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Competition First? Application of State Aid Rules in the Banking Sector

*Szymon Gebski**

The paper discusses application of the State aid rules in the banking sector. It compares the rules relevant to that sector before October 2008 with the legislative framework adopted as a response to the financial crisis. The research question is focused on how the balance between limiting distortions of competition and rebuilding financial stability is struck, and on a more general level it examines the role of State aid control in managing the financial crisis. The paper finds that the Commission has firmly applied the legal test on the notion of aid, mainly due to its expertise originating from previous cases in the banking sector. On the compatibility level, in the rescue phase the crux of the method is a relaxed approach towards solvent banks, with due safeguards concerning remuneration, exit and lending to the real economy. This allowed the stabilization of the financial system, with the cost of treating competition issues as subordinate. In the restructuring of distressed banks, the overriding aim of financial stability serve to justify various measures that are otherwise not a standard under the R&R Guidelines. For that reason the risk of moral hazard may be hardly evitable in the future. With regard to the management of the crisis, it is submitted that under Article 87(3)(b) State aid should be compatible as a part of a broader structural and regulatory programme.

1. INTRODUCTION

The ongoing financial turmoil has left a considerable footprint on the EC State aid legal framework. From October 2008 the European Commission (the Commission) has adopted under Article 87(3)(b) a new legislative package, which aims to remedy a serious disturbance in the Member States' economies. The newly adopted secondary legislation is based on principles of the Community guidelines on State aid for rescuing and restructuring firms in difficulty (the R&R Guidelines), but sets more detailed provisions reflecting the systemic risks addressed. The paper analyses the new legislation[1] and compares it with the former approach to State aid control in the banking sector in order to observe how the Commission has reconciled the goal of limiting the distortion of competition with the overriding aim of financial stability, and to examine the role of State aid control in managing the current financial crisis.

It is submitted that the recently adopted State aid rules set a new balance between competition and financial stability. Under the rescue aid this is achieved through a distinction between sound and distressed banks, whereas in the restructuring phase the overriding principle of financial stability largely influences the scope of compatibility rules. As regards crisis management by the Commission through State aid rules, a two-step approach is defined. In the first place, the Commission preserved basic principles of the State aid legal framework and ensured coordination of public interventions,

* Ph.D. candidate at the Law Department, European University Institute.

[1] The paper concerns developments up to 09.09.2009.

whereas, in the second place, it has taken a more pro-active approach through the regulation of restructuring in the banking sector.

As a starting point, the paper looks at the notion of State aid, as developed in the recent decisions taken by the Commission, pursuant to a massive notification by Member States of rescue measures. Secondly, it examines the legal base and conditions for State intervention in the banking sector, both under the R&R Guidelines and the new legislative framework. The question that this part of the paper tackles, is how Article 87(3)(b) allows the operationalision of the reduction of systemic risks while preserving competition.

2. APPLICATION OF ARTICLE 87(1) CRITERIA IN THE BANKING SECTOR. THE RULE OF LAW AS LEVERAGE TO COORDINATED CRISIS MANAGEMENT

2.1. Political Engagement to Preserve the Rule of Law

The logic of the EC Treaty provisions on State aid implies that the discretionary power of the Commission (exercised under Article 87(3) EC) is triggered insofar as a given State measure fulfils criteria set in Article 87(1) EC. This first step of scrutiny is, therefore, of great importance not only as to its impact on principles guiding national measures and their material scope, but it also implies increased role of the Commission in drafting and implementation of national public policies.

Although the current financial turmoil has provoked a sudden and massive involvement of national measures, the Commission has managed to find consistently the existence of State aid, and to preserve unconditionally the logic embedded in the Treaty. However, what is a recurrent practice of the Commission in normal times, might not be as obvious in the exceptional circumstances of a financial crisis where banks may fail overnight. Hence, it has to be pointed out that preservation of the logic of State aid control in the current crisis seems to be first a result of a political commitment, expressed by Member States during the ECOFIN Council on 7th October 2008, to take measures that enhance the soundness and stability of the banking sector. What is crucial is that the Council underlined the need to establish a coordinated framework and a set of common principles that would guide national measures, among which it enumerated a protection of the legitimate interest of competitors through state aid rules.[2] Recommendations of the ECOFIN Council confirmed the political mandate of the Commission to act pursuant to State aid practice, and more importantly gave a sign that Member States were not willing at that time to avail of Article 88(2) EC, which would have allowed them, subject to unanimity in the Council, to approve exceptional measures addressing the crisis and to bypass the Commission's discretion. This risk of decreasing the rule of law in State aid control, for the sake of addressing financial stability, has not materialised.

[2] See the press release of the 2894th Ecofin Council meeting on 7 October 2008 (13784/08), available on the Council's website at: www.consilium.europa.eu.

2.2. Application of Article 87(1) to Emergency Rescue Measures in the Banking Sector

Article 87(1) states that:

> 'save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market'.[3]

The European Court of Justice (ECJ) has confirmed in *Altmark* that:

> 'Article 92(1) of the Treaty lays down four conditions. First, there must be an intervention by the State or through State resources. Second, the intervention must be liable to affect trade between Member States. Third, it must confer an advantage on the recipient. Fourth, it must distort or threaten to distort competition'.[4]

The focus of examination by the Commission, and therefore analysis of this paper, is primarily on the notion of state resources and on the issue of selectivity and economic advantage. The effect on trade and distortion of competition usually play little role in Commission's assessment of State measures under Article 87(1), this has been even further exacerbated in the examination of measures adopted in the current crisis.

2.2.1. Intervention by the State or through State resources

As clarified by the Court in *Stardust Marine*[5] and *Pearl*,[6] in order to qualify as State aid a measure has to be granted directly or indirectly through State resources and be imputable to the State. In the current crisis, this condition has been fulfilled by the mere fact that any transfer of financial resources, in the form of direct recapitalisation or when triggered by the State guarantee, in fact involved public resources originating directly from the State's budget or a special fund created for that purpose by the State.[7] The Commission found that a guarantee scheme was imputable to the State when the support was to be provided by means of a fund governed by private law, in which the State held 34% of capital, whereas major private banking groups owned 66% of the capital.[8] Despite the majoritarian participation of private capital, the resources were

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[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12006E087:EN:HTML.

[4] C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECR I-07747, para 75.

[5] C-482/99 *French Republic v Commission* [2002] ECR I-04397, paras 23-24.

[6] C-345/02 *Pearle BV, Hans Prijs Optiek Franchise BV and Rinck Opticiëns BV v Hoofdbedrijfschap Ambachten* [2004] ECR I-07139, paras 36-37.

[7] Commission Decision NN 48/2008 of 13.10.2008 *Guarantee scheme for banks in Ireland*, OJ C(2008)6059, para 45.

[8] This was the case of "La société de refinancement des activités des établissements de crédit" (SRAEC), created to issue bonds guaranteed by the French State, and consequently to use the funds collected to finance French banks registered and operating in France, Commission Decision N 548/08 of 30.10.2008 *Mesures de refinancement en faveur des institutions financieres*, OJ C(2008)6617, para 5.

imputable to the State due to its right of veto and the fact that *in fine* the State bore economic risks of the fund's operations.[9]

The Commission also found that a measure was imputable to the State when it was first publicly announced by representative of a government and when such declaration was enshrined in a national legislative act.[10] Quite importantly, Member States have proceeded from announcement of a measure to its enactment, which allowed for a clear-cut application of Article 87(1). However, the Commission has recognised in the past that the focus on effects should be extended to also take into account the intent to award aid. This somewhat innovative approach allowed for a mere announcement on the part of public authorities, which aimed to pre-empt downgrading of a bank by rating agencies, to be capable of constituting State aid.[11] Given the fragility of the balance of power between the Commission and the Member States in the area of State aid, it has to be welcomed that the latter abstained from massively announcing the intent to provide State support, with a view to merely induce reaction of financial markets. The work of the Commission might have been obstructed, if the Member States had in the end desisted from providing such support.

2.2.2. Selectivity and addressing 'systemic' risks

One striking element of those few decisions adopted in October 2008 is that initially some Member States claimed that the criterion of selective economic advantage was not fulfilled. First, as concerns selectivity, the measures adopted clearly escaped qualification as general economic policy measures, since they primarily concerned the banking sector and sectoral aid has always been considered by the Court selective.[12] The sole exception seems to concern measures provided by a national central bank, when it acts within the remit of a monetary authority of the Eurosystem.[13] The Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (the Banking Communication) provided that individual support to a financial institution by a central bank was not State aid when the beneficiary was solvent, the liquidity was fully secured by a collateral and provided at a market rate.[14] This is in line with the argument

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9 Ibid, para 55.

