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State Aid in the Financial Services  
Sector and the Implications of the  
Recent Financial Crisis

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# Contents

<b>SUMMARY</b>	<b>1</b>
<b>ABBREVIATIONS</b>	<b>3</b>
<b>1 INTRODUCTION</b>	<b>4</b>
1.1 Purpose	4
1.2 Method and Material	4
1.3 Delimitation	5
<b>2 STATE AID RULES IN THE FINANCIAL SERVICES SECTOR</b>	<b>7</b>
2.1 Overview of State aid provisions	8
2.1.1 Through Member State or State Resources	9
2.1.2 Economic Advantage	10
2.1.3 Selectivity	12
2.1.4 Distortive Effects on Competition and Trade	13
2.1.5 Derogations	13
<b>3 COMMON TYPES OF STATE AID GRANTED IN THE FINANCIAL SERVICES SECTOR</b>	<b>16</b>
3.1 Rescue and Restructuring Aid	17
3.1.1 Eligibility for the Application of Guidelines	19
3.1.2 Compatibility of Restructuring Aid	20
3.1.2.1 Restoration of financial and commercial viability	21
3.1.2.2 The minimum necessary to restore viability	21
3.1.2.3 No undue distortion of competition	23
3.1.2.4 The one-time last-time principle	24
3.1.3 Compatibility of Rescue Aid	25
3.1.4 Case Analysis	26
3.1.4.1 GAN Group	26
3.1.4.2 Bankgesellschaft Berlin AG	28
3.2 State Guarantees	31
3.2.1 Scope of the Commission Notice	32
3.2.2 Aid Element	33
3.2.3 Conditions Excluding the Existence of Aid	34
3.2.4 Improvements and Some Practical Difficulties	36
3.2.5 Case Analysis	37
3.2.5.1 Anstaltslat and Gewährträgerhaftung	37
<b>4 STATE AID RULES IN THE CONTEXT OF THE CURRENT FINANCIAL CRISIS</b>	<b>40</b>
4.1 Phase I – Adherence to Existing Measures	41
4.1.1 UK Rescue Aid Package for Northern Rock	42
4.1.2 Sachsen LB	44

4.2	Phase II – Acknowledgement of the Systemic Nature of the Crisis and Adoption of New Measures	46
4.2.1	Banking Communication	47
4.2.1.1	Guarantees Covering the Liabilities of Financial Institutions	48
4.2.1.2	Recapitalization of Financial Institutions	49
4.2.1.3	Controlled Winding-up and Other Forms of Liquidity Assistance	50
4.2.2	Recapitalization Communication	51
4.2.3	Guarantee Scheme for Banks in Ireland	52
4.2.4	Aid to ING Groep N.V.	54
<b>5</b>	<b>CONCLUSION</b>	<b>57</b>
	<b>APPENDIX</b>	<b>60</b>
	<b>BIBLIOGRAPHY</b>	<b>63</b>
	<b>TABLE OF CASES</b>	<b>68</b>

# Summary

Financial services sector is fundamental to economic growth and development in all advanced economies. Financial services such as banking, savings and investment, insurance, and debt and equity financing constitute a nation's economic engine by fulfilling three core functions in the economy. Firstly, these services provide financial intermediation functions between savers/investors that are looking for security and growth and consumers/businesses who are looking for access to credit and capital. This intermediation is vital for allocating capital to the most profitable investments, providing a mechanism for saving, raising productivity, and consequently, increasing competitiveness of the nation in the global economy. Secondly, in addition to pooling investment risks, financial services sector provides a mechanism to manage other risks effectively and efficiently by way of insurance and increasingly sophisticated derivatives. These tools help private citizens and businesses cope with diverse global risks and uncertainties. Finally, financial services sector provides the practical mechanisms for money to be managed, transferred and received quickly and reliably. This is an essential requirement for commercial activities to take place and for participation in international trade and investment.<sup>1</sup>

Therefore, the financial services sector is specific and can easily be distinguished from other sectors. A serious downturn encountered in this specific sector might have disastrous impacts on the real economy of a nation. The current economic crisis in the United States and Europe, marked by the ongoing weaknesses of major banks and the resulting credit and capital crunch, highlights the critical importance of the financial services sector in national and global economies.

Considering the importance of this sector, it is very hard for States to be unresponsive to the calls for assistance from ailing financial institutions. In such a situation, the States ask for a well-targeted and organized public measures in order to safeguard financial stability and restore economic viability. The State aid measures are perceived as part of the solution and thus, they are generally implemented to rescue failing firms in the financial services sector. However, Member States in the EU should follow certain State aid rules while intervening to this specific sector. Unfortunately, the specific nature of this sector is not recognized in the EU until the recent banking crisis. Member States are required to follow the same State aid rules as in other sectors. To realize this fact, the Commission had to wait until the end of 2008 when the financial crisis spilled into the real economy. Later then, the Commission adopted some flexible measures for this sector but their sufficiency is also highly doubtful.

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<sup>1</sup> HM Treasury, (March 2005), "The UK financial services sector: Rising to the challenges and opportunities of globalisation" Crown Copyright, pp.1-3, available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

The purpose of this thesis is to provide an overview of the State aid rules applied in financial services sector. In the first part, two common types of State aid measures granted in the financial services sector, rescue and restructuring aid and State guarantees, are discussed in detail. After a review of applicable rules in the form of guidelines and notice for these two forms of aid measures, implications of the recent financial crisis are discussed in the final chapter.

# Abbreviations

Banking Communication	Commission 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
CFI	Court of First Instance
Commission Notice or The Notice	Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees
EC	European Community
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECR	European Court Reports
ELA	Emergency Liquidity Assistance
EU	European Union
EUR	Euro
European Courts	Court of First Instance and European Court of Justice
FRF	French Franc
R&R Guidelines or Guideline(s)	Community Guidelines on State Aid for The rescuing and restructuring firms in difficulty
MEIP	Market Economy Investor Test
OJ	Official Journal
R&R	Rescue and Restructuring
SAAP	State Aid Action Plan
SME	Small and Medium Sized Enterprises

# 1 Introduction

## 1.1 Purpose

Credit institutions play a crucial role in the economy of a State because these institutions provide funding to other firms and sectors. Therefore, ailing of these institutions or distress in the financial services sector might affect the economy in general and create a serious disturbance in the economy of a State. In such cases, public authorities provide funding to these institutions experiencing difficulties. Thus, State aid rules constitute an important part of policy considerations of the Member States in the EU. Member States are generally stuck while searching for a balance. On the one side, they attempt to maintain an efficient and healthy financial system. On the other side, they don't want to infringe Treaty rules on State aid.

This thesis aims at examining the State aid rules in financial services sector and providing guidance as much as possible. For that purpose, following a short overview of the State aid provisions by reference to financial services sector, types of aid granted commonly in this specific sector and rules attached to these aid measures will be discussed. In order to show how the Commission applies these rules in practice, chapters will be supported by corresponding Commission decisions and case analyses.

The last chapter is allocated to the implications of recent financial crisis. The aim of last chapter is to discuss how the Commission's response differed depending on the time and how harsh the crisis is. The Commission adopted several new measures during this period to mitigate the effects of crisis on the real economy. The Commission had to consider two policy options: flexibility or consistency. While the Commission argues that the measures adopted during the time of crisis are flexible enough, the Member States and some authors argue that the measures are nothing more than a simple collection of old and established principles. The novelty of these measures compared to old measures will be discussed in detail.

## 1.2 Method and Material

In order to examine the State aid rules in the financial services sector, I will start presenting the legal framework for State aid rules in general as mentioned in Article 87(1) EC. Conditions attached to this provision will be analysed one-by-one. At some certain points law and economics approach will be used to give the underlying economic rationale of some measures. I will also briefly discuss the derogations of State aid rules as laid down in Article 87(2) and (3) EC. I will be focusing on Article 87(3)(b) and (c) EC which are the most valid provisions for derogations within the context of financial services sector.

Following that analysis, I will introduce common types of State aid granted in the financial services sector; rescue and restructuring aid and State guarantees. The relevant rules mentioned in the respective Commission's Guidelines and Notice adopted on the basis of Article 87(3)(c) EC will be presented. Rules will be explained by reference to relevant case law of the European Courts and the Commission. Moreover, after each measure, the chapter will be complemented by the relevant Commission decisions.

