shareholders from responsibility for the losses and implied high cost for the State over time.

A couple of years later in Italy, Banco di Napoli was split into a bad bank and a good bank after the absorption of the losses by existing shareholders and a Treasury recapitalisation to the extent necessary to keep the bank afloat. Banco Napoli financed the bad bank's acquisition of the discounted but still impaired assets via a subsidised loan of the Central Bank counter-guaranteed by the Treasury. The cleaned bank was privatised one year later. In neither the case of Credit Lyonnais or Banco di Napoli was there an immediate budgetary outlay for the Treasury for the acquisition of the bad assets, over and above the provision of capital to the banks.

²⁸ See Bergström, Englund and Thorell (2002) and Heikensten (1998a and b).

²⁹ This is in sharp contrast to the Japanese policy setting too high values for "bad" assets, thus freezing the real estate market for about a decade.

A soft form of bad bank has been recently used by Germany in dealing with the bad assets of their Landesbanken. In the SachsenLB case, the beneficiary was sold as a going concern after the bad assets of around € 17.5 billion were channelled into a special purpose vehicle (SPV) with the purpose to hold the assets until maturity. The former owners, the Land of Saxony, gave a loss guarantee for around 17 % of the nominal value, which was considered as the absolute maximum of possible losses in a stress test (the base case was estimated only at 2 %). The new owner took over most of the refinancing and covered the remaining risk. The aid amount was at least considered to go up to the worst case estimate of around 4%. In the WestLB case, a portfolio of assets of € 23 billion was channelled into an SPV and equipped with a government guarantee of € 5 billion so as to cover eventual losses and protect the balance sheet of adjusting the value of the assets according to IFRS. This allowed WestLB to remove the market volatility of the assets from its balance sheet. A guarantee fee of 0.5 % was paid to the state. The risk shield is still in place and is considered to be state aid.

In Switzerland, the government has created a new fund to which UBS has transferred a portfolio of toxic assets that was valued by a third party prior to the transfer. To ensure financing of this fund, Switzerland first injected capital into UBS (in the form of notes convertible into UBS shares), which UBS immediately wrote off and transferred to the Fund. The remainder of the financing of the Fund was ensured by a loan from the Swiss National Bank.

In the late 1990s, the Czech banks lending conditions to corporations were very loose. The Czech banks were burned very severely by that and they had to be bailed out in the late 1990s by the government. Major rounds of cleaning up banks' balance sheets were undertaken in order to establish a healthy banking industry.

In February 1991, the Czech government created a consolidation bank (Konsolidační banka, KOB), established in order to take on bad loans from the banking sector accumulated before 1991 – such as debts inherited from the centrally planned economy, especially those related to trading within the Soviet bloc. In September 2001, the special bank turned into an agency that also had to absorb bad loans connected to "new innovative" loans (especially so-called privatization loans, nonperforming loans and fraudulent loans).

Starting in 1991, larger banks were freed from bad loans and as of 1994 emphasis shifted to smaller banks. In particular, the failure of Kreditní banka in August 1996, and a subsequent partial run on Agrobanka, caused some strain on the Czech banking system. The programmes concerned led only to a temporary increase of state ownership in banking in 1995, and again in 1998, due to the revocation of the license of Agrobanka. Overall, the government share in banking rose to 32% at the end of 1995 from 29% in 1994.

Moreover, to support the small banks, another programme - the Stabilisation Programme – was approved in 1997. This essentially consisted of replacing poor-quality assets with liquidity of up to 110% of each participating bank's capital through the purchase of poor-quality assets from the bank by a special company called Česká finanční, with subsequent repurchase of the residual amount of these assets within 5 to 7-year horizon. Six banks joined the programme, but five of these were excluded after failing to comply with its criteria and subsequently went out of business. Thus, the Stabilisation Programme has not been successful and was halted.

By the end of 1998, 63 banking licences had been granted (60 of these before the end of 1994). As of end-September 2000, 41 banks and branches of foreign banks remained in

business, 16 were under extraordinary regimes (8 in liquidation, 8 involved in bankruptcy proceedings), 4 had merged with other banks, and the licence of one foreign bank had been revoked because it had failed to start its operations. Out of the 41 remaining institutions (including CKA) 15 were domestically controlled banks and 27 foreign-controlled banks, including foreign subsidiaries and foreign branches.

