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MANAGING THE FINANCIAL CRISIS IN EUROPE: THE ROLE OF EU STATE AID LAW ENFORCEMENT

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RÉSUMÉ – ABSTRACT

(EN) Since more than four years now, the banking and financial crisis dominates the EU agenda. The present contribution reassesses how the enforcement of the EU State aid rules by DG COMP has contributed to cope with the banking crisis. After a short introduction to the causes of the crisis, rooted in the specificities of the banking sector, and to the various remedial measures designed by national governments (I), it outlines successively how State aid rules have been relied upon as a coordination tool (II) and a regulatory fix (III). It then moves on to consider the deeper impact of State aid enforcement in the crisis context on the reform of the regulatory framework for financial services, on the one hand, and on the general State aid law enforcement framework, on the other hand (IV).

(FR) Depuis plus de quatre ans, la crise bancaire et financière domine l'agenda politique européen. La présente contribution reconsidère la façon dont l'application des règles en matière d'aides d'Etat par la Commission européenne (et donc par la Direction générale de la concurrence) a contribué à contenir la crise bancaire. Après une courte introduction aux causes de la crise et aux différentes mesures de sauvetage mises en place par les gouvernements des Etats membres (I), elle s'attache à démontrer comment les règles en matière d'aides d'Etat ont été utilisées comme instrument de coordination des initiatives nationales (II) et comme palliatif à un cadre réglementaire lacunaire (III). Au-delà de la gestion de la crise proprement dite, elle s'interroge sur l'impact à plus long terme de la façon dont les règles en matière d'aides d'Etat ont été mises en œuvre dans le contexte de la crise financière, sur la réforme du cadre réglementaire applicable aux services financiers, d'une part, et applicable aux d'aides d'Etat dans leur ensemble, d'autre part (IV).

MOTS-CLÉ – KEYWORDS

Financial crisis – State aid – European Union – Competition law – Enforcement - Coordination – Conditionality – Stability – Regulatory framework – Market failure – Moral hazard - State guarantee – Recapitalization – Impaired assets – Restructuring – Burden sharing

Crise financière – Aide d'Etat – Union européenne – Droit de la concurrence – Mise en oeuvre – Coordination – Conditionnalité – Stabilité – Cadre réglementaire – Défaillance du marché – Hasard moral – Garantie publique – Recapitalisation – Actifs dépréciés – Restructuration – Burden sharing

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Since four years now, the financial crisis dominates the EU agenda. What started as the tail of the US subprime crisis turned into a "systemic" issue with the freezing of the wholesale funding market subsequent to Lehman Brothers' filing for Chapter 11 protection on September 15, 2008 (at 1.45 am).[1] Overnight, governments across Europe were forced to devise urgent rescue measures to restore market liquidity and enable banks to meet their refinancing needs in order to prevent a financial meltdown. The role the EU would play in managing the crisis seemed uncertain at first, in the absence of the necessary institutional framework and budgetary means at EU level. Four years later, however, the European Commission ("Commission") – and in particular its Directorate-General for Competition ("DG COMP") – is widely praised for the role it has played in that regard.[2] And the EU State aid rules revealed to be key to that effect.

The present contribution reviews how the enforcement of the EU State aid rules by DG COMP contributed to cope with the financial crisis. After a short introduction to the causes of the crisis, rooted in the specificities of the banking sector, and to the various remedial measures designed by national governments (I), it outlines successively how State aid rules have been relied upon as a coordination tool (II) and a regulatory fix (III). It then moves on to consider the deeper impact of State aid enforcement in the crisis context on the reform of the regulatory framework for financial services, on the one hand, and on the general State aid law enforcement framework, on the other hand (IV).

I. STATE AID AS A MARKET FAILURE REMEDY

The crisis has monopolized an extraordinary quantity of State resources (i.e., taxpayers' money) to the benefit of the economy and, especially, the financial sector. Though that amount is largely fictional from an economic point of view, the Commission estimates that Member States committed approximately € 4.5 trillion to deal with the crisis, of which € 1.6 trillion was actually used but mostly in the form of guarantees (that have not been called upon). Whereas the ten largest beneficiaries received more than 50% of the total amount, about 215 EU financial institutions received some form of assistance since 2008. This Section explores how financial markets failed (1) and how States came to their rescue (2).

1. THE FINANCIAL CRISIS AS A MARKET FAILURE

"*The financial sector is special*".[3] Financial institutions essentially provide intermediation services to both savers, whose deposits constitute liabilities, and borrowers, whose loans represent assets. Notably because they rely on deposits as collateral to back their investments,

[1] Unsurprisingly, the subprime crisis affected primarily those European credit institutions with a particular exposure to the real estate market and specifically mortgage-backed securities, including Northern Rock, Roskilde Bank, West LB AG, Sachsen LB, Hypo Real Estate Holding AG and Bradford & Bingley.

[2] See, *e.g.*, C. Quigley, "Review of the Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis", *J. Eur. Comp. L.&P.*, 2012, p. 237; U. Soltész and Ch. von Köckritz, "Three years after the financial meltdown: Quo Vadis, state aid control?", *MLex Magazine*, April-June 2011, p. 40.

[3] OECD, *Competition and Financial Markets*, 2009, p. 7.

the amount of assets owned by banks largely exceeds their equity base, i.e., a bank's balance sheet is highly leveraged. Moreover, the asymmetry in the maturity of both assets and liabilities creates an inherent instability that is offset by a systematic recourse to the wholesale funding market, which, together with payment systems, creates a very dense linkage of interconnections between banks. These characteristics (intermediation, leverage and linkage) result in a situation where the failure of a bank has the potential of creating huge externalities inasmuch as it would affect a variety of other actors, including depositors, borrowers but also other banks. These externalities are magnified by the size of banks; the bigger the bank, the largest the externalities created by its failure. Hence, the failure of a large financial institution is capable of causing significant losses not only for shareholders but also for depositors and borrowers and may equally drive other banks into insolvency, thereby causing even greater losses to the economy and society as a whole (i.e., generate contagion effects). In fact, the mere loss of confidence in the ability of such an institution to meet its obligations can cause similar effects by triggering massive withdrawals on the part of depositors (i.e., a so-called "bank run") and limiting access to the interbank lending market.

How did that scenario unfold back in 2008? In broad strokes, low interest rates and lenient regulatory requirements, combined with the comfort of significant consolidations and years of record profits, induced banks to increase their (off-)balance-sheet exposure and take up riskier investments. That evolution fuelled financial product innovation, which became a key driver of profitability. However, the complexity of financial products led to pricing failures (e.g., derivatives of subprime mortgages), which resulted in losses amplified by leveraging strategies. The lack of sufficient capital to cover these losses resulted in solvability issues and subsequent liquidity shortages for some banks, which could not be mitigated and led eventually to the failure of one major global player, namely Lehman Brothers. Lehman Brothers' bankruptcy filing caused a general loss of confidence and an immediate freeze of the wholesale funding market, forcing various institutions to request emergency liquidity assistance from central banks to avoid massive defaults and prompting governments to take immediate action by drawing on State resources, *i.e.*, by granting State aid to the financial sector.

2. STATE AID AS A REMEDY

In September 2008, financial markets failed (and revealed the inappropriateness of the applicable regulatory framework). Given the social costs associated with such failure, it was desirable for public authorities to intervene. Still, to reach a positive outcome in terms of welfare, such intervention needed to achieve a delicate balance between the correction of the observed failure and the risk of distorting competition.[4] That balance lies at the core of EU State aid law enforcement, generally, but the industry-wide nature of the observed failure required ad hoc tools to achieve such a balance in the particular context of the financial crisis. Likewise, State intervention raised a particularly acute moral hazard issue, that is a risk of distorting (or of increasing the latent distortion of) the business incentives of banks by allowing them to

[4] See, *e.g.*, Siotis 2010, p. 4.

internalize the possibility of being bailed out in the future in case of repeated failure. Thus, if a return to liquidity/stability was the priority in the short-term, it necessarily had to come with conditions capable of restoring competition and disciplining market actors in the medium-term.