To illustrate the implications of the recent banking crisis, I will provide an analysis of the Commission's response in time. I will describe the new measures (two Commission Communications) adopted on the basis of Article 87(3)(b) EC by the Commission during the time of crisis. These chapters will also be complemented by the relevant Commission decisions.

I will be also using a comparative approach while comparing a new version of a legislation with the older version or while comparing the measures adopted by the Commission on the basis of Article 87(3)(c) EC and Article 87(3)(b) EC.

The thesis is a compilation of numerous legal materials including primary and secondary legislation and case law of the European Courts and the Commission. I have also relied on the literature and articles on the State aid, financial services sector and banking crisis.

## **1.3 Delimitation**

The thesis starts with an overview of the EU State aid rules with relevance to the financial services sector. The aim is not to discuss these rules in detail or to provide the problems encountered in their application. For more information in that regard, references provided in the text should be checked.

There are several derogations for exempting State aid rules as mentioned in Article 87(2) and (3) EC. However, throughout the thesis, the focus will be on two provisions; Article 87(3)(b) and (c).

Moreover, some services provided by credit institutions might be considered as services of general economic interest. The thesis does not contain a detailed analysis of these services and certain doubts in that regard. Also, in the case of services of general economic interest, Article 86(2) EC, in principle, might be relied upon to derogate from the State aid rule. However, this thesis does not discuss the applicability of this derogation.

Article 88 EC and Procedural Regulation<sup>2</sup> establishes the procedural rules applicable in State aid cases. Article 88 EC mentions two main procedural

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<sup>2</sup> Council Regulation 659/1999 laying down detailed rules for the application of Article 93 of the Treaty [1999] O.J.L83/1



rules namely "notification obligation" and "stand-still obligation". In addition, Procedural Regulation differentiates the types of aid and lists the detailed procedures to be used in existing aid, notified aid, unlawful aid, and misuse of aid in the relevant chapters.<sup>3</sup> However, these procedural rules are outside the scope of this thesis. The reader is assumed to be aware of the basic procedural rules of State aid.

The thesis focuses on two common types of aid measures granted in the financial services sector; R&R aid and State guarantees. There are also some other types of State aids granted in the financial services sector such as aids provided in the form of equity transfers, exclusive rights and reservation of banking activities, fiscal benefits and preferential taxation of credit institutions, and aid provided in the context of liquidation, transfer of assets and privatization. These relatively rare types of measures are outside scope of this thesis.

The Commission Guidelines, Notice and Communications analyzed set out particular rules for specific types of companies such as the ones for SMEs. These rules are outside the scope of this thesis. Furthermore, these legislative documents refer to the complex financial calculations e.g. calculation of financial remuneration or own contribution. These specific methods are also outside the scope of this thesis.

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<sup>3</sup> See chapters II, III, IV, and V in Regulation 659/99 for procedures regarding the notified aid, unlawful aid, misuse of aid, and existing aid schemes respectively.

## 2 State Aid Rules in the Financial Services Sector

Government intervention in financial services sector and State protection of national banks are one of the most problematical issues discussed in economic policy. While some views these measures as highly protectionist against the underlying principles of the European Union, others motivated with the implications of recent global financial crises argue that these interventionist policies might be part of the solution. Considering the peculiarities of the financial services sector, importance of that sector for the economy of the nation in general and the probability of having systemic crisis emanating from the financial difficulty of large lending institutions, it is very difficult for any government to resist calls for assistance from those institutions. Although protecting less competitive credit institutions<sup>4</sup> should result in distortion of competition theoretically, there might be some situations where market does not function properly or when the failures of such institutions would have more damaging effects on the economy.<sup>5</sup> In such a case, a carefully designed and well targeted State aid can support business development and even make the financial markets more efficient by eliminating certain obstacles that market forces are unable to tackle on their own.

The EC Treaty aims to establish an internal market for the provision of financial services by credit institutions by adopting harmonization measures. In that regard, various EC Banking Directives<sup>6</sup> have been adopted and the European Monetary Union has been established. The liberalisation of the EU financial services sector is ensured by the transposition of these banking

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<sup>4</sup> Credit institution means: “(a) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or (b) an electronic money institution within the meaning of Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit and prudential supervision of the business of electronic money institutions”. See Article 1 of Directive 2000/28/EC of the European Parliament and of the Council of 18 September 2000 amending Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, OJ L275 of 27 October 2000, p. 37. For simplicity credit institutions can be assumed to mean banks.

<sup>5</sup> Nicolaides, P. & Kekelekis, M. (2004) *An Assessment of EC State Aid Policy on Rescue and Restructuring of Companies in Difficulty*, European Competition Law Review, 2004, 25(9) pp.578-583

<sup>6</sup> These Directives such as First Banking Directive (77/780/EEC), Second Banking Directive (89/646/EEC), the Own Funds Directive (89/299/EEC), the Solvency Ratio Directive (89/647/EEC), the Large Exposure Directive (92/121/EEC) and the Consolidated Supervision Directive (92/30/EEC) are consolidated into a single Directive: The European Parliament and Council Directive 2000/12/EC (OJ L126/2000) as amended by the European Parliament and Council Directive 2000/28/EC, the Banking Consolidation Directive, OJ L257/2000. These Directives are outside the scope of this paper.

Directives and the subsequent coordination of the national legislations.<sup>7</sup> Besides removal of regulatory obstacles to cross-border lending activities in the common market, these Banking Directives set very high burdens on the credit institutions. Now, they have to abide by strict banking law requirements and increase their competitiveness to be able to survive in a broader market. The need for public financing was the inevitable consequence for many credit institutions.

However, neither the EC Treaty nor the Banking Directives contains any specific provisions or exemptions for the financial services sector. Therefore, financial services fall within the scope of the Treaty provisions on competition law including State aid provisions. Although this is quite clear from the Treaty, it took many years for the European judicature to recognize this principle. Credit institutions had argued that they pursued services of general economic interest and as a result Treaty rules on competition should not, or only restrictively, apply to them. While their arguments were partly true<sup>8</sup>, the application of competition rules to the financial services sector was confirmed by the European Court of Justice in its judgment *Zucher v. Bayerische Vereinsbank*<sup>9</sup> in 1981. Accordingly while the national jurisdictions can impose specific obligations and requirements on credit institutions in order to attain public objectives, credit institutions are not “*per se entrusted with services of general economic interest*” and as such are not exempt from the Treaty provisions on competition law. Having this background, the Commission started to apply State aid rules to credit institutions intensively only in the early 1990s.

This chapter is designed to elaborate on the issue of application of State aid rules in the financial services sector. Following a short overview of the State aid rules in this specific sector, types of aid granted commonly in this sector will be discussed. After each type of aid, relevant case laws of the Commission will be provided for exemplification purposes.

## 2.1 Overview of State aid provisions

Article 87(1) EC forbids 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 ... in so far as it affects trade between Member States*” as being

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<sup>7</sup> Rossi, P. & Sansonetti, V. (October 2007) *Survey of State Aid in the Lending Sector: A Comprehensive Review of Main State Aid Cases*, Working Paper Series, pp.1353-1394 Available at SSRN: <http://ssrn.com/abstract=962050>

<sup>8</sup> Some credit institutions fulfill specific tasks that might be considered as services of general economic interest such as (a) promotion of small and medium sized enterprises, (b) granting or guaranteeing of export credits, (c) financing of infrastructure projects, (d) municipal financing, (e) social housing loans, and (f) fundraising of a Member State and its municipalities. See Report of the European Commission to the Council of Ministers: *Services of general economic interest in the banking sector*, adopted by the Commission on 17.06.1998 and presented to the ECOFIN Council on 23.11.1998.