In May 2000, the amended Act on Bankruptcy and Settlement and the Act on Public Auctions became effective, which aimed at accelerating bankruptcy proceedings and balancing creditors' and debtors' rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements.

Annex 3

The definition of categories (“baskets”) of eligible assets and full disclosure concerning the impaired assets as well as the entire business activities of a bank

I. The definition of categories (“baskets”) of eligible assets

The definition of baskets of impaired financial assets of banks should be a common denominator based on categories that are already used for:

- (1) prudential reporting and valuation (Basel pillar 3 = CRD Annex XII; FINREP and COREP);
- (2) Financial reporting and valuation (IAS 39 and IFRS 7 in particular);
- (3) Specialised ad hoc reporting on the credit crisis: IMF, FSF, Roubini and CEBS work on transparency.

Using a common denominator of existing reporting and valuation categories for defining asset baskets will:

- prevent any additional reporting burden for banks;
- allow to assess the basket of impaired assets of individual banks to Community and global estimates (which can be relevant for determining the "economic value" at a point in time); and
- provide objective (certified) starting points for the valuation of impaired assets.

Taking into account the above the Commission suggests the following baskets of financial assets as an entry point for determining the "economic value" and the asset impairment relief:

Table 1:

I Structured finance / securitised products						
	Type of product	Accounting category	Valuation basis for the scheme			Comments
			Market value	Economic Value	Transfer Value	
1	RMBS	FVPL / AFS*				Further refined into: geographic area, seniority of tranches, ratings, sub-prime or Alt-A related, or other underlying assets,
2	CMBS	FVPL / AFS				
3	CDO	FVPL / AFS				

4	ABS	FVPL / AFS				maturity / vintage , allowances and write-offs
5	Corporate debt	FVPL / AFS				
6	Other loans	FVPL / AFS				
			Total			

II Non securitised loans

	Type of product	Accounting category	Valuation basis for the scheme			Comments
			Cost**	Economic Value	Transfer Value	
7	Corporate	HTM/ L&R*	Cost**			Further refinement on: geographic area, counterparty risk (PD) credit risk mitigation (collateral) and maturity structures; allowances and write-offs.
8	Housing	HTM/ L&R	Cost			
9	Other personal	HTM/ L&R	Cost			
			Total			

* FVPL = Fair value through profit and loss = trading portfolio + fair value option); AFS = available for sale, HTM = Held to Maturity, L&R = loans and receivables.

** Cost means the carrying amount of the loans minus impairment.

II. Full disclosure concerning impaired assets and the related business activities

On the basis of these asset baskets, the information provided on the impaired assets of a bank which should be covered by an asset-relief measure should be presented with a further degree of granularity as suggested in the comment column of Table 1.

On the basis of good practices observed by the Committee of European Banking Supervisors³⁰ (CEBS) for disclosures on activities affected by the market turmoil, information on the bank's activities related to the impaired assets that would feed into the viability review referred to in section 5.1 could be structured as follows:

Table 2:

CEBS observed good practices	Senior Supervisors Group (SSG):
	Leading Practice Disclosures

³⁰ Source: CEBS (Committee of European Banking Supervisors) report on banks' transparency on activities and products affected by the recent market turmoil, 18 June 2008

<p>Business model</p> <ul style="list-style-type: none"> • Description of the business model (i.e. of the reasons for engaging in activities and of the contribution to value creation process) and, if applicable of any changes made (e.g. as a result of crisis). • Description of strategies and objectives. • Description of importance of activities and contribution to business (including a discussion in quantitative terms). • Description on the type of activities including a description of the instruments as well as of their functioning and qualifying criteria that products/ investments have to meet. • Description of the role and the extent of involvement of the institution, i.e. commitments and obligations. 	<ul style="list-style-type: none"> • Activities (SPE).* • Nature of exposure (sponsor, liquidity and/or credit enhancement provider) (SPE). • Qualitative discussion of policy (LF).
<p>Risks and risk management</p> <ul style="list-style-type: none"> • Description of the nature and extent of risks incurred in relation to the activities and instruments. • Description of risk management practices of relevance to the activities, of any identified weaknesses of any corrective measures that have been taken to address these. • In the current crisis, particular attention should be given to liquidity risk. 	
<p>Impact of the crisis on results</p> <ul style="list-style-type: none"> • Qualitative and quantitative description of results, with a focus on losses (where applicable) and write-downs impacting the results. • Breakdown of the write-downs/losses by types of products and instruments affected by the crisis (CMBS, RMBS, CDO, ABS and LBO further broken down by different criteria). • Description of the reasons and factors responsible for the impact incurred. • Comparison of i) impacts between (relevant) periods and of ii) income statement balances before and after the impact of the crisis. • Distinction of write-downs between realised and unrealised amounts. • Description of the influence the crisis had on the firm's share price. • Disclosure of maximum loss risk and description how the institution's situation could be affected by a further downturn or by a market recovery. • Disclosure of impact of credit spread movements for own liabilities on results and on the methods used to determine this impact. 	<ul style="list-style-type: none"> • Change in exposure from the prior period, including sales and write-downs (CMB/LF)