Government interventions to remedy the crisis can be classified in three broad categories,[5] which also reflect the chronology of the rescue process: (i) guarantees; (ii) recapitalization measures; and (iii) impaired assets relief schemes. Guarantees came first and were aimed to improve access to funding and restore the liquidity of the wholesale market. Beyond retail and wholesale deposits, newly issued (within an initial window of six months that was later extended) senior short- and medium-term debt instruments (with a maturity of three months to three years) were also eligible in order to improve banks' solvency ratio and induce them to keep lending to the real economy (for the issuance of new loans had virtually come to a halt in the fourth quarter of 2008). Then came recapitalization measures, that is direct capital injections designed to strengthen banks' equity basis. These measures pursued different objectives – avoiding insolvency, restoring liquidity and/or easing credit supply restrictions – and were priced differently depending on whether they were granted to "fundamentally sound" or "distressed" credit institutions (as defined pursuant to a methodology devised by the European Central Bank). Finally, a minority of EU Member States also set up relief schemes to support banks in writing down the value of so-called "impaired assets" on their balance sheet and moving toward long(er)-term stability. The acquisition of these assets above their then market value by the competent national body (such as, e.g., the Irish National Assets Management Agency) was considered to involve public resources and to amount to State aid.

Generally, the Commission treated all three categories of measures as State aid without engaging in a quantification thereof. Rather, it resorted to a qualitative assessment based on the assumption that no reasonable private investor would have granted the same or similar facilities to banks under circumstances similar to those prevailing at the time.[6] Eventually, the Commission adopted no less than 325 decisions authorizing public support to the financial sector, subject to conditions, between September 2008 and September 2012 (including prolongation, extension and amendment decisions).[7] All these decisions were based on Article 107(3)(b) TFEU, a provision allowing for State aid to correct a macro-disturbance in the

5 A majority of EU Member States set up guarantee and recapitalization schemes, whereas impaired asset relief measures were adopted by only nine of them. Five Member States did not adopt any specific measures (Bulgaria, Romania, the Czech Republic, Estonia and Malta) and three did not make use of the measures they put in place (Poland, Slovakia and Lithuania – Finland did so only marginally).

6 Conversely, the Commission held that no State aid was at stake in case of emergency liquidity assistance provided: (i) by an independent central bank against high quality collateral and at its own initiative; or (ii) by a State-owed central bank against a guarantee provided by the private sector. See, Northern Rock, §§32-34 and Roskilde Bank, §§32-33.

7 See MEMO/12/665 – State aid: Overview of decisions and on-going in-depth investigations in the context of the financial crisis (September 13, 2012). At the time of writing, 17 cases involving a limited number of credit institutions were still subject to formal investigation procedures (cf. Bayern LB and its subsidiary Hypo Group Alpe Adria, Dexia, Österreichische Volksbanken AG, Latvian Mortgage and Land Bank, ING, FIH Erhvervsbank A/S, NLB and HFSF recapitalisation of a number of Greek banks incl. Nea Proton, Alpha Bank, National Bank of Greece, EFG Eurobank, Piraeus Bank).

economy of Member States, which had been very scarcely used until then and enabled the Commission to come up with some pragmatic solutions to the issues created by the crisis.[8]

II. STATE AID ENFORCEMENT AS A COORDINATION TOOL

"*When confidence disappears, massive coordination problems arise*".[9] This truism carries particular significance in relation to financial services. However, the failure of Lehman Brothers also raised acute coordination issues in the design of a credible rescue plan in Europe, rooted in the incompleteness of the internal market. Indeed, while large credit institutions compete across borders, bailout funds had to be granted by individual Member states naturally biased in favor of national interests and whose financial means and resources vary significantly.[10] Hence, without proper EU-wide coordination, a rescue measure adopted by one Member State may have had a direct impact on banks headquartered in other jurisdictions, notably by triggering massive transfers of capital, thereby prompting a domino effect on other banks with the potential of exporting problems to other Members States while weakening the effectiveness of the original rescue measure. In the words of then Commissioner Kroes, the risk was nothing less than to turn the EU internal market "*into chaos*".[11]

In the prevailing institutional context characterized by the absence of an EU Treasury, banking regulator and resolution authority, the EU State aid rules enforced by the Commission quickly emerged as a powerful coordination tool capable of addressing the confidence problem laying at the core of the crisis. Thus on October 15, 2008, while endorsing the so-called "EU concerted action plan", the European Council reaffirmed its support for the continued implementation of EU competition rules in spite of the circumstances, including "*the principles of the Single Market and the system of State aids*".[12] Even though their coordination potential was already known,[13] State aid rules were not originally designed to address emergency situations on an EU-wide scale. Still, committing to abide by a common discipline might have been the single most effective move on the part of Member States in order to break the risk of negative spillovers across borders and prevent a financial meltdown in Europe. In turn, that move enabled the

8 Prior to September 2008, the Commission had expressly refused to resort to that provision and examined the case-by-case rescue measures aimed to address liquidity difficulties of credit institutions exposed to the subprime crisis according to established rules on subsidies for firms in difficulty (see Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty [2004] *O.J.* C 244/02), adopted pursuant to Article 107(3)(c) TFEU. In turn, the key element that appears to have triggered the application of Article 107(3)(b) TFEU is the possibility of "*even fundamentally sound financial institutions [...] facing the prospect of going out of business*", which the Commission characterized as a "*clear international market-failure*", combined with the recognition of the "[banking] *sector's pivotal role in providing financing to the rest of the economy*" (see, *e.g.*, case N 507/2008, paras. 44 and 47 and case NN51/2008, para. 40).

9 OECD, *Competition and Financial Markets*, 2009, p. 7.

10 The amount of aid pledged varied significantly from one Member States to another, reflecting the size of domestic economies (*e.g.*, more than 500 billion in the UK and Germany, less than 3 billion in Cyprus and Latvia). Massive cross-border flows of capital were indeed observed in the very early days of the crisis, e.g., in relation to the failures of Northern Rock in the UK and Fortis in Belgium.

11 N. Kroes, "Competition policy, growth and consumer purchasing power", Speech/08/521, Brussels, October 13, 2008.

12 European Council of October 15 and 16, 2008, Presidency Conclusions (doc. 14368/08), para. 5.

13 For example, the rescue and restructuring guidelines were originally conceived as a coordination mechanism to avoid the creation of national champions at the expense of smaller EU economies with less means at their disposal.

Commission to play a critical role in the design of the general recovery plans and individual rescue measures envisaged by Member States and, in effect, to act "*as a de facto crisis-management and resolution authority at EU level*".[14]

This section attempts to further explain how State aid rules have: (i) coped with the challenges created by the crisis and contributed to bring in certainty and restore stability; and (ii) concretely acted as coordination devices in order to ensure the effectiveness of rescue measures, avoid a subsidy race, prevent unfair competition among banks and maintain a level playing field.

1. SALVAGING EU STATE AID RULES TO THE BENEFIT OF CERTAINTY AND STABILITY

The potential of State aid rules to act as effective coordination devices was initially tempered by the notorious length of State aid enforcement proceedings and by DG COMP's lack of experience in dealing with macroeconomic disturbances. Since the circumstances required immediate action and certainty in the implementation of rescue measures, the European Council expressly called for the EU State aid rules "*to be implemented in a way that meets the need for speedy and flexible action*".[15] Conscious that a failure to do so would deprive it of any meaningful role in managing the crisis and might cause serious harm to the internal market and the EU economy in general,[16] the Commission responded to that call by introducing exceptional procedural rules and by developing substantive principles consistent with Art. 107(3)(b) TFEU. However, on both issues, the Commission drew heavily on its previous experience with the application of the rules on rescue and restructuring aid, thereby achieving a balance between flexibility and predictability that was viewed by many as "a political masterstroke".[17]

Adapting existing substantive principles. Immediately after the collapse of Lehman Brothers and throughout the first months of the crisis, the Commission endeavored to issue detailed guidelines on the application of Art. 107(3)(b) TFEU to the various measures adopted or envisaged by Member States. As noted, these guidelines were modeled on the principles laid down in the established "Rescue and Restructuring Guidelines" for aid to firms in difficulty, as generally applicable to individual cases falling under Art. 107(3)(c) TFEU, which were then

[14] J. Almunia, Speech/12/29 to the "Third Future of Banking Summit", Paris, January 24, 2012.