10 Ibid, para 44.

11 Commission Decision NN 25/2008 of 30.04.2008 *WestLB riskshield*, para 37. Along the same line the Commission decided in the France Telecom, where it pointed out that 'an announcement which induced the rating agencies from further downgrading France Telecom was capable of constituting state aid, because such public declarations are equivalent from a legal standpoint to a guarantee and were placing the State's reputation on the line, with economic costs in the event of non-compliance' - see Commission Decision C 13a/2003 of 2.08.2004 *France Telecom*, OJ 2006, L 257/55, para 194.

12 C-173/73 *Italy v Commission* [1974] ECR 00709, para 17.

13 Communication from the Commission of 25.10.2008 on The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ 2008, C270/8, para 51; Commission Decision N 533/2008 of 29.10.2008 *Support measures for the banking industry in Sweden*, OJ C(2008)6538, para 32.

14 OJ 2008, C270, para 51.

prevailing in the academic literature, that intervention by a central bank, acting as 'a lender of last resort', is conceived along the deposit insurance, as a way to prevent or minimise negative effects of a crisis.[15] From a State aid law perspective, measures adopted by central banks seem to correspond to the first best solution, which under the modernised balancing test enshrined in the State Aid Action Plan has to be privileged over State aid.[16]

It can be argued that the Commission views the support provided by central banks restrictively. It recognised that some beneficiaries fulfilled conditions required for a central bank's intervention (i.e. had a particular quality of collateral) only as a result of a previous State aid. Although from the point of view of the central bank such State measure was irrelevant, the liquidity provided by it to a beneficiary (especially when it formed a package of measures taken in parallel by the government and the central bank) constituted aid, as the collateral was only eligible due to a previously granted State measure.[17] Accumulation of such support resulted in a rather unusual examination by the Commission of measures taken by a central bank under the compatibility rules of the R&R Guidelines.[18]

With regard to selectivity the Commission has consistently resisted pressure to allow for measures addressed only at the major national financial institutions. Application of the principle of non-discrimination was tested in the exemplary case of the Irish guarantee scheme, where the Ministry of Finance had initially intended to apply the scheme to six major Irish banks, which were indicated by the central bank as those facing the greatest risk from the systemic perspective. It was only within the dialogue with the Commission that Ireland extended the scope of the guarantee to other banks' subsidiaries in Ireland, 'with a significant and broad based footprint in the domestic economy', as well as to foreign branches of 'a systemic significance'.[19] In search of an objective and non-discriminatory method for eligibility of financial institutions some States opted for a specific quota of the market share. This was the case of the Spanish guarantee scheme, which indicated that all solvent credit institutions registered in Spain and having a share of at least 1/1000 of the credit market were eligible for a guarantee.[20] Along the same line, introduction of the objective criterion relating to a percentage of Tier 1 or Tier 2 capital, to allow only sufficiently capitalised banks to avail of the guarantee, was not found discriminatory.[21]

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15 E Carletti, 'Competition and financial markets' OECD Discussion Paper DAF/COMP(2009)2, pp 5-6.

16 State Aid action plan: Less and better targeted state aid: a roadmap for state aid reform 2005-2009, European Commission Consultation Document COM (2005)107, p 7.

17 Commission Decision N 520a/2008 of 13.11.2008 *Urgent measures to guarantee the stability of the Italian banking system*, OJ C(2008)6989, para 60; N 533/2008, op cit, n 13, para 33.

18 Communication from the Commission of 01.10.2004, OJ 2004, C244/2.

19 Commission Decision NN 48/2008, op cit, n 7, para 47.

20 Commission Decision NN 54/B/2008 of 23.12.2008 *Guarantee scheme for credit institutions in Spain*, C(2009)3069, para 41.

21 Commission Decision N 533/2008, op cit, n 13, para 5.

The problem of eligibility of potential beneficiaries reflects well the balance required between a clearly discriminatory aid addressed only to 'national' banks and support to financial institutions of significant importance to national economy, which are considered as 'systemic'. Application of objective criteria to banks incorporated and operating in a given State appears to provide for a non-discriminatory character of a measure. However, this legal requirement of non-discrimination, driven by internal market concerns, has the effect that not only large and 'systemic' banks, but in practice also smaller banks are eligible for aid. In consequence, all banks seem to qualify as 'systemic', which mirrors the specific rationale of public intervention in the banking sector, as explained in economic theory. This is exemplified by a recent decision on restructuring aid to Kaupthing Bank,[22] where the Commission found a bank with €2.3bn balance sheet and 23,000 depositors to be systemic.

2.2.3. Economic advantage

The issue that raised most concerns in the application of Article 87(1) to the first rescue measures notified in October 2008 was the exercise of the Market Economy Investor Principle (MEIP).[23] Again, we can observe that Ireland, being among the first States to provide support to its banking sector, asserted that the guarantee involved no aid as it was to be provided on commercial terms, in accordance with the MEIP. The State would charge a fee for the provision of the guarantee and it would attach additional conditions to limit possible misuse of the scheme.[24] Nevertheless, the Commission noted that given the very large scope of the guarantee in current financial circumstances no private investor would have granted such support, in terms of its material scope and the overall value. Hence, it pointed out that such guarantees do not exist on the market and, given that the measure allowed to achieve the intended result of intervention, it could be granted only by the State.[25] Moreover, the Commission refused to calculate the remuneration only on the grounds of additional cost for the State induced by the guarantee.[26] In its decision concerning the Danish guarantee scheme, the Commission stated that private participation did not alter the State aid element, and recalled that concomitance of public and private interventions has to be proportionate to each party's interest and provided under the same conditions and industrial rationale.[27] This was a clear-cut application of the previous line of case-law, as established in *Alitalia*.[28] Therefore, the deposit guarantee scheme with a capped banking industry contribution

22 Commission Decision N 344/09 of 09.07.2009, paras 54-55.

23 Its usefulness with regard to the banking sector was proven in the German Landesbanken cases, T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale and Land Nordrhein-Westfalen v Commission* [2003] ECR II-00435.

24 Commission Decision NN 48/2008, op cit, n 7, para 36.

25 Ibid, para 48.

26 Ibid, para 50.

27 Commission Decision NN 51/2008 of 10.10.2008 *Guarantee scheme for banks in Danemark*, C(2008)6034, para 32.

28 T-296/97 *Alitalia - Linee aeree italiane SpA v Commission* [2000] ECR II-03871, para 81.

did not escape the State aid prohibition, when the State bore unlimited liability above the sum provided by the private sector. It was only the unlimited liability of the State that conferred a sufficient credibility for the guarantee to achieve its effect.[29]

Thus, the Commission explicitly rejected any possibility for the State intervention in the current financial turmoil to escape Article 87(1).[30] This is a corollary of the fact that the public intervention is mainly driven by the purpose of addressing financial crisis. Subsequently, (i) the Commission managed to qualify as State aid all measures taken by the Member States in the current financial turmoil, except for a limited scope of measures taken by central banks, and (ii) consequently gained power to exercise discretion over measures notified by Member States. It can be claimed that this firm and convincing application of Article 87(1) has been only possible due to the Commission's past practice concerning aid granted to the banking sector and, in particular, a more elaborate application of the MEIP. Secondly, due to the potential risk for the State of being forced to repay the illegal aid, the Commission's position vis à vis Member States has been reinforced.[31] Thus, the logic of Article 87(1) prevailed over a temptation to avail of the seriousness of the crisis, to create a parallel system of exceptions[32] driven by the aim of aid, i.e. financial stability, directly under Article 87(1). Hence, the Commission has defended its position as a guardian of the State aid principles embedded in Article 87(1).

3. Competition, Financial Stability, Return to Viability or Preventing Moral Hazard. How Does a Compatibility Assessment Under Article 87(3)(b) and (c) Allow Managing the Multiplicity of Goals?

3.1. Application of State Aid Rules to the Banking Sector under the R&R Guidelines.

3.1.1. Particularity of the rescue and restructuring in the banking sector.

The logic of the R&R Guidelines is that a rescue aid is a one-time assistance aiming to keep the ailing firm afloat for the time needed to work out a restructuring or liquidation plan.[33] It should be restricted to a minimum necessary to keep the firm in business for the rescue period. The second step foresees a possibility to grant restructuring aid,

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[29] Commission Decision NN 51/2008, op cit, n 27, point 32.

[30] Commission Decision N 548/08, op cit, n 8, point 58.