<sup>9</sup> Case 172/80 *Zucher v. Bayerische Vereinsbank* [1981] ECR I-2021

incompatible with the common market. Unfortunately, Article 87(1) EC does not define State aid. However, the wording of the article – “...aid granted... in any form whatsoever...” - suggests a broad interpretation.<sup>10</sup> Lack of guidance in the Treaty as to what constitutes a State aid may be intentional because if Member States knew the exact scope of the notion of aid they could easily devise measures which would not satisfy all the requirements of this notion.<sup>11</sup> Furthermore, a definition might limit the scope of the relevant articles if other forms of illegal aid will be introduced in the future. Conversely, lack of a definition lets the European Courts to interpret the notion in a broad and flexible way. The Commission, on the other hand, has provided an illustrative- but not exhaustive<sup>12</sup>- list of the types of aids.<sup>13</sup> Accordingly, direct subsidies, tax exemptions<sup>14</sup>, preferential interest rates, favourable loan terms and exemptions from some monetary charges are the major types of State aids. The ECJ, while defining the concept of aid, does not make a distinction between measures having the positive benefits to the undertaking such as direct subsidies and measures decreasing the charges an undertaking would normally bear under normal market conditions<sup>15</sup> such as tax exemptions, a reduction in social security contributions<sup>16</sup>, or applying preferential rate for the supply of goods or services<sup>17</sup>. According to the ECJ, these two measures have the same effect and both should be included in the concept of aid. Therefore, the crucial element while defining aid is the substance but not the form or the rationale.<sup>18</sup> Before reviewing the common types of State aid measures in the financial sector, the conditions of State aid will be examined in more detail below.

### 2.1.1 Through Member State or State Resources

To be considered as a transfer of State resources within the meaning of Article 87(1) of the Treaty, the aid must be granted either directly by the State including national regional or local authorities or public credit

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<sup>10</sup> Craig, P. & de Burca G., *EU Law: Text, cases and materials*, Oxford University Press, 2008, p.1087

<sup>11</sup> Schina, D., *State Aids under the EEC Treaty Articles 92 to 94*, ESC Publishing Limited, Oxford, 1987, p.13

<sup>12</sup> For example, the list did not include subsidies or tax exemptions, which have been later found to constitute State aid.

<sup>13</sup> Craig, P. & de Burca G., p.1087

<sup>14</sup> Case C-387/92 *Banco de Credito Industrial SA (Banco Exterior de Espana SA) v Ayuntamiento de Valencia* [1994] E.C.R. I-877

<sup>15</sup> *Ibid.* para.13

<sup>16</sup> Case C-75/97 *Belgium v Commission* [1999] E.C.R. I-3671

<sup>17</sup> Case C-387/92 *Banco de Credito*, fn.14; Case C-39/94 *Syndicat Francaise de l'Express International (SFEI) v La Poste* [1996] E.C.R. I-3547, paras.58-60

<sup>18</sup> Case C-310/85 *Deufil GmbH & Co KG v Commission* [1987] E.C.R. 901, para.8; Case C-480/98 *Spain v Commission* [2000] E.C.R. I-8717, para.16. Actually there are some exceptional cases where the ECJ considered the purpose of the measure. For instance, see Joined Cases C-72/91 and C-73/91 *Fima Sloman Neptun Schiffahrt AG v Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG* [1993] ECR I-887 para.22

institutions or indirectly by public or private bodies in a manner imputable to the State.<sup>19</sup> In the financial services sector, transfer of State resources may take many different forms. For instance, interest subsidies, reduced interest or interest free loans, direct subsidies, capital injections<sup>20</sup>, grants, preferential terms, tax concessions<sup>21</sup>, overdraft facilities, State guarantees<sup>22</sup>, asset reevaluations and over compensation of public credit institutions entrusted with services of general economic interest<sup>23</sup> are the main occasions where the transfer of State resources may occur. More details will be provided in the case law analysis parts below.

Central banks have a crucial role in the financial sector since most of the aid in this sector is granted through these institutions.<sup>24</sup> Then, the critical question is whether these institutions can be treated as State authorities within the meaning of Article 87 of the Treaty. Traditionally, central banks have been treated as State authorities when they act on behalf of the Government. Therefore, in such a case State aid provisions would be applicable because any funding provided by them might constitute a grant of State resources imputable to the State. However, when the central bank is acting independently of the Member State in the fulfillment of specific independent central bank tasks, the central bank could not be treated as State authorities within the meaning of State aid provisions of the Treaty.<sup>25</sup> Any funding granted in that case would fail to satisfy the first criterion of the State aid rules; through Member State or State resources.

## 2.1.2 Economic Advantage

There is no doubt that the State can participate actively in the commercial market by using State resources. However, such participation cannot be automatically classified as aid.<sup>26</sup> According to Article 295 of the EC Treaty, State owned or controlled enterprises and private enterprises must be treated in the same way. In order to distinguish between State investment and State

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<sup>19</sup> Joined Cases T-228/99 & T-233/89 *Westdeutsche Landesbank Girozentrale and Land Nordrhein-Westfalen v Commission* [2003] ECR II-345, para.179

<sup>20</sup> Commission Decision 2000/392/EC of 8 July 1999 on a measure implemented by the Federal Republic of Germany for *Westdeutsche Landesbank-Girozentrale (WestLB)* [2000] OJ L150 p.1

<sup>21</sup> Commission Decision 1999/288/EC of 29 July 1999 giving conditional approval to the aid granted by Italy to *Banca di Napoli* [1999] OJ L116 p.36

<sup>22</sup> Commission Decision 2008/263/EC of 27 June 2007 on *State aid implemented by Austria for BAWAG-PSK* [2008] OJ L83 p.7

<sup>23</sup> Commission Decision 2000/480/EC of 8 July 1999 on *aid granted by France to Credit Agricole group in connection with the collecting and keeping of notaries' deposits in rural municipalities*, OJ L193 p.79

<sup>24</sup> For instance, Emergency Liquidity Assistance (ELA) is one of the most fundamental central bank tasks. By providing ELA to the credit institutions, a central bank aims to prevent temporarily illiquid, but solvent, credit institutions from becoming insolvent.

<sup>25</sup> Commission Decision in Case NN/70/2007 (ex. CP 269/07) of 5 December 2007, *United Kingdom, Rescue aid to Northern Rock*, C(2007) 6127final para.38.

<sup>26</sup> Hancher, L., Ottevang, T. & Slot, P. J., (2006), "*EC State Aids: Ch 3.6 State Participation and the Market Economy Investor Test*", Sweet & Maxwell.

aid covered by Article 87 EC and to ensure the principle of neutrality with regard to the system of property ownership and the principle of equal treatment between public and private undertakings, the Commission developed the so called market economy investor test.<sup>27</sup> The European Courts have also adopted this test.<sup>28</sup>

Although this basic principle is originally prepared for public undertakings in manufacturing sector<sup>29</sup>, it has been applied in all other sectors including financial services in the same way. For instance, in its famous 1998 *Credit Lyonnais* decision, the Commission stated that:

“*CDR’s operations with regard to its subsidiaries are deemed not to include any aid component only if they conform with the market economy investor principle.*”<sup>30</sup>

According to the market economy investor test, in order to determine whether the provision of public funds to an enterprise constitutes State aid, one must check whether the terms and conditions on which those funds are provided confer an economic advantage on that enterprise that is not possible to obtain under normal market economy conditions<sup>31</sup> considering the information available and any foreseeable developments at the date the contributions were made.<sup>32</sup> The test therefore involves asking whether a private investor would subscribe to the State’s conduct in comparable circumstances.

It is crucial to note that the market economy investor test is used both to identify and to quantify aid.<sup>33</sup> This principle is also applicable to public undertakings, irrespective of whether they are profit or loss making entities.<sup>34</sup> Even in cases where a public shareholder contributed in the capital of an undertaking to meet the solvency requirements, the return that the public shareholder obtained should be acceptable to a private investor

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<sup>27</sup> In the state aid literature, this test is also referred to as the market investor test, the private investor test, the informed investor test, the informed private investor test, the prudent private investor test or the commercial investor test.

<sup>28</sup> See Case C-40/85 *Belgium v Commission (Boch)*, [1986] ECR I-2321; Case C-305/89 *Italy v Commission (Alfa Romeo)*, [1991] ECR I-1603; Case C-303/88 *Italy v Commission (Lanerossi)*, [1991] ECR I-1433

<sup>29</sup> Commission communication to the Member States – Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 1980/723/EEC to public undertakings in the manufacturing sector, OJ 1980/C 307/03.