[15] European Council of October 15 and 16, 2008, Presidency Conclusions (doc. 14368/08), para. 5. The Council's concerns echo a more general problem facing competition authorities, namely « *to convince legislators or executive branches of governments that competition authorities have the ability to make timely, positive contributions in times of crisis and that competition law is flexible enough to be adapted in scope, time and focus* » (OECD, *Competition and Financial Markets*, 2009, p. 11).

[16] In theory, Member States could have decided to resort to Art. 108(2) TFEU and consider unanimously that, given the "*exceptional circumstances*", the aid measures "shall be considered to be compatible with the internal market".

[17] H. Gilliams, "Stress Testing the Regulator: Review of State Aid to Financial Institutions after the Collapse of Lehman", *E.L. Rev.*, 2011, p. 10.

adapted to reflect the systemic nature of the crisis.[18] Essentially, they provided for additional flexibility as to the nature of acceptable aids (e.g., structural interventions), the duration thereof (i.e., going beyond six months) and recurrence thereof[19] and, originally, the need for structural compensatory measures and the percentage of own contribution to restructuring costs (i.e., less than 50% in some cases). In practice, the Commission issued four main sets of guidelines between October 2008 and July 2009 in the form of "communications" published in the EU official journal, as follows:[20]

- The Banking Communication of October 13, 2008 laid down the analytical framework for assessing the compliance of State rescue measures with Art. 107(3)(b) TFEU.[21] In particular, it gave substance to the following principles: (i) non-discrimination between systemic financial institutions based on their "origin" or main establishment; (ii) limitation of the relevant measure to the minium necessary (e.g., guarantees or recapitalization) both in scope and in time; (iii) appropriate compensation/remuneration by the beneficiary; (iv) behavioral conditions to limit distortions of competition (e.g., advertising ban, limitation of balance sheet expansion, ban on aggressive commercial policies, limitations in the remuneration payable to the management of beneficiary institutions, dividend ban, commitment to use funding for the real economy, etc.); and (v), if necessary structural conditions resulting from the notification of a restructuring or liquidation plan within a certain period and the subsequent approval thereof. In effect, the Banking Communication primarily assisted Member States in accommodating the liquidity difficulties of solvent banks by means of guarantee schemes covering newly issued bonds, whose issuance peaked in the first quarter of 2009.[22]

- The Recapitalization Communication of December 5, 2008 primarily aimed to address the difficult issue of the pricing of capital injections by public authorities.[23] The difficulty stemmed from the variety of objectives sought by such recapitalization, including rescuing ailing banks but also restoring confidence in and the liquidity of wholesale funding markets and ensuring the continued financing of industrial projects. The option chosen at

[18] Note that the Rescue and Restructuring Guidelines already foresee some flexibility with respect to rescue aid in the banking sector, which can be granted in a form other than loans or loan guarantee to the extent that it does not consist in structural measures related to the bank's own funds (*i.e.*, recapitalization).

[19] The grant of rescue and restructuring aids is bound by the so-called "one time, last time" principle according to which beneficiaries may not receive additional rescue or restructuring aid for a period of 10 years. In contrast, the rules set forth by the Commission in relation to the financial crisis allowed credit institutions to benefit from successive aid packages.

[20] Due to lasting uncertainties and fresh turbulences caused by the sovereign debt crisis, the above guidelines were supplemented by additional communications extending the benefit of "*support measures in favour of banks in the context of the financial crisis*" until the end of 2011 and then of 2012, subject to more stringent requirements including increased guarantee fees (by 20/30/40 basis points depending on the beneficiary's rating) and restructuring obligations for all new beneficiaries of recapitalization and impaired assets schemes, as well as banks relying on State guarantees above a certain liability threshold (see [2010] *O.J.* C 329/7 and [2011] *O.J.* C 356/7).

[21] 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 [2008] *O.J.* C 270/8.

[22] During the first quarter of 2009, guaranteed bond issuances are said to have reached a monthly average of 30% of total banks funding in euro.

[23] Communication on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] O.J. C 10/2.

the time was to differentiate the pricing of capital injections according to the risk profile of the beneficiary by means of a methodology devised by the European Central Bank ("ECB") rooted in a distinction between so-called "fundamentally sound" and "distressed" banks (i.e., whose business model was affected by structural weaknesses). While the Recapitalization Communication was generally concerned to provide for effective exit mechanisms in order to incentivize banks to redeem the public capital injected as soon as possible, only distressed banks were forced to notify a restructuring plan involving structural measures.

- The Impaired Assets Communication of February 25, 2009 reflected a move from a rescue to a remedial phase in the management of the crisis and aimed to guide Member States in the design of relief measures directed toward the cleaning of banks' balance sheet of impaired or toxic assets.[24] The envisaged assets purchase or assets guarantee measures primarily faced the difficulty of determining the "real economic value" of the relevant assets, since it required some longer-term estimates. To address that issue, the Impaired Assets Communication provided for a coordinated valuation based on a methodology devised by the ECB following the identification and full disclosure of the relevant assets, and entailing costs-sharing mechanisms coupled with the restructuring of distressed banks.

- The Restructuring Communication of July 23, 2009 laid down detailed criteria guiding the Commission's assessment of restructuring plans for so-called "distressed" banks, i.e., whose business model was deemed unsustainable.[25] The overall objective of such restructuring was double: (i) ensuring the banks' long-term viability without State support and, thereby, the lasting strength of the EU banking system; and (ii) compensating for the competitive distortion caused by the aid granted, while reducing the risks of moral hazard and restoring appropriate business incentives (i.e., long-term stability over excessive risk-taking). In turn, these objectives translated in obligations to discontinue or reduce activities found to be at the root of the solvency issues encountered by the relevant aid beneficiary, and/or to divest significant non-core or loss-making assets. Given the particular conditions created by the crisis, the Restructuring Communication allowed for additional flexibility compared to the requirements provided for under the general Rescue and Restructuring Guidelines, including an extension of restructuring periods up to 5 years (contra normal period of 2 years), an exception to the general requirement that the beneficiary contributes 50% of the restructuring costs (in view of the difficulties in accessing private capital) and the lifting of the one-time last-time rule.

The early practice of the Commission in implementing the above guidelines was consolidated in a Staff Working Document dated August 7, 2009.[26] That practice confirmed the clear filiation

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[24] Communication on the treatment of impaired assets in the Community banking sector [2009] O.J. C 72/1.

[25] Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] O.J. C 195/9.

[26] "DG Competition's review of guarantee and recapitalization schemes in the financial sector in the current crisis" available on DG COMP's website at ec.europa.eu/competition/state_aid/legislation/review_of_schemes_en.pdf.

between the rules applicable in the context of the financial crisis and those laid down in the general Rescue and Restructuring Guidelines, as well as the necessary flexibility to adapt established principles to the specific circumstances of the financial crisis. In turn, these rules attempted to give substance in the crisis context to the overarching principles of appropriateness and proportionality (including necessity), which pervade EU economic law. Eventually, a review of the Commission's decisional practice reveals a willingness to effectively enforce applicable rules, which sometimes led to tense negotiations with Member States.[27]

Introducing exceptional procedural rules. The filiation with the general rescue and restructuring guidelines is also observable, at least conceptually, in the procedural two-pronged sequence followed by the Commission in assessing the compliance of State support to banks with Art. 107(3)(b) TFEU. In particular, the Commission followed a policy of authorizing rescue measures for a temporary six months period, which could be extended after consideration of a report on the implementation of the measures taken or, depending on the case, until a decision on the restructuring plan submitted subsequently.