[31] C-199/06 *Centre d'exportation du livre français (CELF) and Ministre de la Culture et de la Communication v Société internationale de diffusion et d'édition (SIDE)* [2008] ECR I-00469, paras 51-52.

[32] For a discussion of such possibility see Ch Koenig, 'Instant State Aid Law in Financial Crisis, State of Emergency or Turmoil', EStAL 4/2008, pp 627-629. In that context it has to be recalled that case-law decisively rejects the possibility to reduce the material scope of Article 87(1) by giving legal value to aims of a measure; see C-487/06 P, *British Aggregates Association v Commission* [2008] ECR I-10505, para 92.

[33] OJ C 244, op cit, 18, para 15.

which has to be based on 'a feasible, coherent and far-reaching plan to restore a firm's long-term viability'.[34] Financial and physical restructuring may involve:

> 'reorganisation and rationalisation of the firm's activities on to a more efficient basis, typically involving the withdrawal from loss-making activities, the restructuring of those existing activities that can be made competitive again and, possibly, diversification in the direction of new and viable activities'.[35]

A particularity of the rescue and restructuring aid is that it directly neutralises the effect of a competitive process that leads to loss-making and exit of a firm. Pursuant to Schumpeter's theory of creative destruction, innovation and entrepreneurship allow new entrants to gain market power that erodes the position of old firms and ultimately may cause the exit of such firms.[36] As the economic theory suggests, loss-making is a market signal that resources are better used elsewhere; hence a subsidy to the undertaking in difficulty allows it to maintain or increase its market share at the expense of its rivals.[37] From this perspective the R&R aid has a clear anticompetitive effect.

One of the few exceptions, for which assumptions mentioned supra do not hold, concerns the banking sector, where a failure of one institution can lead to a loss of confidence in the market as a whole, resulting in negative externalities (risk of contagion) for other financial institutions.[38] Origins of this specificity of the banking sector lie in its vulnerability to bank runs, resulting both from a loss of confidence by depositors, from banks' poor performance and their propensity to take excessive risks on the asset side.[39] Thus, a collapse of a bank may have negative effects on financial stability. Although 'financial stability' appears to be the major justification for the current massive intervention in the financial sector and is explicitly referred to as a rationale underlying the recently adopted set of legislation, the term lacks a clear definition.

Financial stability can be defined as:

> 'the joint stability of the key financial institutions operating within financial markets and the stability of those markets. For the financial institutions, this generally means that they are sound, meaning that they have sufficient capital to absorb normal, and at times abnormal, losses and sufficient liquidity to manage operations and volatility in normal periods of time. Market stability … generally [means] the

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[34] Ibid, para 17.

[35] Ibid.

[36] B Lyons, J Van Reenen, F Verboven, X Vives, 'EAGCP Commentary on European Community Rescue and Restructuring Aid Guidelines' of 6 February 2008, p 4.

[37] Ibid, p 2.

[38] Ibid.

[39] E Carletti, op cit, n 15, pp 3-6.

> absence of the kind of volatility that could have severe real economic consequences'.[40]

Financial stability can be also defined as a situation in which the financial system is capable of performing its three key functions simultaneously:

> 'First, the financial system is efficiently and smoothly facilitating the intertemporal allocation of resources from savers to investors and the allocation of economic resources generally. Second, forward-looking financial risks are being assessed and priced reasonably accurately and are being relatively well managed. Third, the financial system is in such condition that it can comfortably if not smoothly absorb financial and real economic surprises and shocks [systemic risks]'.[41]

This definition implies that the objective embedded in financial stability is to maintain the functioning of financial system and its ability to support the efficient functioning of the economy, which can be achieved by putting in place, 'mechanisms to prevent financial problems from becoming systemic or from threatening the stability of the financial and economic system'.[42] Therefore, it signifies that financial stability can be both a short and a long-term exercise, which encompasses both addressing systemic risks and regulatory crisis prevention.

The systemic risk is defined as, 'the risk that an event will trigger a loss of economic value or confidence in (…) a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy'.[43] The effect of systemic risks on the economy can occur through payment system disruptions, causing a failure of illiquid but solvent firms; disruptions in credit flows, creating reductions in the supply of funds to finance investments; and collapses in asset prices, inducing failures of financial as well as non-financial firms and households and decreasing economic activity.[44]

Clarifying the rationale of State support is a vital exercise, which allows the State to set the goals of the intervention better, to identify specific actions that need to be taken and to assess the effectiveness of intervention, which *in fine* provides arguments to phasing-out public support. Thus, different policy tools may be appropriate at various levels of tackling the issue of financial stability. Preventing systemic risks and supporting a proper functioning of the market, should be a primary concern of

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[40] G Schinasi, 'Responsibility of central banks for stability in financial markets', IMF Working paper WP/03/121, p 4.

[41] G Schinasi, 'Safeguarding financial stability: theory and practice' (2006), as in DW Arner, *Financial stability, economic growth and the role of law*, Cambridge, CUP, 2007, p 72.

[42] DW Arner, *Financial stability, economic growth and the role of law*, ibid, p 100.

[43] Group of Ten, Consolidation in the Financial Sector, pp 126-127, available at http://www.bis.org/publ/gten05ch3.pdf, as in DW Arner, 'The global credit crisis of 2008: causes and consequences', (2009) 43(1) The International Lawyer 96.

[44] B. Lyons, 'Competition policy, bailouts and the economic crisis', CCP Working Paper 09-4, p 5; DW Arner, 'The global credit crisis of 2008: causes and consequences', (2009) 43(1) The International Lawyer 96.

financial regulation. However, limitations in regulatory arrangements, like those contained in the Basel II accord, appear to have even contributed to the growth of unregulated exposures, excessive risk-taking and weak liquidity risk management.[45]

At this background, it can be argued that the role of public financial support and, consequently, the reach of the State aid legal framework is important, but still limited when compared with financial regulation. Therefore, it is submitted that the aim of State aid in crisis management is, first, to address systemic risks and prevent their further aggravation by means of a rescue aid, and second, to address a long-term problem of financial stability through the examination of restructuring plans. It is put forward that this gives little scope for regulation by means of State aid rules, which can address only individual actors of the financial markets, and still subject to some restraints. However, a coherent and coordinated approach to restructuring has the potential to result in a sound financial sector, which would provide ground for any structural regulatory reform.

3.1.2. Application of the R&R Guidelines in the banking sector until October 2008 - The search for appropriate legal base

Until October 2008 application of the R&R aid to financial institutions had to follow all principles of the R&R Guidelines and there was no provision acknowledging specificity of the banking sector.[46] Starting from the mid 90s to October 2008, the main reason for the application of these rules to the banking sector was the need to maintain the minimum solvency level required by the EC Banking Directives.[47] This already provides for a major discrepancy between the aim of public intervention and its legal justification, which under the R&R Guidelines pointed at the prevention of any actual or potential 'serious social difficulties'[48] provoked by a bankruptcy of a financial institution.

The main feature of decisions adopted before October 2008 is that the Commission has persistently refused to refer to Article 87(3)(b), which allows granting aid 'to remedy a serious disturbance in the economy of a Member State', that is currently the legal base for a newly adopted legislation in the banking sector. There has been very little said on that provision, before the current crisis. The Court clarified that Article 87(3)(b) necessitates a narrow interpretation of what is a serious disturbance, since it must affect

45 Financial Stability Forum, 'Report of the financial stability forum on enhancing market and institutional resilience', p 9.

46 Within the R&R Guidelines, the only provision that directly relates to the banking sector concerns the form of rescue aid, which can be granted not only by means of a loan guarantee or a loan, but can equally take other forms, OJ 2004, C244/2, para 25(a).

47 Directive 2006/48/EC of 14.06.2006 relating to the taking up and pursuit of the business of credit institutions (OJ 2006, L177) and Directive 2006/49/EC of 14.06.2006 on the capital adequacy of investment firms and credit institutions (OJ 2006, L177).

48 OJ 2004, C244/2, para 25(b).

the entire economy of the Member State concerned and not merely one of its regions or parts of its territory.[49]

A major application of Article 87(3)(b) concerned a Greek aid scheme, approved in 1987, aiming to provide aid for restructuring of forty-five undertakings, among which twenty-two were liquidated for the reasons of viability.[50] The Commission accepted the aid scheme because it formed an integral part of a programme of economic recovery, embracing *inter alia* monetary and fiscal reforms.[51] The decisive argument for the Commission's decision was that, 'si l'on permettait à un pan aussi important de l'industrie grecque d'être mis en liquidation, les chances de réaliser avec succès les objectifs du programme d'austérité s'en trouveraient gravement compromises'.[52] However, this did not translate into a lax approach, as the Commission recognised that only fundamentally viable undertakings, which due to economic crisis fell into difficulty, were eligible and subject to restructuring. Hence, this first use of Article 87(3)(b) ensures that it is not a provision that can legitimize pouring money into economy, with no conditions attached. On the contrary, focus on viable companies and emphasis on restructuring, are proportionate measures tackling a serious economic disturbance.