<sup>30</sup> Commission Decision 98/490 of May 20, 1998 concerning aid granted by France to the Credit Lyonnais group [1998] OJ L221/41.

<sup>31</sup> Case C-42/93 *Spain v Commission* [1994] ECR I-4175, par 13.

<sup>32</sup> Case C-482/99 *French Republic v Commission (Stardust Marine)* [2002] ECR I-4397, par 70; Case C-261/89 *Italy v Commission* [1991] ECR I-4437, par 8; Case T-16/96 *Cityflyer Express v Commission* [1998] ECR II-757, par 76. See also Commission Communication to the Member States of 13 November 1993: Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC on public undertakings in the manufacturing sector, par 4.

<sup>33</sup> Harden Ian, (1993), “*State Aid: Community Law and Policy*”, Bundesanzeiger, Koln, p 10.

<sup>34</sup> Commission Decision 2006/737 of October 20, 2004 on *aid from Germany for Westdeutsche Landesbank – Girozentrale (WestLB)* [2006] OJ L307/22

operating under normal market economy conditions.<sup>35</sup> Otherwise, the capital injection would be considered to constitute State aid. However, this test is not relevant where the State is acting, not as a market participant, but in the exercise of its sovereign or public functions, for instance in the adoption of fiscal legislation or social policy. By definition, there can be no normal market comparator in such cases; therefore the focus is rather on whether the measure is selective<sup>36</sup> which represents the next criterion under Article 87 EC.

In recent years, the European Courts and the Commission have extended the rationale of market investor test and created various iterations of this test to cover all types of State measures including government capital injections and the grant of State guarantees for obligations of enterprises, where reference is made to a private investor, sales of government assets and privatizations, where reference is made to a private vendor, loans granted by the State and waivers of debt by the State where reference is made to a private creditor.<sup>37</sup> All these tests include a comparison of acts of State with a reference market player, either with an investor, vendor or creditor, operating under normal market economy conditions.

### 2.1.3 Selectivity

Selectivity criterion is integrated basically for defining the fine line between general measures of economic policy of States and the State aid while applying the non-discrimination principle in the Community. General measures of economic policy are in the sovereignty of States. Therefore, the rules on State aid cannot be applied for such measures based on the condition that they are applied equally to every party irrespective of origin. Thus, if a State authority decides to grant public funding to a particular firm to the disadvantage of its competitors and if it is not granted to all entities without distinction, selectivity condition of Article 87(1) EC would be fulfilled.

It follows that although certain measures of tax or social policy could give a competitive edge to undertakings established in a given Member State, they do not fall within the State aid rules.<sup>38</sup> For instance, a general interest rate reduction cannot be classified as State aid although this measure increases the industrial sales up to a certain extent.<sup>39</sup> In order to be on the safe side

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<sup>35</sup> Joined Cases T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale and Land Nordrhein-Westfalen v Commission* [2003] ECR II-435 paras. 241 and 313-315

<sup>36</sup> Biondi, A., Eeckhout, P., & Flynn, J., (2004), *The Law of State Aid in the European Union*, Oxford University Press, p 346

<sup>37</sup> For a more detailed discussion on different variants of market economy investor principle, see Rydelski Michael Sanchez, (2006), *The EC State Aid Regime: Distortive Effects of State Aid on Competition and Trade*, Cameron May, Ch.6

<sup>38</sup> Steiner, J., Woods, L., & Twigg-Flesner, C., *Textbook on EC Law*, Oxford University Press, 2003, p.286

<sup>39</sup> Case C-143/99 *Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanzlandesdirektion für Karnten* [2001] E.C.R. I-8365, para.35

with respect to State aid rules, Member States or central banks could adopt general measures open to all actors in the market (e.g. a general lending opportunity offered to the whole market) instead of granting selective advantages to individual banks.<sup>40</sup>

## 2.1.4 Distortive Effects on Competition and Trade

Finally, concerned aid measure must have a potential effect on competition and trade between Member States. In order to evaluate distortion of competition, the position of the aid recipient prior to the receipt of aid compared to its actual or potential competitors in the relevant market should be considered. If this position has been improved then the condition in Article 87(1) EC will be met<sup>41</sup>. However there is no presumption that the grant of aid will result in a distortion of competition in any case<sup>42</sup>. The Commission should make an individual assessment in each case showing the actual or potential distortion of competition in the relevant market.

Effect on inter-state trade is closely connected with the distortion of competition criterion. That is to say, if aid strengthens the financial position of an undertaking as compared with other undertakings competing in the Community then effect on intra-Community trade can be assumed to exist.<sup>43</sup> It is sufficient to establish that the beneficiary is pursuing an economic activity in a market where there is trade between Member States. In the financial sector, since the liberalization of financial services and the integration of financial markets are making intra-Community trade more and more sensitive to distortions of competition, an aid measure might easily be liable to have a distorting effect on intra-Community trade.<sup>44</sup>

## 2.1.5 Derogations

State interventions fulfilling the above-mentioned criteria under Article 87(1) EC are regarded to be incompatible with the common market. In practice, incompatibility means that the aid measure is prohibited unless the Commission authorizes it. Exceptions to this rule can be found in Article 87(2) and (3) of the Treaty.<sup>45</sup> Article 87(2) of the EC Treaty specifies three

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<sup>40</sup> MEMO/08/202 “*State aid: Commission launches in-depth investigation into UK restructuring aid package for Northern Rock- frequently asked questions*”, Europa Press Releases 02/04/2008.

<sup>41</sup> Case C-730/79 *Philip Morris Holland BV v Commission* [1980] E.C.R. 2671, para.11; Case 173/73 *Italy v Commission* [1974] E.C.R. 709, para.17

<sup>42</sup> Cases C-296 & 318/82 *Netherlands and Leeuwarder Papierwarenfabriek BV v Commission* [1985] E.C.R. 809, para.24

<sup>43</sup> Case C-730/79 *Philip Morris Holland BV v Commission* [1980] E.C.R. 2671

<sup>44</sup> Commission Decision 95/547/EC of 26 July 1995 giving conditional approval to aid granted by France to the bank Credit Lyonnais, OJ L/308, p. 92-119

<sup>45</sup> In the case of credit institutions entrusted with performing services of general economic interest, Article 86(2) EC could also be relied to exclude the general prohibition on State



types of aid which shall be declared compatible with the common market. As the wording implies, these exemptions have an automatic nature. Types of exceptions listed under this provision include aids with a social character, aids to rectify damages caused by natural disasters and, finally, special aids to compensate for the economic disadvantage of Germany due to its division. Additionally, Article 87(3) EC encompasses some further exemptions but of a discretionary nature. The mere fact that the aid falls within one or more of the criteria laid down in this article may not be sufficient to be qualified for exemption. The Commission may check the compatibility of aid under Article 87(3) EC with other provisions of the Treaty<sup>46</sup> and if aid schemes infringe other provisions of the Treaty, they are disqualified from exemption.<sup>47</sup>

In financial services sector, there are two provisions which are generally considered as relevant for potential justifications of aid measures to credit institutions:

- Article 87(3)(b) which provides derogation for “*aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State*”, and;
- Article 87(3)(c) which provides derogation for “*aid to facilitate the development of certain activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest*”.

The issue whether the public funding granted to an entity operating in the financial sector might be justified as a “*remedy for a serious disturbance in the economy of a Member State*” has been raised in many cases especially during the financial crises. For the first time, this question has been addressed in the Commission’s 1995 *Credit Lyonnais* decision<sup>48</sup> where the Commission held that when the circumstances outside the control of the credit institutions cause a crisis of confidence resulting in a true systemic turmoil, the derogation in Article 87(3)(b) EC may be invoked. Additionally, aid has to be granted in a non-arbitrary way covering the whole system and amount of aid should be restricted to what is strictly necessary. The Commission has also paid attention to keeping distortive effects of the measure on the competition to a minimum by way of compensatory measures. In a way, the Commission was trying to ensure “*quid pro quo*” before the grant decision as far as possible. If distortion of competition is unavoidable, then sufficient compensatory measures

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aids contained in Article 87(1) EC. However, considering the doubtful nature of the issue, application of this derogation remains within the discretion of the Commission. See Case C-280/00, *Altmark Trans*, [2003], ECR I-774, for further conditions attached to the application of exemption under Article 86(2) EC.