<p>Exposure levels and types</p> <ul style="list-style-type: none"> • Nominal amount (or amortised cost) and fair values of outstanding exposures. • Information on credit protection (e.g. through credit default swaps) and its effect on exposures. • Information on the number of products • Granular disclosures of exposures with breakdowns provided by: <ul style="list-style-type: none"> • level of seniority of tranches; • level of credit quality (e.g. ratings, investment grade, vintages); • geographic origin; • whether exposures have been originated, retained, warehoused or purchased; • product characteristics: e.g. ratings, share of sub-prime mortgages, discount rates, attachment points, spreads, funding; • characteristics of the underlying assets: e.g. vintages, loan-to-value ratios, information on liens, weighted average life of the underlying, prepayment speed assumptions, expected credit losses. • Movement schedules of exposures between relevant reporting periods and the underlying reasons (sales, disposals, purchases etc.). • Discussion of exposures that have not been consolidated (or that have been recognised in the course of the crisis) and the related reasons. • Exposure to monoline insurers and quality of insured assets: <ul style="list-style-type: none"> • nominal amounts (or amortized cost) of insured exposures as well as of the amount of credit protection bought; • fair values of the outstanding exposures as well as of the related credit protection; • amount of write-downs and losses, differentiated into realised and unrealised amounts; • breakdowns of exposures by ratings or counterparty. 	<ul style="list-style-type: none"> • Size of vehicle versus firm's total exposure (SPE / CDO). • Collateral: type, tranches, credit rating, industry, geographic distribution, average maturity, vintage (SPE/CDO/CMB/LF). • Hedges, including exposures to monolines, other counterparties (CDO). Creditworthiness of hedge counterparties (CDO). • Whole loans, RMBS, derivatives, other (O). • Detail on credit quality (such as credit rating, loan-to-value ratios, performance measures) (O) • Change in exposure from the prior period, including sales and write-downs (CMB/LF) • Distinction between consolidated and non consolidated vehicles. Reason for consolidation (if applicable) (SPE). • Funded exposure and unfunded commitments (LF)
<p>Accounting policies and valuation issues</p> <ul style="list-style-type: none"> • Classification of the transactions and structured products for accounting purposes and the related accounting treatment. • Consolidation of SPEs and other vehicles (such as VIEs) and a reconciliation of these to the structured products affected by the sub-prime crisis. • Detailed disclosures on fair values of financial instruments: <ul style="list-style-type: none"> • financial instruments to which fair values are applied; • fair value hierarchy (a breakdown of all exposures measured at fair value by different levels of the fair value hierarchy and a breakdown between cash and derivative instruments as well as disclosures on migrations between the different levels); • treatment of day 1 profits (including quantitative information); • use of the fair value option (including its conditions for use) and related amounts (with appropriate breakdowns). • Disclosures on the modelling techniques used for the valuation of financial instruments, including discussions of the following: <ul style="list-style-type: none"> • description of modelling techniques and of the instruments to which they are applied; • description of valuation processes (including in particular discussions of assumptions and input factors the models rely on); • type of adjustments applied to reflect model risk and other valuation uncertainties; • sensitivity of fair values; and • stress scenarios. 	<ul style="list-style-type: none"> • Valuation methodologies and primary drivers. (CDO). • Credit valuation adjustments for specific counterparties (CDO). • Sensitivity of valuation to changes in key assumptions and inputs (CDO).
<p>Other disclosure aspects</p> <ul style="list-style-type: none"> • Description of disclosure policies and of the principles that are used for disclosures and financial reporting. 	