However, apart from this example, the criteria of application of Article 87(3)(b) can only be defined *a contrario*, when Commission indicated in which situations it should not apply. In the *Credit Lyonnais I* decision[53], the Commission stated that although it was aware of the special sensitivity of financial markets and of the possible undesirable negative consequences of the Credit Lyonnais bankruptcy, Article 87(3)(b) was not applicable when aid intended to remedy only the difficulties of a single recipient, the problems of which were connected with the bank's aggressive lending and investment policy[54]. In *WestLB* the Commission confirmed that a serious economic disruption is not remedied by aid that, 'resolve[s] the problems of a single recipient [...], as opposed to the acute problems facing all operators in the industry'.[55] This approach has been reiterated in subsequent Commission's decisions, despite calls from Member States to avail of Article 87(3)(b).[56]

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[49] T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, para 167; C-57/00 P and C-61/00 P, *Freistaat Sachsen and Volkswagen AG and Volkswagen Sachsen GmbH v Commission* [2003] ECR I-09975, paras 97-98.

[50] Décision de la Commission 88/167/CEE concernant la loi 1386/1983 par laquelle le gouvernement grec accorde une aide à l'industrie grecque, JO 1988, L76, p 5.

[51] JO 1988, L76, p 5.

[52] Ibid.

[53] Commission Decision 95/547/EC of 26.07.1995 giving conditional approval to the aid granted by France to the bank Credit Lyonnais, OJ 1995, L308 (*Credit Lyonnais I*).

[54] Ibid, para 7.

[55] Commission Decision NN 25/2008 of 20.04.2008 *WestLB riskshield*, OJ 2008, C1628, para 41.

[56] See i.e. Commission Decision 98/490/EC of 20.05.1998 concerning aid granted by France to the Credit Lyonnais group, OJ 1998, L221 (*Credit Lyonnais II*); Commission Decision 98/204/EC of 30.07.1997

This lack of legal certainty concerning conditions triggering application of Article 87(3)(b) in the banking sector has been nevertheless welcomed in the economic theory. Accordingly, provision of liquidity to banks in difficulty by the State, acting as a lender of last resort, should remain discretionary as a high degree of certainty concerning this type of support would create moral hazard encouraging potential beneficiaries to bear higher risks.[57] As the Commission recognised in *GAN* decision, a confidence of the bank that the State would intervene encouraged the unsound management and delayed the corrective action of the market.[58] It is submitted that by refusing to apply Article 87(3)(b) the Commission created at that time a sort of intermediary situation between a bank in difficulty due to its wrong business strategy and a systemic failure concerning all financial institutions.[59] The outer limits of the 'too big to fail' were tested in two decisions concerning Credit Lyonnais, which at the time of granting aid was the biggest institution of the banking sector in France. As regards specificity of the banking sector and the bank's importance for the national economy, the Commission did not find it a reason to deviate from Article 87(3)(c). In *Credit Lyonnais I* it was declared that:

> 'while difficulties encountered by one or a number of banks do not necessarily lead to a crisis of confidence throughout the system, the failure of a single bank of some size, though due to internal management errors, may place a number of other credit institutions which are financially linked to it in difficulty, thereby causing a more general crisis. State support may be necessary but that should not mean unconditional support for the failing institution, and the support should not be provided without serious action being taken on the definitive restructuring and on the individual limitation of the competitive distortion caused by the aid'.[60]

This gave instruction, on the Commission's discretion, to bend the rules in the extreme case of a bank that would be too big to fail.

3.1.3. Compatibility assessment of R&R aid to banks before October 2008. The nature of a link between competition and financial stability

Hence, the Commission based its decisions on the R&R Guidelines, under which banks were treated as any other undertaking, with the sole exception of the 'one time, last time' principle.[61] The restructuring of a bank necessitated submission and monitoring of a plan on return to viability, as well as the adoption of compensatory measures: contribution by the bank to the restructuring costs to limit the amount of aid (of at

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conditionally approving aid granted by France to the GAN group, OJ 1997, L78; Commission Decision NN25/2008 *WestLB,* ibid; Commission Decision NN 70/2007 of 5.12.2007 *Northern Rock*, OJ 2007, C6127.

[57] M Aglietta, 'A lender of last resort for Europe', Working Paper CEPII as in P.-B. Barets, 'Le droit des aides d'Etat applique aux secteurs dela banque et de l'assurance', Concurrences 1/2007, p 16.

[58] Commission Decision 98/204/EC of 30.07.1997 conditionally approving aid to granted by France to the GAN group, OJ 1997, L78, p 10.

[59] P-B Barets, op cit, n 57, p 16.

[60] Commission Decision 95/547/EC, op cit, n 53, para 3.2.

[61] Pursuant to that rule, rescue and restructuring aid should be granted only once, OJ 2004, C244/2, para 72.

least 50% in case of a large bank), limitation on the growth of the balance sheet, assets divestment to reduce market power and compensate competitors.[62] For Credit Lyonnais, the *qui pro quo* principle required the bank to indirectly compensate rivals by reducing its commercial presence both in France and in Europe through the sale of subsidiaries, which limited the bank's balance sheet by 1/3.[63] Along the same line, it has to be acknowledged that other decisions taken in the banking sector under the R&R Guidelines confirmed the strict approach towards substantial compensatory measures, both at home and in foreign markets.[64]

The role of compensatory measures in the banking sector is a good example on the interaction between competition and long-term financial stability. On the one hand, they limit the negative effect of a subsidy on competitors, which is a corollary of the 'effects on rival's profits' standard. This notion of the *qui pro quo* principle is a clear transposition of the logic of the R&R Guidelines. On the other hand, a particularity of the banking sector is that the extent of compensation cannot deprive beneficiary of resources necessary to fulfil and maintain the required solvency ratio during its return to viability. The Commission noted that:

> 'the objectives of competition policy and those of prudential banking policy cannot be mutually incompatible, since both are designed to achieve a common end, namely the development of a competitive, healthy banking sector'.[65]

Furthermore, the Commission submitted that the solvency ratio limited credit institutions ability to grow irresponsibly and held back the growth of inefficient institutions, as they could only increase their own capital by either attracting new capital or by increasing their profits.[66] Thus, this restraint on growth of less efficient banks, coupled with compensatory measures imposed on the beneficiary of aid, 'illustrates very clearly the way in which prudential policy and competition policy complement each other'.[67]

Therefore, in the light of those decisions, the crucial exercise consisted in finding the right balance in drafting compensatory measures between a dirigiste policy and the requirements of prudential regulation. Further, the aim of State aid control exercised by the Commission was to ensure that a subsidy did not drastically alter the level playing field in a sector that was subject to deregulation. It was exactly in that place, that

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62 Ibid, paras 34-45.

63 Commission Decision 98/490/EC, op cit, n 56, p 75.

64 See i.e. Commission Decision 98/204/EC, ibid; Commission Decision 2000/600/EC of 10.11.1999 conditionally approving the aid granted by Italy to the public banks Banco di Sicilia and Sicilcasa, OJ 2000, L256; Commission Decision 99/288/EC of 29.07.1999 conditionally approving the aid granted by Italy to the Banco di Napoli, OJ 1999, L116.

65 Commission Decision 98/490/EC, op cit, n 56, p 75.

66 Seventh Survey on State aid in the European Union in the Manufacturing and Certain Other Sectors, COM(1999) 148.

67 Commission Decision 2001/89/EC of 23.06.1999 conditionally approving aid granted by France to Credit Foncier de France, OJ 1999, L34, para 94.

competition met financial stability, ensured by prudential regulation. It can be implied that the State aid control, when applied to individual cases pursuant to the R&R Guidelines, certainly did not serve to regulate the entire sector through the back door, its aims were rather modest and tailored to the situation of the beneficiary.