<sup>46</sup> Rose M.D’Sa, (1998), “*European Community Law on State Aid*”, London Sweet & Maxwell.

<sup>47</sup> XXIII<sup>rd</sup> Report on competition policy (1993), para.394, cited by Rose M.D’Sa, (1998).

<sup>48</sup> Commission Decision 95/547/EC of 26 July 1995 giving conditional approval to aid granted by France to the bank Credit Lyonnais, OJ L/308.

benefitting competing undertakings must be taken to mitigate the harmful effects of the aid.<sup>49</sup>

Moreover, the Commission asserted that the failure of one or more credit institutions does not necessarily lead to a system-wide crisis. On the other hand, the Commission has accepted the fact that in some cases the difficulties faced by a single credit institution may affect other credit institutions harmfully. However, for instance, the Commission did not accept the applicability of the derogation set out in Article 87(3)(b) of the Treaty to the aid granted to *Credit Lyonnais* because this measure was not designed to remedy a serious disturbance in the economy but only remedy the difficulties of a single undertaking. Actually, in that case problems encountered by *Credit Lyonnais* were not stemming from a banking crisis in France but largely caused by poorly designed risk monitoring policies of the company.<sup>50</sup>

The Commission had a chance to investigate the probability of possible systemic crisis in many instances during the recent banking crisis. After a couple of years of being unresponsive to the crisis and being dependent on the pre-existing principles, the Commission finally recognized the systemic effects of the crisis in the financial services sector on the real economy. In that regard, the Commission adopted a Communication and set out detailed rules for application of exemption under Article 87(3)(b) EC. In some cases, the Commission even recognized that failing of a single credit institutions might produce harmful effects on the economy of a Member State. Further details will be provided in Chapter 4.

On the other hand, Article 87(3)(c) of the Treaty is more often relied as a possible justification of the State aid granted in financial services sector. The Commission continuously adopts guidelines and notices for exempting certain categories of State aid based on Article 87(3)(c) EC derogation. 2004 Community Guidelines on State aid for rescue and restructuring firms in difficulty and the recent 2008 the Commission Notice on the application of Article 87 and 88 of the Treaty to State aid in the form of guarantees are two examples of the Commission's act in that regard. Details of these legislative acts will be discussed in the next chapter.

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<sup>49</sup> Weenink, H. & Steinen, P.S. (2008), “*State Aid in the Financial Services Sector*”, *Journal of International Banking and Regulation*, 2008, 23(10), pp.514-522

<sup>50</sup> Commission Decision 95/547/EC of 26 July 1995 giving conditional approval to aid granted by France to the bank *Credit Lyonnais*, OJ L/308.

### 3 Common Types of State Aid Granted in the Financial Services Sector

After a brief examination of the main provisions for State intervention as contained in Article 87 of the Treaty, this chapter is designed to elaborate on the State aid granted in the financial services sector.

Financial institutions play a very crucial role in the economy of a State since they bring stability to the market by providing credit and liquidity support. Importance of these institutions in the EU has increased dramatically during the recent years with the effect of rapid integration of the financial markets. In the era of financial globalization, failure of these institutions might be threatening to the economic development and growth of a society. Such failures might even lead to an overall institutional breakdown.<sup>51</sup> Therefore, State authorities in the EU acted as a “*lender of last resort*” in many cases to protect the working status of their financial system and to avoid a financial institution from insolvency.

In general, the financial difficulties experienced by the credit institutions may take two common forms namely; market illiquidity and funding illiquidity. Market illiquidity refers to the ease and speed with which credit institutions can trade their assets without causing a significant movement in the price and with low transaction costs. On the other hand, funding illiquidity refers to the ease with which credit institutions can obtain funding.<sup>52</sup> Although these concepts are theoretically separate, they are dependent on each other. For instance, recent US sub-prime crisis on mortgages affected liquidity of these assets. Later, this liquidity problem spread to other assets and created a market illiquidity problem which then led to funding problems. Instruments for dealing with these difficulties are also different. Market liquidity is, in principle, provided by central banks through open market operations. Therefore, any measure adopted to tackle a problem encountered in that regard will be specific to that system or those central institutions. For funding illiquidity, there are three options available to solve that problem. First, private credit institutions or other market participants might provide funding to credit institutions experiencing funding illiquidity. Second option is to use public funds to support credit institutions. Finally, central banks might provide liquidity assistance to credit institutions experiencing funding illiquidity.<sup>53</sup>

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<sup>51</sup> Tsakatoura, A., (22 June 2002) *EU Banking: State Aids in the EU Banking Industry*, Inter-Lawyer, Lex-E Scripta Articles.

<sup>52</sup> Brunnermeier, M.K. & Pederson, L.H. (10 December 2008), *Market Liquidity and Funding Liquidity*, RFS Advance Access, Oxford University Press, p.1

<sup>53</sup> Weenink, H. & Steinen, P.S. (2008), pp.514-522

However, State authorities should take into account the relevant EU legislation in their attempts to solve these problems and to maintain an efficient and healthy financial system. As we will see, a detailed analysis of the EU legislation and case law reveals that the Commission most commonly applies the rules concerning aids for rescuing and restructuring companies in difficulty and the rules concerning aids granted in the form of guarantees while assessing the compatibility of aid measures with the Treaty. The Commission applies these rules both for the cases where the State aid is granted directly to the financial institution and for the cases where State aid is granted to the clients or debtors of the institution but benefits the financial institution indirectly. In the next part, the rules for aids for rescue and restructuring firms in difficulty, rules for aids in the form of guarantees will be analysed.<sup>54</sup> In each section, analysis will be followed with case law analysis to exemplify the Commission's approach in these specific types of measures.

### 3.1 Rescue and Restructuring Aid

Aid for rescue and restructuring (R&R) operations has given rise to some of the most controversial State aid cases during the precedent years. Mostly due to this controversial nature, the Commission continuously improved rules for the approval of rescue and restructuring aid by adopting several Community Guidelines. The first Community Guidelines on State aid for rescuing and restructuring companies in difficulty were adopted in 1994<sup>55</sup> and remained in force until 1999 when they were replaced by a revised version<sup>56</sup> then lastly they have been modified in 2004<sup>57</sup>.

R&R aid is undisputedly one of the most negative types of State aid distorting competition as acknowledged by the Court of First Instance in *HAMSA*<sup>58</sup>. By way of R&R aid, a company which runs into difficulties is kept artificially in the market by the State. However, this cannot be the norm because the exit of unprofitable firms is a normal part of the functioning of a market economy.<sup>59</sup> Also, market exit of a firm in difficulty would create a chance for competitors to gain market force. Therefore, by rescuing such a firm competitors are prevented to increase their share in the market. In addition, State support can create some inappropriate incentives for the

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<sup>54</sup> There are also some other types of State aids granted in the financial services sector such as aids provided in the form of equity transfers, exclusive rights and reservation of banking activities, fiscal benefits and preferential taxation of credit institutions, and aid provided in the context of liquidation, transfer of assets and privatization. These relatively rare types of measures are outside scope of this paper.

<sup>55</sup> Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 1994 C368, p.12

<sup>56</sup> Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 1999 C288, p.2

<sup>57</sup> Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 2004 C244, p.2

<sup>58</sup> Case T-152/99 *HAMSA* [2002] ECR II-3049, para.77

<sup>59</sup> European Commission, State Aid Scoreboard, COM (2003) 636 final, 29.10.2003, p.13

failing firms. Aid granted to these companies enables them to act at a higher risk, engage in aggressive price races, or simply operate with low efficiency.<sup>60</sup>

However, as mentioned before, State aid might facilitate the development of certain economic activities. Thus, the provision under Article 87(3)(c) of the Treaty could be a justification for R&R aid. The R&R Guidelines provide three complementary reasons for the Commission to allow State aid.<sup>61</sup> Accordingly, aid may be justified either by:

- social or regional policy considerations (to prevent employment problems or to favour the development of an underdeveloped region)
- the need to take into account the beneficial role played by small and medium-sized enterprises (SMEs) in the economy (it is not designed for a single SME but to overcome the dimensional difficulties faced by SMEs in the economy), or
- the desirability of maintaining a competitive market structure when the demise of firms could lead to a monopoly or to a tight oligopolistic situation.