In turn, the Commission was able to issue provisional authorization decisions in a matter of days, if not hours,[28] following the notification of the contemplated State aid, pursuant to a delegation of decisional power from the College of Commissioners (i.e., the whole Commission) to the Commissioner in charge of competition.[29] That delegation expressly aimed to reconcile "*the legitimate interests of Member States to prevent* […] *potentially harmful spill-over effects in the financial sector*", "*the need for effective State aid control*" and "*the need* [for private undertaking participating in rescue operations, e.g., the acquirer of a financial institution in difficulty] *to obtain as quickly as possible a degree of legal certainty* […] *as to the State aid law implications of envisaged or adopted rescue measures*".[30] Meanwhile, the Commission established an Economic Crisis Team to assist Member States in the design of their economic recovery plans.

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According to many, "[t]*he European Commission can be commended for treading a fine line between the rigorous enforcement of the relevant provisions of the Treaty and the need for flexibility and a speedy treatment of the most urgent cases*".[31] This is not to say that the Commission's action was exempt of tensions (see section 1.3(b) below). Still, by developing

27 Thus, DG COMP did not limit itself to rubber-stamp Member States' interventions in favor of their domestic banking industry, as some commentators initially observed (see Ph. Marsden and I. Kokkoris, "The Role of Competition and State Aid Policy in Financial and Monetary Law", *Journ. Int. Econ. L.*, 2010, p. 875).

28 For example, the Commission was able to decide on the compatibility with State aid principles of the package of measures designed to ensure the orderly winding down of Bradford & Bingley, within 24 hours ("*State aid: Commission approves UK rescue aid package for Bradford & Bingley*", European Commission press-release IP/08/1437, October 1, 2008).

29 The delegation, which was originally valid for three months starting October 1, 2008 provided that decisions had to be taken in agreement with the President of the Commission and the Commissioners for Economic and Monetary Affairs and for Internal Market, subject to: (i) the certification of the urgency of the measures to be adopted by a reasoned letter of the governor of the central bank of the Member State concerned; and (ii) prior approval by the Commission's Legal Service, DG ECFIN and DG Markt.

30 Communication from the President in agreement with Ms Kroes – Temporary empowerment, SEC(2008) 2575/2.

31 See, *e.g.*, D. Spector, "Competition policy in times of crisis", Concurrences, 2-2009, p.1.

workable rules based on established principles under tight deadlines, it brought welcome clarity at a time of great uncertainty. Did it manage to strike the right balance between strict enforcement and flexibility? This is not the focus of the present contribution even if it is interesting to observe in that regard that the number of appeals to the General Court against Commission decisions has been very limited,[32] though the only case decided so far did reveal some negligence with significant consequences. Rather, after reviewing the policy options pursued by the Commission, the following section explores the contours of the main tool relied upon by the Commission to combine the objective of restoring financial stability in the short-term with that of ensuring effective competition and restoring proper incentives in the European banking sector in the medium/long-term, that is conditionality.

2. CONDITIONALITY AS THE PREEMINENT COORDINATION TOOL

The objective of restoring financial stability in effect ruled out the possibility for the Commission to prohibit envisaged rescue measures. Hence, in order to balance that objective with the need to prevent distortions of competition, address moral hazard issues and prevent failed business models to perpetuate, the Commission had little choice but to authorize State intervention pursuant to Article 107(3)(b) TFEU, subject to conditions. In turn, these conditions were used as a key coordination tool and the negotiation of the terms thereof lied at the center of the interactions between the Commission, the relevant State and the beneficiary(-ies) of the aid.[33]

In practice, next to strict eligibility and remuneration requirements for the benefit of state support, whether in the form of guarantees, loans or capital injections,[34] the Commission conditioned the authorization of rescue schemes and individual remedial measures to a range of behavioral and, for distressed banks, structural conditions. These conditions impacted different actors including shareholders/investors, managers and the beneficiary institution itself. They are reviewed successively below under a somewhat arbitrary distinction between conditions

32 T-29 and 33/10, *ING/Commission* [2012] ECR II-not yet reported, appeal pending before the ECJ under reference C-224/12P (partial annulment of a Commission decision holding that an amendment to capital injection repayment terms amounted to an additional aid of two billion euros); T-332/12, *ING/Commission*, pending (concerning the conditions attached to the authorization of aid granted by the Netherlands); T-22 and 27/11, *Westälisch-Lippischer Sparkassen and Rheinischer Sparkassen und Giroverband/Commission*, pending on the merits after rejection of interim measures (concerning the refusal of the extension beyond February 15, 2011 of the time-limit for the sale and disposal of the new operations of Westdeutsche Immobillenbank AG in the framework of WestLB AG restructuring); T-457/09, *Westfälisch-Lippischer Sparkassen- und Giroverband (one of WestLB AG shareholder)/Commission*, pending on the merits after rejection of interim measures (action for annulment of the decision authorizing the €5 billion recapitalization aid given by Germany); T-319/11, *ABN Amro/Commission*, pending (concerning the acquisition ban attached to the authorization of the bank's recapitalization, and the duration thereof; and T-487/11, *Banco Privado Português et al./Commission*, pending (concerning the motivation of a Commission decision ordering the recovery of the payment by the Portuguese State of a loan owed by the applicant).

33 The Commission endeavored to leave a certain margin of discretion to Member States to reflect country- or institution- specific circumstances in devising rescue schemes and remedial measures.

34 For a thorough analysis, see D. Gerard, "EC competition law at grips with the financial crisis: flexibility on the means, consistency in the principles", *Concurrences*, No. 1-2009, pp. 46-62.

aimed at addressing moral hazard issues, on the one hand, and at preventing restrictions of competition, on the other hand.[35]

Conditions primarily aimed at addressing moral hazard issues. As noted, one of the main concerns of the Commission in dealing with moral hazard issues was to ensure that shareholders/investors support their fair share of the consequences of the financial turmoil and of the costs associated with the rescue measures designed by Member States.[36] To that end, various conditions have been imposed to the benefit of state guarantees, on the one hand, and of capital injections, on the other hand. The first condition attached to the benefit of state guarantee schemes related to the eligible debt instruments, which were limited, in essence, to retail and wholesale deposits and short-and medium-term debts and excluded hybrid and subordinated debts considered as Tier 2 capital (e.g., covered bonds).[37] Likewise, the benefit of guarantees was subject to proper remuneration in the form of service fees based on institution-specific risk and fixed premiums set according to a methodology devised by the ECB.[38]

As far as state recapitalization measures are concerned, the key issue was the proper remuneration thereof, knowing that the capital itself had to be paid back in any event. Eventually, a distinction was introduced between the remuneration of capital provided to insolvent or distressed credit institutions, on the one hand, and capital provided to 'sound' banks to strengthen their capital ratio and/or ensure the continuous supply of credit to the 'real economy', on the other hand.[39] Again, the ECB came up with a methodology to calculate proper remuneration rates with the double objective of helping banks – thus providing for an interest rate below market rates – while maintaining sufficient incentives for banks to redeem the capital injected and exit the state support scheme.[40] Overall, the benefit of capital injections was conditioned on an annual return comprised between 8 and 12%. Given their structural character, recapitalisation schemes have also been considered much more carefully by the Commission than guarantee schemes and therefore subject to tighter requirements, including:

- limitations on the distribution of dividends in the form of either an outright prohibition pending redemption[41] or the grant of a special dividend/coupon for the state.[42] The underlying rationale is that taxpayer money ought not to serve remunerating capital but to

35 As explained in section 3 below, there is in fact a clear convergence between the conditions imposed to tackle moral hazard and to prevent restrictions of competition. Likewise, the objectives sought by the Commission were broader and included, prominently, restoring the long-term viability of the EU banking system.

36 This is particularly apparent from the conditions surrounding the eligibility of debt instrument for the benefit of State guarantees.

37 Banking Communication, para. 21. For a discussion, see, *e.g.*, the Commission decision approving the Danish (NN 51/2008) and Spanish (N 54/2008) rescue plans.

38 On 20 October 2008, the European Central Bank issued "Recommendations on government guarantees on bank debt", which were largely relied upon by member states and the Commission in setting adequate remuneration rates.