3.1.4. Article 87(3)(c) and the R&R Guidelines brought to their limits

Given this experience, it appears quite natural that the Commission in the period directly preceding October 2008 applied the R&R Guidelines to banks that fell in difficulty as a consequence of the sub-prime mortgage lending in the US. In the few cases decided by the Commission, that is aid to IKB,[68] Sachsen LB,[69] Northern Rock[70] and Roskilde Bank,[71] it has consistently refused to apply Article 87(3)(b) and followed the R&R Guidelines. This implied a grant of rescue aid *inter alia* in the form of guarantee on deposits,[72] working capital facility or acquisition of toxic assets.[73] The ultimate decisions taken under the traditional legal base concerned Bradford & Bingley[74] and Hypo Real Estate Holding AG,[75] and it is in particular in the former case that we find boundaries of the R&R Guidelines. In the fall of 2008, Bradford & Bingley was downgraded by major rating agencies, its solvency ratio dropped and its permission to accept deposits was about to be withdrawn, effectively closing the bank down. In response, the bank was nationalised. The decision contained a package of measures designed to ensure financial stability by protection of retail depositors (prevention of bank runs) and support to bank's orderly winding down.[76] Although the decision was based on point 25(b) of the R&R Guidelines, justifying aid by prevention of serious social difficulties, it is clear that the structural measures indicated therein went beyond the protection of jobs and primarily aimed at protecting deposits and preventing aggravation of systemic risk.

3.2. A New and Temporary Legal Framework for State Aid in the Banking Sector.

As argued *supra*, the Council and the Commission have made a political decision to depart from the R&R Guidelines and construct a new compatibility assessment framework. Although, one may agree with the claim that this departure lacked sound

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68 Commission Decision C 10/2008 of 11.03.2008 *Restructuring aid to IKB*, OJ 2008, C76.

69 Commission Decision C 9/2008 of 4.06.2008 *Restructuring aid to Sachsen LB*, OJ 2008, C71.

70 Commission Decision NN 70/2007 of 5.12.2007 *Northern Rock*, OJ 2007, C135.

71 Commission Decision NN 36/2008 of 31.7.2008 *Roskilde Bank*, OJ 2008, C238. In the end the bank was liquidated and a guarantee was granted by the State to cover losses incurred by the central bank and Danish banking association (IP/08/1633).

72 NN 70/2007, op cit, n 70, para 44.

73 C 9/2008, op cit, n 69, para 99.

74 Commission Decision NN 41/2008 of 01.10.2008 *Rescue aid to Bradford & Bingley*, OJ 2008, C290.

75 Commission Decision NN 44/2008 of 02.10.2008, OJ C 293; Commission press release IP/08/1453.

76 NN 41/2008 op cit, n 74, paras 2-4.

legal reasoning on why the R&R Guidelines might not apply,[77] this does not devalue the new regulation in legal terms. State aid law is a process driven framework, which the Commission's discretion reflects clearly. Given that Article 87(3)(b) does not contain any balancing mechanism and that the compatibility criteria it sets are purely descriptive (reflecting the serious economic disturbance), this new legal base allows for a greater flexibility than the R&R Guidelines.

Deviation from the usual R&R rules demonstrates the fact that restructuring measures addressing systemic risks need to go beyond the social justification of aid to a bank. Furthermore, the R&R Guidelines are applicable to firms that are in difficulty due to their endogenous problems, whereas international market failure in the financial sector[78] justifies an approach that takes into account a specificity of the sector and exogenous (systemic) character of the problems faced by some banks. It can also be claimed that a coordination function of State aid rules can best be ensured when Member States draft and notify to the Commission general aid schemes instead of individual aid measures, as has been the case under the R&R Guidelines.

The relationship between the new set of legislation and the R&R Guidelines is that the former constitute a *lex specialis* foreseeing specific criteria for the financial sector, while the R&R Guidelines, and in particular, their logic and basic principles are of general application.[79] It can be claimed that the secondary legislation adopted to tackle the crisis reveals a two-step approach, which in its content, as it has been already pointed out elsewhere, is consistent on principles and flexible on the means.[80] In the first place, when confronted with massive notifications of national rescue measures, the Commission focused primarily on the preservation of basic principles of the Treaty, like non-discrimination (see *supra* at para 1), proportionality and necessity, which are common both to State aid rules and free movement provisions. It is also within this first step that we see a rough coordination of national measures through the secondary legislation, but with a certain discretion being left to the Member State as to the choice of appropriate measures. This also sets limit to the Commission's scope for intervention, as ultimately it is the Member State that makes the decision on whether to intervene. Hence, the first step primarily reveals the aim to preserve the level playing field and to coordinate national rescue measures. It could be claimed that the second step of the legislative reaction of the Commission is more pro-active, as it intends to reassure its position as not only a guardian of the Treaty and of the principles contained therein, but also as a distinct party in the process of addressing systemic crisis and rebuilding financial stability. Along the same line, it is interesting to verify to what extent may the State aid rules serve to regulate the substantive provisions concerning

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77 RM D'Sa, 'Instant state aid law in a financial crisis – a U-turn?', EStAL 2/2009, p 142.

78 See i.e. Commission Decision NN 51/2008, op cit, n 27, para 40.

79 OJ C270, op cit, n 13, para 6.

80 D Gerard, 'EC competition law enforcement at grips with the financial crisis: flexibility on the means, consistency in the principles', Concurrences 1/2009, pp 46-62.

return to financial stability and how they set a balance between competition and financial stability.

Since the adoption of the new legislative framework, from October 2008, the Commission has taken 39 individual aid decisions and has approved 26 aid schemes: 11 guarantee schemes, 7 recapitalisation schemes, 6 schemes combining guarantees with recapitalisation and 2 asset relief schemes.[81] Until August 2009, the total volume of approved guarantee measures amounted to €2.9 trillion (with a take-up rate of 32.8%) and of the recapitalisation measures to €313 billion (take-up rate of 54.8%).[82]

3.2.1. Banking Communication

The Banking Communication,[83] based on Article 87(3)(b), recognised systemic risks inherent to the financial crisis due to the fact that it affected fundamentally the sound financial institutions whose difficulties stemmed from the general market conditions, which have severely restricted access to liquidity.[84] Consequently, not only healthy banks had problems in access to liquidity, but due to their central role in the economy, also other sectors were concerned with the drying up of the loan market (disruption in credit flows).

The Banking Communication clarified that both general schemes (open to undetermined number of financial institutions) and individual aid can be approved on its basis. However, the practice provides that individual aid is granted either in the absence of a general scheme at the moment the bank enters into difficulties, or due to the fact that the bank is not eligible for aid under the scheme.[85] The Banking Communication allowed the provision of guarantees covering liabilities of financial institutions, to establish recapitalisation schemes and ultimately set criteria for a controlled winding-up.

The principles guiding application of these measures are those of non-discrimination and proportionality. Proportionality implies that a measure has to be well-targeted and necessary to be able to achieve the objective of remedying a serious disturbance in the economy and has to minimise the negative spill-over effects on competitors and other Member States.[86] In practical terms, proportionality limits the material scope of guarantees to retail deposits, certain types of wholesale deposits, as well as short and medium-term debt instruments.[87] The guarantee should not include subordinate debt and an indiscriminate coverage of all liabilities, as it would rather preserve interests of

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81 As of 09.09.2009, Memo/09/380.

82 'DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis', 7 August 2009, pp 2-4.

83 OJ C270, op cit, n 13.

84 Ibid, para 2.

85 State Aid Scoreboard Spring 2009 Update, COM(2009) 164, p 21.

86 OJ C270, op cit, n 13, para 15.

87 Ibid, para 21.

risk capital investors[88] and consequently may not directly help address the market failure. Furthermore, to better address systemic risk, some States allowed for provision of a guarantee only to solvent banks (that is with a core capital ratio (Tier 1 ratio) of at least 7%).[89] State commitments have to be also limited in time, the schemes can last from 6 months up to maximum 2 years (but with a period of issuance limited to 6 months)[90] and may be further extended upon Commission's approval,[91] provided that every 6 months the State carries out review of measures applied. So far, the Commission has accepted a prolongation of all renotified schemes.[92] This two-year limit, ending in the fall of 2010, should be regarded as a rough indication of a gradual phasing-out of the guarantee schemes and a tool in the hands of the Commission allowing to get back to usual R&R rules. It should be also regarded as an attempt to ring-fence the new legislation to the systemic risks. It is certainly a legal commitment and it might be inquired what will be its political value if the situation targeted by the aid does not ameliorate.