In addition, as the name of the Guideline implies, R&R aid should contribute to overcome the beneficiary company's difficulties. The end goal of these grants is to restore company viability in the market so that investor will consider investing in these companies again.

Finally, Article 87(3)(c) EC requires the rescue and restructuring aid to be proportionate to the objective pursued. In other words, the negative aspects of the State aid should not outweigh the positive effects. Instead the aid measure should strike a right balance between an objective that justifies the aid and the distortion of competition.<sup>62</sup> Motivated by these concerns, the Commission provides a number of criteria in the Guideline to ensure that the R&R aid is proportionate. *Max Lienemeyer* in his contribution to "*the EC State Aid Regime*" groups these criteria into three main categories. Accordingly, the State aid must be:

- appropriate to fulfil the objective (for instance, by enabling the company to overcome its difficulties and restoring the long-term viability of it),
- necessary to achieve the objective (the aid granted should be the strict minimum necessary to achieve the goal), and
- proportional (undue distortions of competition should be minimized with the help of compensatory measures if they cannot be avoided at all).

These criteria constitute the main principles underlying the R&R Guideline and will be elaborated in the following chapters.

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<sup>60</sup> Lienemeyer, M. in his contribution to Rydelski, M.S., (2006), "*The EC State Aid Regime: Distortive Effects of State Aid on Competition and Trade*", Cameron May, pp.183-184

<sup>61</sup> R&R Guidelines, §8

<sup>62</sup> Lienemeyer, M. in his contribution to Rydelski M.S., (2006), p.185

### 3.1.1 Eligibility for the Application of Guidelines

For the application of Guidelines, firstly the beneficiary undertaking within the meaning of Article 87(1) EC should be identified. This process is relatively easy when the recipient undertaking is a single firm. However, it gets more complex if the aid recipient is a part of group of companies. The Guidelines state that a company belonging to a group is not normally eligible for the R&R aid because in such a case the group should help to the suffering unit with its own resources. However, if the difficulties are company-specific and are not result of an arbitrary allocation of costs within the group, or when the difficulties are too serious to be dealt with by the group itself<sup>63</sup>, then the firm in difficulty is still eligible for the R&R aid. The applicability of this criterion is highly criticized by *Nicolaides* and *Kekelekis* because the Commission assumes that the parent company will always be willing to support its subsidiary in financial difficulties.<sup>64</sup>

Another important factor for the application of Guidelines is that the beneficiary undertaking should be in difficulty. Interestingly, there is no Community definition of when a company is in financial difficulties. Due to the differences in national insolvency laws and procedure, it is very difficult to derive a definition from the practice of Member States.<sup>65</sup> However, the Commission provides a useful description in the Guideline. Accordingly, a firm will be regarded as being in difficulty “*where it is unable, whether through its own resources or with the funds it is able to obtain from its owner/shareholders or creditors, to stem losses which, without outside intervention by the public authorities, will almost certainly condemn it to going out of business in the short or medium term*”.<sup>66</sup> This condition must be assessed *ex ante*.<sup>67</sup> Another important issue is that the Commission’s determination of whether a company is in difficulty should not be based on severe criteria. It has to be kept in mind that the main objective of R&R aid is to restore the viability of the company. If the Commission waits too much to identify those difficulties, it might be too late for the company.

Newly created firms<sup>68</sup> are in principle not eligible for the R&R aid because these companies should commence their activities by considering the market situation.<sup>69</sup> State aid cannot be used to reduce the risk involved in the creation of the company. However, this issue is also problematic because new firms also need to be sufficiently capitalized *ab initio*.<sup>70</sup>

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<sup>63</sup> R&R Guideline, §13

<sup>64</sup> Nicolaides, P. & Kekelekis, M. (2004), pp.578-583

<sup>65</sup> Nicolaides, P., Kekelekis, M. & Buyskes, P., (2005) *State Aid Policy in the European Community: A Guide for Practitioners*, Kluwer Law International, International Competition Law Series, Second Edition, pp-111-114

<sup>66</sup> R&R Guidelines §9

<sup>67</sup> Commission Decision in Case C62/2000 *Kahla*, OJ 2003 L227, p.12, para.112

<sup>68</sup> In the R&R Guidelines, a firm is considered as newly created for a period of three years following the start of operations.

<sup>69</sup> Commission Decision in Case C34/2003 *CMR*, OJ 2005 L100, p.26, para.72

<sup>70</sup> Valle, E. & Van de Castele, K., (2004), *Revision of the State Aid Rescue and Restructuring Guidelines*, EC Competition Policy Newsletter No.3, 58

Finally, it is crucial to remind that R&R Guidelines has privilege for the firms in difficulty meaning that when the aid beneficiary has financial difficulties, any other Guidelines cannot be applied if the aid measure is not exempted by a regulation.<sup>71</sup> The Commission states that “*a firm in difficulty cannot be considered an appropriate for promoting other policy objectives*”. This is also applicable for the existing aid under approved schemes. For instance, if a regional aid recipient under an approved scheme starts to suffer from financial difficulties, the regional guidelines do not apply anymore.<sup>72</sup> Instead any aid granted to that company has to be justified under the R&R Guidelines.

### 3.1.2 Compatibility of Restructuring Aid

Restructuring aid involves “*a feasible, coherent and far-reaching plan to restore a firm’s long-term viability*”.<sup>73</sup> Therefore, restructuring generally entails the reorganization and rationalization of the firm’s activities on to a more efficient basis such as by withdrawing the loss-making activities or by restructuring the existing uncompetitive activities that can be restored. A restructuring aid does not necessarily include financial restructuring but also might imply a physical restructuring.<sup>74</sup> However, a mere financial assistance designed to compensate past losses will not be considered as a restructuring aid within the scope of Guidelines but a pure operating aid incompatible with the common market.<sup>75</sup>

Therefore, a restructuring plan including a series of measures to restore the long-term viability of the enterprise within a reasonable time<sup>76</sup> on the basis of realistic assumptions is one of the core elements of restructuring aid. The Commission assesses the aid measure on the basis of this restructuring plan.

Apart from restructuring plan, there is a number of criteria to be satisfied. The remaining requirements established by the Guidelines for considering a State aid for restructuring a firm in difficulty compatible with the common market are the following ones:

- Restoration of financial and commercial viability,
- The minimum necessary to restore viability,
- No undue distortion of competition, and
- The one-time last-time principle.

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<sup>71</sup> For example, Commission Regulation (EC) 69/2001 provides exemption for de minimis aid, OJ 2001 L10; Commission Regulation 68/2001 provides exemption for training aid, OJ 2001 L10; Commission Regulation 2204/2002 provides exemption for employment aid, OJ 2002 L349

<sup>72</sup> Community Guidelines on national regional aid for 2007-2013, OJ 2006, C54

<sup>73</sup> R&R Guidelines, §17.

<sup>74</sup> Tsakatoura, A. (22 June 2002).

<sup>75</sup> Delfino, R., (2004), *Credit Institutions and State Aids in EC Law*, European Business Law Review, vol. 15, n° 4, pp. 775-810.

<sup>76</sup> Generally the plan should cover a period of two to five years. Actually, the Commission has accepted eight year restructuring period once in its ZMD decision. See Commission Decision in Case NN-92/99 ZMD, 18.07.2001.

### **3.1.2.1 Restoration of financial and commercial viability**

The restructuring plan should include appropriate measures capable of bringing the company to long-term viability and enabling it to stand on its own feet. The Commission preferred to give a general definition of the performance expected from a viable firm instead of giving specific financial ratios for long-term viability.<sup>77</sup> Accordingly, a viable firm should have an expected revenue sufficient to cover its financial outlays and operating costs including depreciation and ought to generate an acceptable return to its shareholders.