39 Recapitalisation Communication, para. 3.

40 Recommendations of the ECB Governing Council on the pricing of recapitalisations, November 20, 2008 (available at www.ecb.int/pub/pdf/other/recommendations_on_pricing_for_recapitalisationsen.pdf).

41 See the Commission decisions approving the rescue plans of Germany (N 512/2008) and Denmark (N 51/2008).

42 See the Commission decisions concerning ING (N 528/2008) and the Anglo Irish Bank (N 9/2009).

enable banks to pursue their activities with a focus on long-term stability rather than short-term returns;

- limitations on share buyback programs, which were imposed for roughly the same reason as limitations on the distribution of dividends, either in the form of an outright prohibition pending redemption[43] or subject to approval by State Board representatives;[44] and

- the possibility for states to exercise oversight and/or control on important strategic decisions of recapitalized banks, either through the issuance of preferred shares carrying extra rights,[45] and/or the appointment of State Board representatives carrying special veto rights.[46]

The Commission has also endeavored to mitigate moral hazard issues on the part of managers with a view to ensuring that they are guided by the right incentives and favor stability over excessive risk taking. Accordingly, it viewed positively the dismissal of the management of ailing banks such as Sachsen Landesbank (C 9/2008) or Fortis (NN 42/2008), the review of risk management and corporate governance practices as in the Commerzbank case (N 625/2008) and the imposition of limitations on managers' compensations and severance packages.

The limitations put on managers' compensations illustrates well the margin of discretion left to Member States in the implementation of conditions imposed by the Commission, notably in view of the diversity of national corporate culture and political priorities.[47] This is also visible in relation to the implementation of the requirement to condition capital injections to sustained lending to the real economy, which typically came as a counterpart to a lower capital remuneration rate (around 8%).[48]

***Conditions primarily aimed at preventing distortions of competition*.** Generally, a key concern of the Commission has been to prevent State support from giving a competitive edge to banks in difficulty over their competitors. In that respect, one can distinguish between behavioral conditions, on the one hand, which are generally imposed on the beneficiaries of bailout plans and (in theory) subject to close monitoring and structural conditions, on the other hand, which are tied to the restructuring of ailing or 'distressed' institutions.

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43 Commission decision approving the Irish rescue plan (N 48/2008).

44 See, *e.g.*, the ING decision (N 528/2008).

45 See, *e.g.*, the Allied Irish Bank decision (N 241/2009).

46 See, *e.g.*, the Commission decisions approving the rescue plans of Greece, Ireland and the Netherlands.

47 For example, France (N 618/2008) mandated compliance with ethics rules aimed at executives and traders and prohibited severance package in case of "management failure", while Greece (N 560/2008) decided to cap the level of compensation of bank executives at the level of that of the Chairman of the Greek Central Bank. In the UK, key measures included: (i) no 2008 cash bonus; (ii) compliance with best practice codes; (iii) dismissal at reasonable and fair cost. In Germany, executive compensation was capped at € 500 K and contractual severance terms were prohibited. Ireland established a public committee to oversight compensation and 'golden parachute' issues. Denmark chose to prohibit any new stock-option plans.

48 In the UK (N 507/2008), the authorities committed to require banks to maintain the availability of lending to homeowners and small businesses at 2007 levels and to support schemes to prevent home foreclosures. In France (N 618/2008), beneficiaries of capital injections were bound by an obligation to increase loans to individuals, SMEs and local authorities by 3-4% annually. In Germany (N 512/2008), a general requirement was included in the bailout plan to the effect that beneficiaries ought to take account of domestic industry's borrowing requirements (particularly SMEs).

The Commission has systematically conditioned the benefit of bailout plans, whether in the form of guarantees and/or capital injections, to a series of behavioral conditions that have been applied in a relatively homogeneous fashion across the European Union, including: [49]

- *Advertising restrictions*. The most pervasive behavioral condition imposed on the beneficiaries of state support was a prohibition to communicate on and market that advantage to customers or to develop a commercial strategy on that basis.[50] At the peak of the crisis in October 2008, one could witness a tendency of certain institutions to claim such advantage to attract - or at least slow the run of - customers.[51] The Commission insisted that such behavior be properly sanctioned but no formal finding of abuse appears to have been reported.

- *Growth ceilings*. Early on in the crisis, the Commission also systematically imposed growth ceilings on the beneficiaries of bailout plans, expressed in terms of GDP, market share, balance sheet or historical growth.[52] Later on, the Commission abandoned that practice, acknowledging that it could form an obstacle for fundamentally sound banks to sustain lending to the economy and, generally, to compete for customers and increase output levels.[53] However, the Commission continued imposing limitations on external growth on a case-by-case basis.[54] In some cases, mainly those involving Dutch financial institutions (e.g., N 528/2008 and N 569/2008), one also encountered a sort of catchall condition imposing on beneficiaries to "*refrain from expansion of business activities that would not have been pursued absent the capital injection*".

- *Restrictions to the remuneration of retail banking services*. In some cases, reportedly at the request of complainants, the Commission imposed a prohibition to undercut rivals either for specific services, in certain areas of business or even across the board.[55]

49 One of the main reasons underlying the imposition thereof has been the massive inflow of deposits observed in the early days of the crisis towards banks benefiting from state backing. The ultimate example of such phenomenon was Northern Rock, which in only a few weeks moved from the brink of bankruptcy after customers withdrew deposits massively to a much healthier situation after having been virtually nationalized.

50 Banking Communication, para. 26 and various Commission decisions on national rescue plans.

51 For example, competitors of *Fortis Bank* and *KBC* in Belgium and of *ABN AMRO* in the Netherlands have complained that those banks introduced more aggressive offers after having benefited from capital injections by the Belgian, French, Dutch and/or Luxemburg authorities.

52 Banking Communication, paras. 26-27. For example, in seeking the approval of their national rescue plan, the German authorities committed to ensure that the beneficiaries thereof would not exceed a certain balance sheet growth rate (N 512/2008).

53 See in particular footnote 18 of the Recapitalisation Communication.

54 For example, in the case of Commerzbank, it noted that: "*Commerzbank has recently acquired Dresdner Bank. However, Commerzbank will not be in a position to use state aid to the detriment of competitors. The bank will be restricted from acquiring other competing financial institutions for a period of three years*" (see N. Kroes, Opening remarks at press-conference – State aid decisions on Commerzbank, Hypo Real Estate and Northern Rock, Brussels, 7 May 2009, SPEECH 09/217). Likewise, in one of the decisions concerning Fortis Bank Belgium (NN 42/2008), the Commission imposed a commitment on the acquirer BNP Paribas "*not to repurchase Fortis Netherland assets for a 4 years period*".

55 In the Fortis decision of December 3, 2008 (NN 42/2008), for example, the Commission referred to a "commitment not to offer for Internet accounts interest rates higher than the other main retail banking actors in Belgium", with some limitations if, for example, Fortis' market shares dropped below 25%. In the

- *Solvency requirements*. Another relatively common condition entailed the obligation to keep high solvency ratios and, conversely, to avoid that capital injections be used to fuel growth and, generally, for other purposes than ensuring long-term stability.[56]

To ensure a level playing field and prevent the continuation of failed business models, the Commission also imposed structural conditions on distressed credit institutions, in pursuance of a triple objective of burden-sharing, compensation and long-term viability. The conditions have taken the form of reductions in activities and/or outright divestitures of non-core or loss-making assets.

- Reductions in activities entailed the discontinuation of businesses that were found to be at the root of the solvency issues encountered by the beneficiaries of state rescue measures. They involved, for example, the termination of proprietary trading activities,[57] or more institution-specific measures. The following examples are illustrative of the kind and scope of such measures: (i) Sachsen LB had to undertake the closure of its Irish subsidiary involved in structured financial investments and international real estate business (C 9/2008); (ii) Northern Rock committed originally to the closure of many of its overseas operations, to a drastic reduction in its lending operations and to enter into a retail mortgage redemption program (NN 70/2007); and (iii) Commerzbank pledged to a reduction in its investment banking operations (N 625/2008).