Presentation issues

- Relevant disclosures for the understanding of an institution's involvement in a certain activity should as far as possible be provided in one place.
- Where information is spread between different parts or sources clear cross-references should be provided to allow the interested reader to navigate between the parts.
- Narrative disclosures should to the largest extent possible be supplemented with illustrative tables and overviews to improve the clarity.
- Institutions should ensure that the terminology used to describe complex financial instruments and transactions is accompanied by clear and adequate explanations.

* In the SSG Report, each feature refers to an specific type of SPE, or to all of them as a whole, being SPE (Special Purpose Entities in general), LF (Leveraged Finance), CMB (Commercial Mortgage-Backed Securities), O (Other sub-prime and Alt-A Exposures), CDO (Collateralised Debt Obligations)

Annex 4

Valuation and pricing principles and processes

I. Valuation methodology and procedure

For the purposes of the measures, assets should be classified along the lines of the illustrative tables 1 and 2 in Annex 3.

The determination of the real economic value within the meaning of this Communication (see section 5.5) should be based on observable market inputs and realistic and prudent assumptions about future cash flows.

The valuation method to be applied to eligible assets should be agreed at the Community level and could vary with the individual assets or baskets of assets concerned. Whenever possible, such valuation should be re-assessed in reference to the market at regular intervals over the life of the asset.

In the past, several valuation options have been applied more or less successfully. Simple reverse auction procedures proved useful in the case of categories of assets where market values are reasonably certain. However, this approach failed in valuing more complex assets in the United States. More sophisticated auction procedures are more adapted where there is less certainty about market values and a more exact method of price discovery of each asset would be needed. Unfortunately, their design is not straightforward. The alternative of model-based calculations for complex assets presents the drawback of being sensitive to the underlying assumptions³¹.

The option of applying uniform valuation haircuts to all complex assets simplifies the process of valuation overall, although it results in less accurate pricing of individual assets. Central banks have substantial experience regarding possible criteria and parameters for collateral pledged for refinancing, which could serve as a useful reference. .

Whatever the model chosen, the valuation process and particularly the assessment of the likelihood of future losses should be based on rigorous stress-testing against a scenario of protracted global recession.

The valuation must be based on internationally recognised standards and benchmarks. A common valuation methodology agreed at the Community level and consistently implemented by Member States could greatly contribute to mitigating concerns regarding threats to a level playing field resulting from potentially significant implications of discrepant valuation

³¹ In any case, an auction would only be possible for homogeneous classes of assets and where there exist a sufficiently large number of potential sellers. In addition a reserve price would need to be introduced to ensure the protection of the interest of the State and claw back mechanism in case the final losses would exceed the reserve price, so as to ensure a sufficient contribution by the beneficiary bank. In order to assess such mechanisms, comparative scenarios with alternatives guarantee/purchase schemes will have to be submitted, including stress tests, in order to guarantee their global financial equivalence.

systems. When assessing the valuation methods put forward by Member States for asset-relief measures, the Commission will, in principle, consult panels of valuation experts³².

II. The pricing of State support on the basis of valuation

The valuation of assets must be distinguished from the pricing of a support measure. A purchase or insurance on the basis of the established current market value or the 'real economic value', factoring in future cash flow projections on a hold-to-maturity basis, will in practice often exceed the present capacities of beneficiary banks for burden-sharing³³. The objective of the pricing must be based on a transfer value as close to the identified real economic value as possible. While implying an advantage as compared to the current market value and thus State aid, pricing on the basis of the 'real economic value' can be perceived as counterbalancing current market exaggerations fuelled by current crisis conditions which have led to the deterioration or even collapse of certain markets. The greater any deviation of the transfer value from the 'real economic value', and thus the amount of aid, the greater the need for remedial measures to ensure accurate pricing over time (for example, through better fortune clauses) and for more in-depth restructuring. The admissible deviation from the result of valuation should be more restricted for assets the value of which can be established on the basis of reliable market input than for those for which markets are illiquid. Non-compliance with these principles would represent a strong indicator for the necessity of far-reaching restructuring and compensatory measures or even an orderly winding-up.