There are mainly three restructuring options for the companies to implement.<sup>78</sup> In *operational restructuring*, the firm should redirect its activities to regain the viability and ensure profitability. For that matter, loss-making activities should be abandoned and operating costs should be reduced. The company can even consider rationalization of geographical representation.<sup>79</sup> *Industrial restructuring* requires the replacement of obsolete machinery and instead the installment of more efficient ones. Success of these measures has to be proven in the restructuring plan possibly by providing a simulation of future sales figures and prices. Such demonstrations are vital for the Commission's assessment.<sup>80</sup> Finally, in addition to restructuring measures for tackling the causes of the losses, the company needs *financial restructuring* for sustainability. The company should be viable in the long-run meaning that it has to survive on its own not only during good times but also during downturns.

However, at the end of the day, the company has a wide margin of discretion in deciding which measures are the best for restoring its viability. Therefore, fulfillment of the restoration of viability criterion usually is not a problem.

### **3.1.2.2 The minimum necessary to restore viability**

In order to limit the distortive effects, the State aid must be kept at a minimum. The beneficiary undertaking should not receive more aid than what is strictly necessary to implement its restructuring plan. At the same

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<sup>77</sup> However, the Commission welcomes the restructuring plans providing precise ratios as contained in a normal investment plan. Financial ratios commonly used in such plans are Return on Investment (ROI), Return on Equity (ROE), and Return on Capital Employed (ROCE).

<sup>78</sup> Lienemeyer, M. in his contribution to Rydelski M.S., (2006).

<sup>79</sup> See Commission Decision in Case C-58/2003 *Alstom*, OJ 2005 L150, paras. 162&163.

<sup>80</sup> The Commission has to decide whether the forecasts reveal the reality or whether the market developments are taken into consideration. Success of the company at the end of operating period should stem from the internal measures taken because in some cases the mere increase of working hours or the favorable developments in the market might result in turnover increase. In that regard, see the Commission Decision in Case C-39/2001 *Minas de Rio Tinto*, OJ 2004 L98, and Commission Decision in Case C-66/2000 *ZEMAG*, OJ 2002 L62, par. 24



time, aid beneficiaries should make a significant contribution to the restructuring plan from their own resources.

Limitation of the aid amount to a minimum is especially important to avoid market-distorting activities not serving to the final objective; restoration of viability. The company cannot use the aid to expand its activities or undertake investments which are unrelated to restructuring. Nor can it use aid to acquire shares in other companies. The language of the Guidelines is rather strict in that context. An activity carried out by the firm might be useful for the company but for approval it has to be strictly necessary for restructuring.<sup>81</sup>

After the amount of aid necessary for the restructuring is determined, the own contribution of the aid beneficiaries should be established. Aid beneficiaries are expected to contribute to the restructuring significantly by selling their assets not necessary for the firm's survival or by raising money through external financing options. The company might divest its fixed assets or show them as collateral to get some loans from external sources. However, the Guidelines require the own contribution to be a genuine private contribution. Therefore, private loans backed up by State guarantee or loans on preferred rates cannot be counted as 'own' contribution. As the wording implies, the contribution should come from the owners or the owners' efforts on the capital markets not from State resources directly or indirectly. Moreover, such contribution must be *real*. Thus, expected future profits or depreciation of long-term assets<sup>82</sup> should be excluded from own contribution calculations.

Once the elements of own contribution are determined, it must be compared with the overall cost of restructuring process. The Commission provides guidance on the size of this contribution in proportion to the size of the beneficiaries.<sup>83</sup> Accordingly, the aid beneficiary's contribution to the restructuring must be at least 25% in the case of small enterprises, at least 40% for medium-sized enterprises and at least 50% for large firms. However, there are two exceptions from these pre-determined own contribution thresholds. Firstly, in exceptional circumstances and in cases of particular hardship, which must be demonstrated by the Member State, the Commission may accept a lower contribution.<sup>84</sup> Unfortunately there is no definition of 'exceptional circumstances' and 'extreme hardship' in the Guideline. It can be argued that exceptional circumstances should apply to the situation of the firm in difficulty, while hardship should occur when the firm is going out of business.<sup>85</sup> Second option, which is a more realistic exception, allows the Commission to lower own contribution in a case

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<sup>81</sup> This is also approved by the CFI in Case T-17/03 *Schmitz-Gotha v Commission* [2006] ECR II-1139

<sup>82</sup> Commission Decision in Case N-464/05 *AB Kauno* [22.02.2006], par.17

<sup>83</sup> R&R Guidelines §44.

<sup>84</sup> *Ibid.*

<sup>85</sup> Lienemeyer, M. in his contribution to Rydelski M.S., (2006), p.207

where a beneficiary is operating in an assisted area.<sup>86</sup> The Guidelines does not define the extent of reduction in such cases pointing that the Commission has a wide margin of discretion in adopting less stringent conditions.

### 3.1.2.3 No undue distortion of competition

In order to minimize the adverse effects on trading conditions, the company should compensate its competitors for the aid it receives. Previously, these compensatory measures are limited to sectors suffering from structural overcapacities. However, there is no justification for such a limitation because the aid might result in distortions of competition also in the sectors without structural overcapacities. Therefore, this approach is abandoned in new Guidelines. Compensatory measures are compulsory, irrespective of the sector. What matters is the degree of distortion only.<sup>87</sup>

There are three types of compensatory measures accepted by the Commission: reductions in capacity or market presence, divestment of assets, or reduction of entry barriers on the markets concerned. In addition to commitments by the beneficiary, the Member States may also need to take legislative action. For instance, in *Alstom* case<sup>88</sup> France was obliged to early transpose a public procurement directive to eliminate the tendency in the French market to give preference to national undertakings.<sup>89</sup>

The Commission pays special attention to the compensatory measures in the markets where the firm will have a significant market share after restructuring. To this end, firstly the relevant market has to be determined. Unfortunately, the Guidelines do not provide any definition of the relevant market but it can be extracted from the Community competition law.<sup>90</sup> Secondly, the firm should have a significant market position in this market. Due to the lack of definition, it can be argued that the Commission has a wide discretion in determination of what constitutes a significant market position in a relevant market.<sup>91</sup> Finally, compensatory measures must be in

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<sup>86</sup> R&R Guidelines §56

<sup>87</sup> This does not mean that structural overcapacity has no relevance anymore. Actually, the criterion of a sector suffering from long-term structural overcapacity still remains as an important factor to determine the degree of capacity reduction.

<sup>88</sup> Commission Decision in Case C-58/2003 *Alstom*, OJ 2005 L150, pars 85&204.

<sup>89</sup> However, State measures should be applied as a last resort because logically the aid recipient should compensate for the distortion created in the market and also if the State fails to comply with the obligation imposed by the Commission, the beneficiary cannot be held liable for that.

<sup>90</sup> Commission Notice on the definition of the relevant market for the purpose of Community competition law, OJ 1997, C372. Accordingly, the relevant product market includes the product concerned and its substitutes considered to be such either by the consumers or by the producers. The geographic market is normally the Community market.

<sup>91</sup> The only hint can be gathered by comparing new Guidelines with 1999 Guidelines where the Commission stated that the market shares below 5% is negligible. Although this phrase is deleted in the new Guidelines, there is no indication that the Commission wants to depart from its previous practice. Therefore, it might be assumed that firm's share of the relevant market below 5% will be considered as not significant.

proportion to the distortive effects of the aid. The degree of compensation will be established on a case-by-case analysis by taking into account the firm's size and its importance on the market.