- As noted, the Commission also imposed compensatory measures for the benefit of state support in the form of outright divestitures. Unsurprisingly, the actual assets to be divested were not necessarily identified in the decisions conditioning the benefit of capital injections and other rescuing measures. For example, the Sachsen LB decision refers merely a "sale of assets" (C 9/2008). In the Commerzbank case, though, after controversies as to the scope and nature of the requested divestitures, it was disclosed that the bank would divest its real estate activities (Eurohypo), as well as "other subsidiaries" (N 625/2008).

To this day, it is estimated that over 50 financial institutions have been the subject of restructuring measures, including 85% of the beneficiaries of recapitalization measures and all beneficiaries of impaired asset relief support. Likewise, these measures would have entailed about €2.4 trillion in balance sheet reductions. In contrast to the situation in the US, orderly liquidations were limited to a few cases where the viability of the relevant bank could not be restored, including Fiona in Denmark, Kaupthing Luxembourg, WestLB in Germany, Bradford & Bingley in the UK and Banco Privado Portugues.

Dexia decision of November 2008 (NN 50/2008), the Commission referred to a "commitment not to offer interests rates for retail deposits higher than those of the three main attractive remunerations offered by the ten largest retail banks in each of Luxembourg, France and Belgium", in addition to a limitation on the openings of preferred savings accounts. Likewise, in the press-release commenting on the Commerzbank decision,[55] the Commission emphasized that the bank "will be prevented from doing business (including deposit taking) under more favorable price conditions that its top three competitors in markets/products where it has a market share above 5%".

56 See, *e.g.*, Commission decision N 528/2008.

57 See, *e.g.*, Commission decisions on Sachsen LB (C 9/2008) and West LB (NN 25/2008).

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In view of the above, it appears that the conditions attached to the benefit of State support enabled the Commission to pursue a complex mix of competition and regulatory objectives in dealing with the unprecedented challenges raised by the crisis. In the words of EU Competition Commissioner Kroes: "[T]*he current financial crisis is a good illustration of one of the ways regulation and competition law are connected*".[58] In turn, the next section focuses on how the Commission's reliance on EU state aid rules enabled it to palliate the regulatory failures revealed by the financial crisis.

III. STATE AID ENFORCEMENT AS A REGULATORY FIX

As noted, the crisis revealed that the EU lacked common tools to address the failure of banks with cross-border operations and to coordinate national recovery plans.[59] Likewise, it highlighted the absence at EU and national level of prompt corrective action mechanisms and special resolution regimes. The State aid control system then emerged as the most robust management and coordination instrument available and enabled the Commission to play the role of "*de facto crisis-management and resolution authority at EU level*".[60] Beyond the institutional perspective, the State aid control system and in particular the conditions attached to the authorization of rescue measures allowed the EU to mitigate structural problems affecting the EU banking system and, in effect, to palliate substantive regulatory failures.

It is commonly agreed that "*regulation is a necessary ingredient for well functioning financial systems*", but that it "*did not achieve the correct balance between risk and the search for return*" in the years preceding the crisis.[61] Once the crisis broke out, State aid control allowed the Commission to swiftly address incentive problems affecting the EU banking system and, subsequently, to create the conditions for "*a leaner, cleaner and healthier banking system*", to use one of Commissioner Almunia's favorite lines.[62] Because it aims to "remedy a serious disturbance in the economy of a Member State", Art. 107(3)(b) TFEU is naturally designed to tackle macroeconomic issues calling for industry-wide remedies that are necessarily regulatory in nature. This is clearly apparent from the Commission's focus on the return of distressed banks to long-term viability, which led it to second-guess business models, analyze portfolio valuations and order structural remedies in the form of divestiture and deleveraging requirements.

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58 N. Kroes, "The interface between regulation and competition law", speech at the Bundeskartellamt Conference on Dominant Companies – The Thin Line between Regulation and Competition Law, Hamburg, 28 April 2009 (SPEECH 09/202).

59 Some instruments of coordination already existed but quickly showed their limits in view of the magnitude of the crisis. See, e.g., Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability, June 1, 2008, ECFIN/CEFCPE(2008)REP/53106 REV REV.

60 J. Almunia, "Restructuring EU banks: the role of State aid control", Speech/12/122, Brussels, CEPS, 24 February 2012.

61 OECD, *Bank Competition and Financial Stability*, 2011, p. 20; OECD, *Competition and Financial Markets*, 2009, p.7.

62 J. Almunia, Speech/12/29 to the "Third Future of Banking Summit", Paris, January 24, 2012.

The following two sections briefly review the regulatory objectives sought by the Commission in enforcing State aid rules in the context of the crisis (1) and highlights tensions between these objectives and the means developed to achieve them (2).

1. REGULATORY OBJECTIVES UNDERLYING THE CRISIS REGIME OF STATE AID CONTROL

Drawing on previous sections, the following table outlines the regulatory objectives underlying the enforcement of the EU State aid rules in the context of the financial crisis and lists the corresponding steps taken to implement them.

Regulatory Objectives and Implementation Steps	
Financial stability	• Authorization of Member States rescue schemes and individual remedial packages (guarantees, recapitalization, impaired assets relief measures) on the basis of common principles.
Integrity of the single market	• Coordination of national measures by the Commission through enforcement of State aid law principles adapted to the crisis (Art. 107(3)(b) TFEU) and interpreted in communications; • Non-discrimination requirements in the eligibility of credit institutions to the benefit of national recovery plans.
Competition	• Burden sharing/remuneration of State support and exit incentives; • Own contribution to restructuring; • Solvency requirements; • Advertising ban; • Growth ceilings; • Constraints on retail banking pricing.
Moral hazard	• Burden-sharing/remuneration of State support and exit incentives; • Own contribution to restructuring; • Solvency requirements; • Moratorium on payment of dividends and coupons and limitations on share buyback programs; • Management dismissal and compensation limitations; • State oversight/veto.
Return to long-term viability	• Restructuring, *i.e.*, closing of activities, divestiture of assets, deleveraging/compliance with capital ratio requirements

As apparent from this table, conditionality was again the key feature that enabled the Commission not only to coordinate national bailout plans but also to pursue a combination of regulatory objectives in the enforcement of EU State aid rules. Likewise, it appears that certain conditions enabled the Commission to tackle different objectives. In other words, while balancing these objectives was a clear challenge, they converged in various ways. For example, the same key remedies enabled the Commission to pursue the objectives of limiting distortions of competition and of addressing moral hazard concerns. Such convergence raises interesting questions as to the virtues of competition as a market discipline and the relationship between competition and stability.

However, the pursuance of different regulatory objectives necessarily creates tensions, which need to be arbitrated. Though a formal hierarchy between these objectives does not clearly transpire from the Commission decisional practice, certain priorities may have existed at certain points in time and/or shifted over time. The following section highlights some of the tensions observed between the various objectives pursued by the Commission and the choices underlying the enforcement of State aid rules in the context of the crisis.

2. REGULATORY CHOICES: TENSIONS IN THE CRISIS REGIME OF STATE AID CONTROL

As noted, the apparent convergence between certain regulatory objectives pursued by the Commission cannot hide some more or less deep tensions between them involving mainly, but not exclusively, restructuring requirements. The present section sketches a number of these tensions with no other ambition than to outline choices inherent to, and highlight the complexity of, the balancing exercise undertaken by the Commission in applying State aid principles to national bailout plans.