The principle of necessity signifies that aid has to be limited to minimum, which implies a significant contribution by beneficiary. Thus, a guarantee must be provided against adequate remuneration. Given the difficulty to determine such market conform rate of remuneration in times of systemic crisis, the Commission acknowledged that a fee charged for the provision of a guarantee shall be as close as possible to the market rates, and that it has to reflect the degree of risk, as well as the beneficiaries different credit profiles.[93] In practice a number of Member States followed the recommendations of the European Central Bank.[94] To limit the distortions of competition, in particular towards banks not benefiting from a guarantee, a beneficiary should be subject to behavioural constraints ensuring that it does not engage in aggressive expansion. This can be done by restrictions on commercial conduct, such as advertising invoking a guarantee, pricing, business expansion (through introduction of market share ceilings) or prohibition of conduct that runs against the objective of the guarantee, like new stock options for management.[95] Since guarantees are conceived as temporary rescue measures, they have to be followed by appropriate adjustments; that is either restructuring or liquidation.[96]

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[88] Ibid, para 23.

[89] See i.e. Commission Decision N 625/2008 of 12.12.2008 Rescue package for financial institutions in Germany, OJ 2009, C43/1, para 10; Commission Decision NN 51/2008, op cit, n 27, para 43.

[90] Some States opted for a duration of three years - see Commission Decision N 533/2008 of 29.10.2008 Support measures for the banking industry in Sweden, para 43.

[91] OJ C270, op cit, n 13, para 24.

[92] "DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis", 7 August 2009, p 2.

[93] OJ C270, op cit, n 13, para 26.

[94] See i.e. Commission Decision N 520a/2008 of 13.11.2008 *Urgent measures to guarantee the stability of the Italian banking system*, OJ 2009, C29, para 75.

[95] OJ C270, op cit, n 13, para 27.

[96] Ibid, para 29.

3.2.2. Recapitalisation Communication

Recapitalisation is the second structural measure aiming to tackle systemic risks and restore financial stability. Its conditions are specified in the Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition[97] (Recapitalisation Communication). Recapitalisation is governed by principles that apply *mutatis mutandis* to guarantees; hence the Recapitalisation Communication is focused on some specificities of this measure. A more detailed guidance has been necessary, as some Member States envisaged recapitalisation of banks, not to rescue them but to ensure lending to the real economy. This provides for a multiplicity of goals and the need to ensure a requisite equilibrium, so that provision of liquidity is treated differently depending on its objective. The Commission underlined that:

> 'a balance must be struck between competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the one hand, banks must have sufficiently favourable terms of access to capital in order to make the recapitalisation as effective as necessary. On the other hand, the conditions tied to any recapitalisation measure should ensure a level playing field and, in the longer-term, a return to normal market conditions'.[98]

This appears to be a reasonable approach to tackle direct symptoms of systemic risks. An adequate remuneration, close to a market price and providing for exit incentives, is a crucial element to reconcile competition and financial stability, but also to prevent moral hazard. However, it has to be underlined that the remuneration, given the sudden increase of market price due to systemic risks, has still remained below the market price.

In return for liquidity the State may i.e. receive shares or silent participations.[99] For solvent banks, when State capital injections are made on equal terms with significant participation of private investors (30% or more), the Commission will accept the remuneration set in the deal.[100] In general, the Commission followed recommendations of the European Central Bank, which set a price corridor for solvent banks between 7 to 9.3%.[101] The usual behavioural safeguards attached to recapitalisation prohibit aggressive commercial conduct and impose acquisition ban. As to exit incentives, the

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[97] OJ 2009, C10/2.

[98] OJ 2009, C10/2, para 11.

[99] Commission Decision N 512/08 of 27 October 2008 *Support measures for financial institutions in Germany*, para 12.

[100] Ibid, para 54.

[101] OJ 2009, C10/2, para 27.

Communication provided either for increase over time of the pricing structure or for a restrictive dividend policy.[102]

When Member States use recapitalisation to finance the real economy, 'they should attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending'.[103] Although this clause is a tool to address one of the main symptoms of systemic risks, its inherent danger is the one of market fragmentation, since the State primarily aims to ensure lending to its national economy. Thus, it is submitted that the clause should not limit lending to undertakings, in a way that would contravene the internal market objective and impede cross-border provision of funding to profitable projects. Recapitalisation of banks that are not fundamentally sound is subject to stricter requirements; either they submit a restructuring plan[104] or wind-up.[105]

Within the ongoing prolongation of recapitalisation schemes, the Commission has introduced an additional condition on coupon payments on hybrid capital and prohibited such payments, when they are funded from State aid.[106] Although this constitutes an additional safeguard against misuse of aid, it is interesting to examine how in practice, the ban would be executed, i.e. towards a contractual obligation of a bank to pay.

3.2.3. Impaired Assets Communication

The third legislative measure is the Communication on the Treatment of Impaired Assets in the Community Banking sector (the Impaired Assets Communication).[107] In light of the economic literature on previous banking crisises, adoption of the said measure is a necessary element of the return to long-term financial stability. An adequate policy to tackle the crisis should in fact provide in the first place for a guarantee on deposits to prevent bank runs, require separation of the good and bad assets and clear bank's balance sheets from the bad assets, and finally should allow recapitalizing of the asset-cleansed banks by finding new equity holders (either State or private investors).[108] The lesson of the Japanese banking crisis confirms that the failure

[102] Ibid, paras 31-33. See i.e. Commission Decision N 625/2008 of 12.12.2008 *Rescue package for financial institutions in Germany*, OJ C(2008) 8629 fin, para 17, which introduces a dividend ban or provides for an increase of remuneration by 0.5% annually.

[103] OJ C(2008) 8629 fin, para 39.

[104] Ibid, point 44.

[105] In the case of a controlled winding-up the Banking Communication provides for a set of rules to minimise moral hasard, avoid distortions of competition and ensure that no aid is granted to the buyers of the financial institution - see OJ C270, op cit, n 13, paras 43-50. In practice it has been applied to Roskilde Bank, see NN 36/2008, op cit, n 71.

[106] Commission Decision N244/2009 of 27.06.2009 *Commerzbank*, OJ C 147, p. 4; Commission Decision N352/2009 of 24.07.2009 *Prolongation of the Austrian Scheme*, OJ C 172, p. 3.

[107] Communication from the Commission on the Treatment of Impaired Assets in the Community banking sector, OJ 2009, C72.

[108] A Blundell-Wignall, P Atkinson, S Hoon Lee, 'The Current Financial Crisis: Causes and Policy Issues', OECD 2008, pp 13-14.

to take the second step might prolong the financial turmoil, since unless banks are cleared from bad assets, further recapitalisation might be required to avoid credit crunch.[109] In this context, the Impaired Assets Communication is genuine policy-making by the Commission.

The policy aim is to overcome uncertainty concerning the valuation and location of the impaired assets, by encouraging banks to a full disclosure of toxic assets, prior to a government intervention. The Communication highlights the need for a coordinated approach. This is to be achieved through development of categories of eligible assets (baskets) and their ex-ante valuation, based on common methods, such as a valuation of asset's real economic value[110] (rather than current market value), certified by independent experts and validated by banking supervisory authorities.[111] Interestingly, the Communication recognised that when putting a bank into administration, or when its winding up is unadvisable for reasons of financial stability, it could be granted aid in the form of guarantee or asset purchase to allow it to devise a plan for restructuring or orderly winding-up. Accordingly, nationalisation options may also be considered.[112] The latter provides for a recognition of a 'too big to fail' excuse for a bank whose winding-up might have dangerous systemic implications. The downside of such approach is that it may only improve the moral hazard.

The reason why State aid control may be triggered with regard to asset relief programmes is that under R&R aid, asset relief is a structural operation which requires assessment of an adequate contribution of the beneficiary to the costs of the impaired assets programme; necessitates in-depth restructuring through focussing on its core business, reorientation of business models, closure or divestment of business subsidiaries, changes in the asset-liability management; and necessary measures to remedy competition distortions.[113] Asset relief measures can be granted for six months and are conditional on the submission of details of the impaired assets' valuation, as well as a restructuring plan.

3.2.4. Restructuring Communication

The systemic crisis has forced the Commission to apply a coordinated approach in the restructuring phase. The Restructuring Communication,[114] issued in August 2009, complemented the EC legislative framework adopted under Article 87(3)(b). The core elements of the Restructuring Communication are: restoration of the long-term

[109] Ibid, p 15.

[110] Under the Spanish Fund for the Acquisition of Financial Assets remuneration is set through the mechanism of the reverse auction, which enables the Fund to purchase highly rated assets at the highest possible remuneration (interest rate) - see Commission Decision NN 54/A/2008 of 04.11.2008, para 15.

[111] OJ C72, op cit, n 107, paras 20 and 33.

[112] Ibid, para 23.

[113] Ibid, para 49.