In any event, any pricing of asset relief must include remuneration for the State that adequately takes account of the risks of future losses exceeding those that are projected in the determination of the 'real economic value' and any additional risk stemming from a transfer value above the real economic value.

Such remuneration may be provided by setting the transfer price of assets at below the 'real economic value' to a sufficient extent so as to provide for adequate compensation for the risk in the form of a commensurate upside, or by adapting the guarantee fee accordingly.

Identifying the necessary target return could be 'inspired' by the remuneration that would have been required for recapitalisation measures to the extent of the capital effect of the proposed asset relief. This should be in line with the Commission communication on the recapitalisation of banks³⁴, while taking into account the specific features of asset-relief measures and particularly the fact that they may involve higher exposure than capital injections³⁵.

The pricing system could also include warrants for shares in the banks equal in value to the assets (implying that a higher price paid will result in a higher potential equity stake). One model for such a pricing system could be an asset purchase scenario, in which such warrants

³² The Commission will use the opinion of such panels of valuation experts in a manner similar to other State aid proceedings, where it may have recourse to external expertise.

³³ See section 5.2.

³⁴ Communication from the 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*, OJ C 10, 15.01.2009, p. 2.

³⁵ In an asset guarantee scenario, it would also have to be taken into consideration that in contrast to recapitalisation measures, no liquidity is provided.

will be returned to the bank once the assets are sold by the bad bank and if they have earned the necessary target return. If the assets do not yield such a return, the bank should pay the difference in cash to reach the target return. If the bank does not pay the cash, the state would sell the warrants to achieve the target return.

In an asset guarantee scenario, the guarantee fee could be paid in the form of shares with a fixed cumulative interest representing the target return. Where the guarantee needs to be drawn upon, the Member State could use the warrants to acquire shares corresponding to the amounts that had to be covered by the guarantee.

Any pricing system would have to ensure that the overall contribution of beneficiary banks reduces the extent of net State intervention to the minimum necessary.

Annex 5

State aid procedure

Member States notifying asset-relief measures shall provide the Commission with comprehensive and detailed information on all the elements of relevance for the assessment of the public support measures under the State aid rules as set out in this Communication³⁶. This includes notably the detailed description of the valuation methodology and its intended implementation involving independent third-party expertise³⁷. Commission approval will be granted for a period of 6 months, and conditional on the commitment to present either a restructuring plan or a viability review for each beneficiary institution within 3 months from its accession to the asset relief programme.

Where a bank is granted aid either as an individual measure or under an approved asset-relief scheme, the Member State shall provide the Commission, at the latest in the individual notification concerning the restructuring plan or viability review, with detailed information regarding the assets covered and its valuation at the time such individual aid is granted, as well as the certified and validated results of the disclosure of impairments concerning the assets covered by the relief measure³⁸. The full review of the bank's activities and balance sheet should be provided as soon as possible to initiate discussions on the appropriate nature and extent of restructuring well in advance of the formal presentation of a restructuring plan with a view to accelerating this process and providing clarity and legal certainty as quickly as possible.

For banks that have already benefited from other forms of State aid, be it under approved guarantee, asset swaps or recapitalisation schemes or individual measures, any assistance granted under the asset-relief scheme is to be reported first under existing reporting obligations so that the Commission has a complete picture of multiple State aid measures benefiting an individual aid recipient and can better appreciate the effectiveness of the previous measures and the contribution that the Member State proposes to introduce in a global assessment.

The Commission will reassess the aid granted under temporary approval in light of the adequacy of the proposed restructuring and the remedial measures³⁹, and take a view on its compatibility for longer than 6 months through a new decision.

Member States shall also provide a report to the Commission every six months on the functioning of the asset-relief programmes and on the development of the banks' restructuring plans. Where the Member State is already subject to a reporting requirement for other forms of aid to their banks, such a report shall be complemented with the necessary information concerning the asset-relief measures and the banks' restructuring plans.

³⁶ Pre-notification contact is encouraged.

³⁷ See section 5.5 above and Annex 4.

³⁸ A letter from the head of the supervisory authority certifying the detailed results shall be provided.

³⁹ In order to facilitate the work of the Member States and the Commission, the Commission will be prepared to examine grouped notifications of similar restructuring/ winding-up cases. The Commission may consider that there is no need to submit a plan for the pure winding up of an institution, or where the size of the institution is negligible.