- *Tension between restructuring conditions and financial stability*. The objectives to limit distortions of competition, address moral hazard issues and ensure long-term stability have led the Commission to require so-called distressed banks to restructure, which entailed reductions in activities and outright divestitures potentially amounting to a very large percentage of banks' respective balance sheet.[63] Naturally, in a crisis context, it is inherently difficult to value the assets to be divested, to attract purchasers and to secure the financing of large acquisitions. Hence, the question arose as to whether forced assets disposals did actually benefit competitors, redress incentives and restore long-term viability or whether they were rather harming financial stability by depreciating the assets value of the banking sector as a whole. To address that tension, the Commission displayed flexibility in the implementation of restructuring processes, for example by considering alternative divestitures, as it did in the cases of KBC and Commerzbank, or by delaying the divestment schedules.[64]

63 Commerzbank and ING are said to have been compelled to reduce their balance sheet by about 500 billion.

64 The Commission also displayed a willingness to treat with flexibility solvability issues arising from the sovereign debt crisis and the need to resort to public support to mitigate the consequences thereof, *e.g.*, by

- *Tension between financial stability and burden-sharing*. The principle of burden-sharing, whereby shareholders, creditors and hybrid capital investors are to support their fair share of the costs associated with a bank's rescue, is a central pillar of the Commission strategy to address moral hazard issues and limit distortions of competition. It translated, notably, in restrictions on banks' freedom to pay dividends and coupons, and to purchase own shares, pending reimbursement of taxpayers' money. However, a bank's ability to pay coupons to hybrid capital investors, for example, is one among other important factors to guarantee its credibility on the wholesale lending market, ensure its liquidity and, given the interdependence of financial institutions, to contribute to financial stability. In that regard, while not entirely consistent, the Commission appears to have been quite strict and to have favored other indicators of banks' liquidity, such as higher capital ratio requirements.

- *Tension between competition and restructuring*. One tension that emerged quickly when the crisis broke out was that of the need for restructuring measures to limit restrictions of competition. The argument was that, because of the interconnectedness of the financial sector, banks directly benefit from the mere fact that competitors got rescued. In addition, some observers queried whether forced assets sales were likely to lead to more or less competition. The substance of these interrogations diverged, however; while some were concerned that divestitures could reduce scale and innovation efficiencies, other pointed to the risk of increased concentration. The former interrogations were confronted to, and apparently muted by, the need to ensure the long-term viability of the EU banking system and to create the conditions for "*a leaner, cleaner and healthier banking system*". As to the latter, empirical evidence shows that concentration on national and EU markets did not increase on account of the effects of the crisis and of the implementation of rescue plans.[65] Generally, though, it appears that non-aided banks performed better since 2008 than those that had recourse to public rescue schemes.

- *Tension between competition and consumer benefits*. As noted, the Commission imposed behavioral obligations on beneficiaries of State support that aimed to compensate for the impact thereof on competition. Some of these obligations related to retail banking services and included prohibitions to compete aggressively on prices and to undercut rivals. Imposing pricing constraints with the view to promoting competition is of course inherently questionable, even more so when consumer interests appear to be directly at stake. Recently, consumer associations in the Netherlands, for example, complained that higher mortgage rates than in surrounding countries might have been caused by price-leadership bans imposed in the framework of the restructuring of large credit institutions accounting for 70% of the domestic mortgage market.

favoring a package of behavioral constraints over divestments and balance-sheet reductions (see J. Almunia, Speech/12/29 to the "Third Future of Banking Summit", Paris, January 24, 2012).

65 G.-J. Koopman, "Stability and competition in EU banking during the financial crisis: the role of State aid control", CPI Journal, 2011, vol. 7, n°2, p. 17.

- *Tension between long-term viability and the integrity of the internal market*. When approving rescue schemes, the Commission was particularly careful to ensure that they contain objective and non-discriminatory eligibility criteria.[66] Guarantee and recapitalization plans, in particular, were to be open to all credit institutions with systemic relevance to the economy, regardless of their origin, i.e., all banks incorporated in a relevant Member State, including subsidiaries or branches of banks headquartered abroad, with "significant activities" in that Member State.[67] However, tensions arose between divestitures required as part of restructuring plans and the internal market policy because banks had a tendency of divesting operations outside of their home markets, which was seen as reinforcing the home-country bias of State support schemes and as capable of leading to internal market fragmentation. The early cases involving the German Landesbanken, for example, fuelled such concerns.[68] However, the Commission appears to have favored more consistent remedies in later cases, for example by refraining to mandate the divestiture of Commerzbank's retail banking network in Central and Eastern Europe. Likewise, it seems to have favored cross-border rescue mergers over purely domestic ones.[69]

- *Tension between long-term viability and economic growth*. Since the early days of the crisis, the Commission was concerned to ensure that banks keep lending to the real economy and supporting industrial projects. In Europe, SMEs are particularly dependent on credit institutions to support their growth and States are very much dependent on SMEs as a source of growth (and employment). The severe reduction in the issuance of new loans toward the end of 2008 led the Commission to introduce some flexibility in the conditions attached to recapitalization measures when they were designed for so-called "sound" banks. A tension surfaced, however, between the restructuring obligations imposed on "distressed" banks and the concern to see banks continue financing the economy. The argument was that reduced balance sheets entailed reduced financial surfaces and a reduced ability and incentive to lend to companies and individuals. Similar arguments were voiced in the debate about the Basel III proposal and its requirements for larger reserves and lesser risk exposure. In theory, that tension can have significant consequences. Likewise, it is a fact that some important EU credit institutions were subject to significant restructuring obligations (e.g., ING and

66 *Banking Communication*, para. 16.

67 *Banking Communication*, para. 18 and *Recapitalization Communication*, para. 46. See, *e.g.*, Denmark, para. 6: an estimated 140 banks are eligible under the Danish scheme. In Spain, the guarantee scheme is open to all solvent registered credit institutions having a share of at least 1/1000 of the credit market (see Commission press-release IP/08/2049 of December 23, 2008: "*State aid: Commission approves Spanish guarantee scheme for credit institutions*") Note also that the issue of discrimination is particularly sensitive in those Member States, like Belgium, which have adopted a series of individual measures instead of devising a general remedial scheme.

68 See, *e.g.*, the original WestLB decision (NN 25/2008) where the Commission noted with apparent satisfaction that: "*In the context of its strategic reorientation, WestLB will refocus on its home market…and reduce its international activities*" (see also the Bayern LB case N 615/2008).

69 See, *e.g.*, Case COMP/M.5363 – *Santander/Bradford & Bingley Assets* and Case COMP/M.5384 – *BNP Paribas/Fortis Belux* (*contra* the Fortis Netherlands/ABN Amro case and Commission press-release MEMO/08/729 of 21 November 2008: "Mergers: Commission closely monitoring Dutch State plans as regards Fortis Bank Nederland and ABN AMRO Bank Nederland").

Commerzbank). However, data suggest that the size of the banking sector calculated in terms of assets value still increased between 2007 and 2009, even if by a modest 2.4%. Likewise, the Commission claims that no evidence have been found to the effect that the crisis regime of State aid control would have led to a negative effect on lending to the real economy by forcing across-the-board deleveraging.[70]

The above discussion outlined a number of issues that the Commission had to consider and/or address while applying State aid principles to the circumstances created by the financial crisis. These issues necessarily called for regulatory choices, which were informed by constant interactions with Member State governments and aid beneficiaries. Fundamentally, the complexity and rapidly changing character of these circumstances also created tensions in the enforcement strategy followed by the Commission, notably between the need for coordination and legal certainty, on the one hand, and that of adaptability and flexibility, on the other hand. While the Commission endeavored to issue detailed guidelines in the form of communications, the implementation thereof necessarily required taking account of specific market and regulatory contexts. Thus a tension surfaced over time between, on the one hand, the need for a case-by-case assessment of the viability of credit institutions and of the restructuring conditions attached to the benefit of public support and, on the other hand, the requirement of equal treatment. Put otherwise, the principle of proportionality sometimes required derogations to (or a differentiated implementation of) stated principles but the lack of clarity as to the circumstances justifying these derogations raised concerns of discrimination. That tension illustrates in fact a fundamental limit to the management of the financial crisis by means of the EU State aid rules, specifically to tackle the root causes thereof and effectively return the EU banking system on a path towards long-term viability. In other words, there was and still is a need to move beyond State aid enforcement in dealing with the crisis.