[114] Commission Communication on the return to viability and the assessment of restructuring measures in the fianancial sector in the current crisis under the State aid rules, OJ 2009, C195.

viability, burden sharing and limiting distortions of competition. Building on these three basic principles of the R&R Guidelines, the Restructuring Communication set detailed provisions adjusted to the specificity of the systemic crisis in the financial sector. So far, the only decision on restructuring adopted under Article 87(3)(b) is the decision on aid to West LB[115] approved in May 2009. However, its particularity is that the restructuring plan was approved directly under Article 87(3)(b), while taking due account of the three principles of the R&R Guidelines, since at that time there was no specific secondary legislation on restructuring of banks in the systemic crisis.

Since restructuring is a corollary of the rescue aid, the scope of legislation is limited to situations when the State has provided funds. More specifically, banks that are fundamentally sound (see supra) and banks benefiting from asset relief which have also received aid that does not exceed 2% of the their risk weighted assets, are only requested to provide a viability plan.[116]

The core element of the viability review and specificity of restructuring, which aims to ensure financial stability, is the stress test. The test should take into account 'the current state and future prospects of the financial markets, reflecting a base-case and worst-case assumptions'.[117] The stress test should therefore assess future viability of a bank in a different range of scenarios, from a profound recession to economic recovery, and be compared with sector-wide benchmarks. However, given the 5-year period in which a restructuring plan has to be assessed, it might be a difficult exercise, both for a Member State and the Commission, to reach agreement on such forecasts and the viability review. This uncertainty and diverging views might create obstacle to a smooth adoption of restructuring plans. Assessment of future viability will be exercised by the Commission on the grounds of information on the bank's business model, funding structure, corporate governance, risk managements, asset-liability management, cash-flow generation, adequacy of capital in line with supervisory regulation and the remuneration incentive structure.[118] The plan should compare various scenarios of withdrawal from activities which would remain structurally loss making in the medium term, including a break-up and absorption by another bank or winding-up, to allow the Commission assess, at least in theory, which of the options is the least distortive and serves best financial stability. So far, the only example of West LB indicates that the systemic crisis does not alter application of substantial viability remedies under Article 87(3)(b). The bank's restructuring plan contained significant measures, i.e. 50%

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[115] Commission Decision C 43/2008 of 12.05.2009 *Aid for the restructuring of West LB*, OJ C 3900.

[116] OJ C72, op cit, n 107, para 55. The viability plan should comprise information on the use of public funds, on the path towards exit from the reliance on State support and should demonstrate the risk profile to allow evaluate bank's business plan. This would constitute a lighter form of review of bank's viability, then the one required in the restructuring plan.

[117] The viability of a bank is defined in the Restructuring Communication as bank's ability to cover all its costs including depreciation and financial charges and provide an adequate return on equity, taking into account its risk profile. The restructured bank should be able to compete in the marketplace for capital on its own merits in compliance with regulatory requirements, OJ 2009, C195, op cit, n 114, para 13.

[118] Ibid, para 11.

reduction of balance sheet, change of ownership structure through a sale of the bank and of nearly all its subsidiaries. The sale of the bank is to be preceded by unbundling of its activities into three core business areas.[119]

Burden sharing aims to limit the amount of aid through bank's own contribution. This translates into a sale of bank's assets or provision of capital by shareholders, in proportion to their stake. A novelty is that own contribution can be lower than 50% and postponed in the rescue phase for reasons of financial stability; it should not be further delayed in the restructuring.[120] Thus, when the costs of restructuring so necessitate, farther-reaching compensatory measures may be applied. The problem of burden sharing includes also the necessity to balance between accumulation of bank's own funds to finance restructuring and attracting new private capital. The ban on dividend or coupon payments might in the short-term increase bank's solvency, but limit in the long run its access to private funding. Hence, the Restructuring Communication prohibited payment of dividends and coupons on outstanding subordinated debt, with a view to limit the misuse of aid. However, it treated more favourably payment of coupons on newly issued hybrid capital.[121] This exemplifies the level of Commission's interference in a bank's daily business, justified by the aim of reassuring financial stability and preventing short-sighted free riding on the public funding. However, this approach also largely relies on the regulatory classification of capital (subordinated debt). Given the regulatory failure of risk assessment under the Basel II accord, this might provide for incentive to banks to circumvent the rules and purposefully wrongly classify the capital.

Limiting distortions of competition is probably one of the toughest tasks to accomplish under the currently overriding objective of financial stability. As the paper has argued supra, until October 2008 the Commission has found no clash between the two. On the contrary, as *Credit Lyonnais II* provided, prudential regulation and competition can go hand in hand. However, given the recent massive public intervention, addressing a systemic crisis should not result in a long-term damage to competition. The scope of compensatory measures shall result from: (i) the amount of aid and conditions and circumstances under which it was granted; and (ii) characteristics of the market on which the beneficiary bank will operate (size, scale and scope of bank's activities) after implementation of the viability remedies.[122] Therefore, this allows for the observation that both the level of burden sharing and pricing (influencing amount of aid) and the extent of viability oriented divestitures (limiting market presence) set a starting point for the scope of competition-oriented remedies. It is however clear that since remuneration of aid has been initially set at a level that helps to address the symptoms of systemic crisis, the pricing in restructuring phase may not rise drastically for the same reasons. That is why the Restructuring Communication allowed including claw-back clauses or

[119] *WestLB*, op cit, n 115, paras 68, 71, 73-74.

[120] OJ C195, op cit, n 114, paras 22-24.

[121] Ibid, para 26.

[122] Ibid, para 30.

setting additional compensatory measures.[123] The scope of compensatory measures may include divestment of subsidiaries, portfolios of customers or business units or other structural measures, which should be applied both on domestic and foreign markets.[124] Although in theory, the viability and competition remedies are separate and pursue different goals, provisions of the Restructuring Communication allow the observation that competition remedies should primarily support a return to a long term-viability and may not always constitute stand-alone remedies. This sets a new standard, in which the overriding aim of financial stability influences the scope of acceptable competition distortion. In practice, as the decision in *West LB* provided,[125] viability remedies might be sufficient to avoid imposition of further structural measures.

Restructuring plans should contain acquisition bans for at least three years, save for exceptional circumstances where acquisition is a part of consolidation process necessary to restore the financial stability and upon notification to the Commission.[126] This gives a wide discretion to the Commission in the restructuring phase, but may be a necessary safeguard in cases when most of the players on a given market are subject to both structural remedies and acquisition bans. When finding a buyer is objectively difficult, then ultimately one of those players might be allowed to acquire divested parts of another bank, for the sake of ensuring financial stability. The upshot of that discretion is a genuine power of the Commission to independently run sectoral policy, which might be close to an industrial policy-making.

The systemic effects of cumulated application of a number of restructuring plans at the same time have been foreseen in the Restructuring Communication. It provided that implementation of structural measures might be extended to five years (three years usually), when finding a buyer is objectively difficult and to avoid depressing markets through 'fire sales'.[127] Furthermore, to ensure equal treatment between various plans adopted at the same time, the Commission committed to compare measures applied in cases relating to the same markets or market segments.[128]

Although the balance between discretion of the Commission and voluntary commitments by Member States is delicate, the Commission can examine the degree of market opening and expect the State to also propose measures that favour entry.[129] So far the Commission has not been explicitly vested with such a power and this requirement of market opening has not been codified in the State aid legal framework. The only application of such possibility in the past concerned restructuring aid to

[123] OJ C195, op cit, n 114, para 25.

[124] Ibid, paras 35-36.

[125] *WestLB*, op cit, n 115, paras 83-85.

[126] OJ C195, op cit, n 114, paras 40-41.

[127] Ibid, point 15.

[128] Ibid, point 38.

[129] OJ C195, op cit, n 114, paras 44-45.

Alstom,[130] where the oligopolistic structure of the relevant market would have been reinforced by the application of traditional R&R aid divestments.[131] This gives the Commission a potential leeway to influence the outlook of the market after adoption of a number of restructuring plans and creates a thin line between regulation of the market and decisions on individual aid. Although, such approach generally allows putting a foot in the door of closed markets, it can be claimed that only objective data on the degree of market penetration, and not ideological concerns, should serve as a benchmark triggering such commitments.

Quite significantly, the Commission agreed to depart from the 'one time last time' principle and declared that when provision of additional aid during the restructuring period is justified by financial stability, it should be possible, but subject to ex ante notification.[132] Although this is a major deviation from the R&R Guidelines, where additional aid was prohibited save for exceptional circumstances, this however codifies past practice. In *Credit Lyonnais II* the Commission justified additional aid by unforeseeable circumstances in the financial sector for which the bank was not responsible.[133] This however bears the risk of postponing a gradual phasing-out of support measures to the financial sector.

3.2.5. On the role of State aid control in crisis management

To operationalise reaction to the systemic risk and to ensure financial stability, within the framework of the rescue aid, a distinction has been made in the treatment of illiquid but otherwise fundamentally sound banks and banks that are characterized by endogenous problems. The main differences are that solvent banks do not need to present restructuring plans, are not subject to compensatory restraints and are not bound by growth limitations. A relaxed approach towards solvent banks, but with due safeguards concerning remuneration, exit and lending to the real economy, intends primarily to remedy a market failure and is a novelty in the approach to rescue aid. Distressed financial institutions are required to wind-up or to present a far-reaching restructuring plan with significant compensatory measures.

Furthermore, the approach adopted by the Commission in the rescue phase, large-scale public intervention on generous terms, has certainly led to diminishing the scope of systemic risks. The numerous State interventions seem to have improved financial stability, without taking into account competition concerns. It is in the restructuring phase that the Commission has more discretion and can impose measures that would explicitly limit the distortion of competition and enhance financial stability. However, in the Restructuring Communication we observe a departure from the past practice.

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[130] Commission Decision 2005/418/EC on the aid measures implemented by France for Alstom, OJ 2005, L150, para 204.

[131] C Galand, E Marteil, A Bacchiega, F Malbo, E Valle, 'Commission authorises restructuring aid to Alstom under condtitions', Competition Policy Newsletter 3/2004, p 15.

[132] OJ C195, op cit, n 114, point 16.

[133] Commission Decision 95/547/EC, op cit, n 53, p 37.

The overriding principle of financial stability seems to justify various measures that are otherwise not a standard under the R&R Guidelines (see *supra*). Therefore, it might be argued that it is necessary to ring-fence application of Article 87(3)(b) only to systemic crisis. For that reason, the choice of a new legal base has the advantage of facilitating return to normal R&R rules.

A possible critique of the approach developed under the new legislative framework is that in fact the Commission allowed the grant of all notified measures which, while addressing systemic risks, has enhanced moral hazard. The only element that effectively limits moral hazard is the fact that liquidation of a bank is an option under the Banking Communication. This has been exercised so far towards a limited number of banks.[134] Still, the Banking Communication allowed banks to continue their operations during the liquidation procedure, under condition that they do not start new activities until withdrawal of the banking licence. However, the fact that no time-limit is indicated for a complete winding up, except for reference to the 'period strictly necessary',[135] may further exacerbate moral hazard and make the Commission subject to interest lobbying.

Thus, restructuring of aid beneficiaries and credible bankruptcy regime coupled with a modernised prudential regulation, adopted as a package of measures, can help to establish financial stability.[136] From the legal point of view, a broad approach to remedying the disturbance in the economy, both at the individual (beneficiary) and regulatory levels, appears to be the major condition to justify aid under Article 87(3)(b). In fact, when we examine application of Article 87(3)(b) in the past, we find that the restructuring aid scheme for Greek undertakings was approved because it constituted a part of a structural programme aimed to remedy the crisis of national economy. Although, it is apparent that the reaction to the current financial crisis has been first marked by a rescue aid, and it is only now that we see EU proposals for regulatory measures,[137] the fact that State aid is a part of a broader picture constitutes the standard for compatibility assessment of aid under Article 87(3)(b).

The response provided by the Commission to tackle the systemic crisis, raises concerns on the application under Article 87(3)(b) of the 'more economic approach', embedded in the modernised balancing framework, introduced in the State Aid Action Plan (SAAP). This more economic approach to State aid relies on a three-step test that looks at the market failure, examines whether the aid is well targeted, establishes a magnitude of effects on trade and competition, and weighs positive and negative effects.[138] Under the SAAP, the test serves as the main decision criterion and a legislative tool. However, this approach is completely absent under the 87(3)(b) legislative package, although it can be asserted that the idiosyncrasy of that legislation is a combination of the R&R aid

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[134] See i.e. Commission Decision NN 39/2008 of 05.11.2008 *Aid for liquidation of Roskilde Bank*, OJ 2009, C12.

[135] OJ C270, op cit, n 13, para 47.

[136] B Lyons, op cit, n 44, p 11.

[137] See Memo IP/09/1347 ,'Commission adopts legislative proposals to strengthen financial supervision in Europe'.

[138] COM (2005)107, op cit, n 16, p 6.

with responses to a market failure. Furthermore, the inherent aim of the 'more economic approach' to State aids is to check whether the aid is in fact an adequate solution to remedy a market failure, as aid should be a second best option.[139] However, in the 'instant law making'[140] applied to tackle systemic risks, there is no deliberate search for an adequate policy option. The best option, namely a modernised regulatory framework, seems to be only an issue in the aftermath of the crisis.

A final point, concerns future problems originating from nationalisation or increased public ownership of banks, i.e. in case of Northern Rock and Commerzbank.[141] Decisions concerning German Landesbanken, as well as examples of GAN Group or Credit Lyonnais, reveal that public ownership of financial institutions may be detrimental to competition and endanger financial stability, since it creates a moral hazard that the State would always provide funds to ailing financial institution of major importance to national economy. As the Commission pointed out in *Credit Lyonnais II*:

> 'management failings were accentuated by confusion between the roles of the state as shareholder, the state as entrepreneur, the welfare state and the state as legislator, a confusion which resulted in the state as shareholder allowing a situation of unprecedented gravity to degenerate further, contrary to its asset-related interests'.[142]

This further accentuates the long-term risks emanating from current public interventions and highlights the need to include in the restructuring plans a time limit for gradual withdrawal of the State or a change in corporate governance. However, given the ownership neutrality imposed by Article 295 EC, the latter depends on the voluntary commitments by the State, which might be an obstacle in bringing the sector back to sound market conditions.

4. CONCLUSION

The Commission has consistently applied the notion of State aid, which allowed it to exercise discretion towards measures adopted by Member States. This firm application of Article 87(1) would not have been possible without a political decision to fully apply State aid control and, second, the Commission's expertise originating from past cases on aid in the banking sector. Consequently, this gave the Commission a leeway to assess the balance between competition and financial stability.

As regards compatibility assessment in the period preceding the financial turmoil, application of the R&R Guidelines, including strict compensatory measures, allowed to align competition with prudential regulatory policy aiming at financial stability. The new legislative framework adopted under Article 87(3)(b) recognised the need to apply a

[139] Ibid, p 7.

[140] A term coined with respect to State aid law applied in the current financial crisis by Ch Koenig, op cit, n 32 p 627.

[141] Commission Press Release IP/09/711.

[142] Commission Decision 98/490/EC, op cit, n 56, p 63.

coordinated approach, aimed at a number of sound and distressed banks. Clear identification of systemic risks and recognition of specificity of the banking sector allowed the introduction of structural measures that may help to address those risks and establish the long-term financial stability. To operationalise the balance between competition and financial stability, under rescue aid, the crux of the method applied is the relaxed approach towards solvent banks, but with due safeguards concerning remuneration, exit and lending to the real economy. This allowed the stabilisation of the financial system, with the cost of treating competition issues as subordinate to the overriding aim of the public intervention. In the restructuring of distressed banks, despite application of basic restructuring aid principles, the overriding objective of financial stability seems to justify various measures that are otherwise not a standard under the R&R Guidelines (i.e. departure from the 'one time last time principle'). For that reason the risk of moral hazard may be hardly evitable in the future. Further, it appears that although in theory the viability and competition remedies are separate and pursue different goals, the Restructuring Communication and (still limited in number) cases decided so far indicate that competition remedies would primarily support a return to a long term-viability and may not always constitute stand-alone remedies. This would set a new standard, in which the overriding aim of financial stability influences the scope of acceptable competition distortions.

Although the Restructuring Communication provides only guidance on how to restructure, the corollary of a systemic approach is that the Commission has the leverage to influence the post-crisis design of the market by expecting commitments for market opening, going beyond its standard practice, or by applying its discretion to lift the acquisition ban.

It is submitted that the aim of State aid control in crisis management is primarily to address systemic risks and prevent their further aggravation by means of a rescue aid, and second, to address a long-term problem of financial stability through the examination of restructuring plans. A coherent and coordinated approach to restructuring has the potential to result in a sound financial sector, which would provide ground for future regulatory reforms.

It appears that the fact that State aid is a part of a broader structural programme constitutes the standard for compatibility assessment of aid under Article 87(3)(b). However, the legislation adopted under that provision is far from a 'more economic approach' that is the driving decision-making and legislative criterion in the State aid legal framework. That is why the choice of a new legal base has the advantage of facilitating return to normal rules and allows to ring-fence the application of Article 87(3)(b) to systemic crisis.