IV. BEYOND THE CRISIS AND BEYOND STATE AID ENFORCEMENT

The reliance on State aid principles enabled the Commission to coordinate national rescue plans and to pursue a number of regulatory objectives, to a certain point. However, the case-by-case assessment of the situation of individual banks showed its limits in securing a return to normal market conditions and in addressing the root causes of the financial crisis. Though effective as an emergency tool,[71] the crisis regime of State aid control was considered early on as suboptimal compared to changes in the regulatory framework applicable to financial services. Section (1) below reviews a limited number of these regulatory initiatives aimed to address permanently some of the issues originally dealt with through the enforcement of State aid principles. Interestingly, the crisis has also shaken State aid rules and prompted a review of the State aid enforcement system, as outlined in section (2) below.

70 G.-J. Koopman, *op.cit.*, 2011, vol. 7, n° 2, p. 17.

71 With liquidity becoming more widely available, banks started withdrawing from public support schemes in the first months of 2010 (except in some Member States such as Germany, Greece, Spain and Ireland). However, the sovereign debt crisis and the remaining volatility of financial markets prompted the Commission to extend beyond 2010 (so far until the end of 2012) the possibility for credit institutions to have recourse to crisis-related State support approved on the basis of Article 107(3)(b) TFEU.

1. MANAGING THE CRISIS BEYOND STATE AID ENFORCEMENT

It is widely perceived that the regulatory landscape prevailing before the crisis contributed to changes in business models and activities that were not conducive to financial stability.[72] Immediate stability issues were addressed by emergency bailout plans that afforded no cure, though, for the structural flaws unveiled by the crisis. As a result, new and improved rules for bank regulation, supervision and resolution were considered necessary in order to solve the coordination and substantive issues encountered by the EU and its Member States when the crisis broke out. In effect, the Commission has tabled about 30 proposals to improve the regulation of the EU financial system since 2008, including with respect to issues that were originally tackled by means of the enforcement of State aid principles.

Coordination issues. As noted, DG COMP's State aid Directorate acted over the past years as a de facto crisis-management and resolution authority at EU level. However, it is neither its primary institutional role nor does it have all appropriate tools at its disposal to that effect. Legislative action was therefore required to provide for permanent preventive and corrective mechanisms, which led to the revamping of the EU banking supervision system, on the one hand, and to proposals for a permanent bank recovery and resolution system, on the other hand. Thus, within the European System of Financial Supervision (ESFS), the European Systemic Risk Board (ESRB) is now directly responsible for the macro-prudential oversight of the EU financial system, with the objective of preventing and mitigating systemic risks capable of harming the financial stability of the EU.[73] To that effect, it is empowered to issue warnings and to recommend ex-ante remedial measures. As far as correction mechanisms are concerned, the Commission has recently proposed the adoption of a "*common toolkit and roadmap to manage the failure of banks*",[74] which aims primarily to strengthen and harmonize resolution tools and powers across the EU in order to move the cost of future bank failures to the private sector,[75] thereby also addressing moral hazard issues.

However, coordination issues have not only been institutional in nature. In fact, the need for coordination at EU level was prompted in the first place by large flows of deposit money travelling across borders in search for the most protective regulatory regime. Paradoxically, the consequence of that regulatory competition was to threaten the credibility of the most generous regimes, while worsening the solvability of banks established elsewhere, thus affecting overall stability. Through its various State aid communications interpreting the contours of Art. 107(3)(b) TFEU, the Commission endeavored to contain these pressures. In the early days of the crisis, these efforts were supplemented by a welcome review of the EU regulatory framework for

72 OECD, *Bank Competition and Financial Stability*, 2011, p. 10.

73 Regulation 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] *O.J.* L 331/1.

74 New crisis management measures to avoid future bank bailouts, IP/12/570, June 6, 2012.

75 The Commission initiative is based on the observation that the underdevelopment of resolution mechanisms at EU level, especially compared to the US, has proved very costly for Member States and taxpayers.

deposit-guarantee schemes "*in order to ensure consumer protection and financial stability in the* [EU] *and to avoid distortions of competition between Member States*".[76]

Substantive issues. Next to coordination issues pertaining to the management of the crisis, the EU legislator also endeavored to address directly a number of factors viewed as contributing causes thereof, which could only imperfectly be dealt with by means of conditions attached to the benefit of public support schemes in the framework of State aid enforcement. This has been the case for capital requirements, for example, with the adoption of two directives aimed to improve the quality of banks' capital and the management of large exposures and liquidity risks.[77] Likewise, the EU took a number of initiatives responding to the "*widespread consensus that inappropriate remuneration practices in the financial services industry also induced excessive risk-taking and thus contributed to significant losses of major financial undertakings*".[78] Notably, it empowered banking supervisors to assess remuneration schemes as part of the prudential review of regulated financial institutions.[79]

The above examples illustrate the close connections between the crisis regime of State aid control and the reform of the EU banking regulatory framework. While the former was relied upon as a default crisis-management mechanism, the latter has endeavored to complement emergency State aid guidance and decisions, and to reduce the likelihood of future bank failures. Interestingly, in a sort of reflexive twist, the crisis also prompted regulatory initiatives in the sphere of State aid enforcement, as briefly reviewed below.

2. STATE AID ENFORCEMENT BEYOND THE CRISIS

If State aid enforcement has been used as a financial crisis management tool in recent years, the financial crisis has also contributed to reforming procedural and substantive aspects of the State aid enforcement system. Procedural efficiency, in particular, has been a landmark of the Commission's State aid enforcement practice in the framework of the crisis. As noted, authorization decisions were sometimes adopted within days of the notification of the relevant aid or aid schemes after (sometimes tense) pre-notification discussions aimed to clear contentious points. That experience has now permeated State aid procedures beyond the crisis context. A simplified procedure for the treatment of certain types of aid has been introduced, entailing the adoption of a short-form authorization decisions (no aid or no objection) within 20

76 Directive 2009/14 of 11 March 2009 amending Directive 94/19 on deposit-guarantee schemes as regards the coverage level and the payout delay [2009] *O.J.* L 68/3.

77 Directive 2009/111 of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] *O.J.* L 302/97; Directive 2010/76 of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] *O.J.* L 329/3.

78 Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector [2009] *O.J.* L 120/22, para. 2.

79 See above Directive 2010/76 of 24 November 2010.

working days from the date of notification.[80] Likewise, the Commission has issued best practices for the conduct of State aid control procedures, which emphasize the "*added value of pre-notification contacts* [to] *pave* […] *the way for a more speedy treatment of notifications*" and the possibility to enter into a "*mutually agreed planning* […] *to increase the transparency and predictability of the likely duration of a State aid investigation*".[81]

From a substantive point of view, the crisis has certainly reaffirmed the legitimacy of State aid control as a tool "*essential to ensure a well functioning single market*".[82] As part of the EU State Aid Modernization Initiative, the Commission has now announced its intention to put in place a permanent set of rules for rescuing and restructuring financial institutions in the post-crisis environment, consistent with regulatory proposals for a permanent EU crisis management and resolution system.[83] Likewise, the experience gained in dealing with the crisis has triggered a revision of the Rescue and Restructuring Guidelines for non-financial firms, with the view to tightening the control of "*that very distortive type of aid in order to ensure that the market process of exit is interrupted by State intervention only when truly justified*".[84]

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Over the last four years, the State aid enforcement system has proved to be a – somewhat unexpected – cornerstone of the management of the financial crisis in Europe. In particular, it enabled the Commission to coordinate the various national recovery plans and to pursue a combination of competition and regulatory objectives by conditioning the benefit of public support schemes to various requirements. Though surprisingly effective, the reliance on State aid rules has also shown its limits and has been supported and supplemented by a broad legislative agenda for reforms of the EU regulatory framework for financial services. Eventually, the financial crisis provides in many respects another yet fascinating example of the complex interaction and complementarity between competition and regulation, which remains one of the great puzzles of economic policy.

80 Notice from the Commission on a simplified procedure for the treatment of certain types of State Aid [2009] *O.J.* C 136/03.
81 Code of Best Practice for the conduct of State aid control procedures [2009] *O.J.* C 136/04, paras. 10 and 19.
82 Communication on EU State Aid Modernisation (SAM) - Brussels, 8.5.2012 COM(2012) 209 final, para. 15.
83 Idem, para. 18.
84 Idem.

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