There are three exceptions under this condition which need to be highlighted. Firstly, these restrictions are waived when the beneficiary is small enterprise because it is assumed that small enterprises do not normally distort competition to an extent contrary to the common interest.<sup>92</sup> This exception needs to be clarified more in the Guidelines because there is no explanation for the favorable treatment of small companies apart from the implicit justification that they are too small. However, the EC courts have held that even very small amounts of aid might have distortive effects on intra-community trade and competition. Also, there is no definite relationship between the size of the company and its market share. A small company specialized in a small market or niche might have a significant market share. Furthermore, as *Nicolaidis* and *Kekelekis* argued that if small companies do not need to compensate competitors because they do not have any significant impact on the economy, then why should they be saved?<sup>93</sup> Secondly, when the recipient is located in an assisted area, the extent of compensatory measures required by the Commission will be correspondingly lower.<sup>94</sup> However, this process is also ambiguous because the Guidelines do not provide any explicit thresholds on how much less capacity reduction should be required in assisted areas. Consequently, neither the recipient companies, nor their competitors have any clear idea of what to expect.<sup>95</sup> Finally, aid for social measures exclusively for the benefit of redundant employees is disregarded for the purposes of determining the extent of the compensatory measures.<sup>96</sup>

#### **3.1.2.4 The one-time last-time principle**

In order to prevent unfair distortions of competition, the Guidelines establish that aid to firms in difficulty should be granted only once. In practice, this means that companies cannot be rescued and restructured repeatedly. Otherwise, repeated grants would merely postpone the inevitable consequence, and in the meantime shift economic and social problems on to other, more efficient producers or other Member States. In other words, the discipline of the market will be removed. Therefore, the Member State must identify whether the current firm has already received R&R aid in the past, including any unnotified aid<sup>97</sup>. If so, and where less than 10 years have

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<sup>92</sup> R&R Guidelines §§ 41 and 57(a)

<sup>93</sup> Nicolaidis, P. & Kekelekis, M. (2004) pp.578-583

<sup>94</sup> R&R Guidelines §56

<sup>95</sup> Nicolaidis, P. & Kekelekis, M. (2004).

<sup>96</sup> R&R Guidelines §66

<sup>97</sup> If the previous aid was not notified, it would be considered as unlawfully granted aid and normally the recipient will be asked to recover the old aid. However, recovery of past aid would reestablish the previous situation. Therefore, in such a case applicability of one-time last-time principle is questionable. On the other hand, if the application of one-time last-time principle is excluded in that case, the less-law abiding aid beneficiary, who received non-notified incompatible aid, would be treated better than the one who received a notified

elapsed since the rescue aid was granted or the restructuring period came to an end or implementation of the restructuring plan has been halted (whichever is the latest), the Commission will not allow further R&R aid.<sup>98</sup>

Exceptions to the application of the one-time last-time principle are permitted in exceptional and unforeseeable circumstances for which the company is not responsible.<sup>99</sup> These difficulties must be external to the company, implying a *force majeure* situation where the company has no power of influence.

### 3.1.3 Compatibility of Rescue Aid

Rescue aid is short-term assistance which makes it possible to keep a company in difficulty afloat for the time needed to work out a restructuring or liquidation plan that would bring it back to financial viability. Rescue aid is by nature temporary and reversible.<sup>100</sup> Once a restructuring or liquidation plan for which the aid requested has been established and is being implemented, rescue aid is no longer available for the firm and all further aid will be considered as restructuring aid.<sup>101</sup> However, as in restructuring aid, rescue aid shall not simply maintain the *status quo* and postpone the inevitable. Therefore, the Commission and the European Courts are cautious about the aid measures designed to keep a firm alive.<sup>102</sup>

Point 25 in the Guidelines stipulates five cumulative conditions for the approval of rescue aid. Accordingly:

- rescue aid shall consist of liquidity support in the form of loans or loan guarantees where the interest rate of loan granted shall be comparable to those observed for the loans to healthy firms, and in particular the reference rates adopted by the Commission;
- loan and guarantee must be limited to six months unless the Member State has not submitted a restructuring plan within those six months and the Commission has not decided on the plan yet. In such a case, the rescue aid will normally be prolonged<sup>103</sup>;
- the aid amount must be limited to the amount necessary to keep the firm in business for six months;

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compatible restructuring aid. Therefore, *Lienemeyer, M.* suggests that for the application of one-time last-time principle it should only matter whether the recipient was in difficulty at the time it received aid, whereas the compatibility of aid received in the past should be irrelevant for the Commission's assessment. (See Rydelski M.S., (2006), "*The EC State Aid Regime: Distortive Effects of State Aid on Competition and Trade*", Cameron May)

<sup>98</sup> R&R Guidelines §73

<sup>99</sup> *Ibid.*

<sup>100</sup> R&R Guidelines §15

<sup>101</sup> R&R Guidelines §16

<sup>102</sup> See Joined Cases T-126/96 and T-127/96 *BFM and EFIM v Commission* [1998] ECR II-3437 where the company was merely kept in business until privatization had taken place, and Case T-152/99 *HAMSA* [2002] ECR II-3049, par 50 where the same type of aid was received for the same reason more than once.

<sup>103</sup> Valle, E. & Van de Castele, K. (2004).

- the aid must be granted on the grounds of serious social difficulties and create no negative externalities on other Member States; and,
- the company should not have benefited from any R&R aid in the last 10 years.<sup>104</sup> Rescue aid is also a one-off measure which is designed to keep a company in business for a limited period.

Finally, considering the urgency problem of rescue aid cases, the Commission proposed a new simplified procedure in point 30 of the Guidelines. Accordingly, the Commission will endeavour to adopt a decision within a period of one month for cases where the firm is unquestionably a firm in financial difficulties and the amount of rescue aid is based on the past operating cash flow of the firm and does not exceed EUR 10 million. One could easily envisage that the Commission is suggesting, by adopting such a simplified procedure, a kind of block exemption approach for certain kinds of rescue aid.<sup>105</sup> However, there are two problems attached to the new procedure. Firstly, the threshold of EUR 10 million is relatively low compared to the size of companies asking for rescue aid. Therefore, the new procedure can be said to be limited in scope. In addition, the formula based on past operating cash flow might not always reveal the real future liquidity needs of the companies.

### 3.1.4 Case Analysis

The sub-chapters below analyse two decisions adopted by the Commission. In the area of R&R aid, there is dominance of French, Italian and German cases. Interestingly, these cases show very similar characteristics and resemble each other. Therefore, the two cases below are selected from these three Member States; one from France and other from Germany. Moreover, in order to provide a kind of historical evolution and differences in the Commission's approach, if exist, two cases are selected through time; one from 1998 and other from 2005. More recent case laws during the time of financial crisis will be provided in Chapter 4.

#### 3.1.4.1 GAN Group

In 1998 the Commission approved a restructuring aid granted by France for the ailing GAN group<sup>106</sup>. GAN, a State controlled banking and insurance group, not only was the fifth largest insurer in France in terms of turnover with wide operations abroad, but also controlled 93% of the *Credit Industrial et Commercial* (CIC) banking group, which was the fifth largest bank in the French Association of Banks. The difficulties experienced by GAN related both banking and insurance sections: its banking division had been hard-hit by the crisis in the property sector and the deterioration in the financial position of SMEs; its non-life insurance business had suffered the

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<sup>104</sup> 10-year time limitation might be shortened due to unforeseeable circumstances for which the company is not responsible.

<sup>105</sup> Valle, E. & Van de Castele, K. (2004).

<sup>106</sup> Commission Decision 98/204/EC of 30 July 1997 conditionally approving aid granted by France to the GAN group, OJ L78 of 16 March 1998, p.1

consequences of the aggressive expansion strategy followed by a fall in the market. In 1995 the French Government had decided to support GAN through a capital injection of FRF 2.86 billion in the framework of a plan involving the privatization of CIC. The Commission had then considered the aid compatible with the common market due to the positive effects of the privatization in the market.<sup>107</sup>

However, the privatization was subsequently suspended because GAN's turnovers turned out to be less encouraging than envisaged. As a result, the French Government decided to intervene again with an additional aid amounting to FRF 20 billion which is almost seven times bigger than the original aid. This aid package might be broken down as follows:

- a capital injection of FRF 11 billion to give the insurance companies an appropriate financial structure and to restore the capital base requirements of UIC ( a property development subsidiary of GAN),
- a government commitment to cover the estimated losses of FRF 9 billion which GAN would incur in implementing guarantees that it would have to provide, as part of the restructuring plan, for loans granted to the hived-off property company, *Baticredit Finance et Cie*.

The Commission then decided to initiate formal proceedings in respect of both the new and old aid packages to GAN. After re-examining the compatibility of previous aid package (capital injection of FRF 2.86 billion) in the light of the new aid package, the Commission decided to approve restructuring aid to GAN subject to various conditions. These conditions included in particular:

- the reduction of GAN's insurance operations outside France by 50%
- the sale of GAN's insurance business, of its banking group CIC and of other subsidiaries according to a sale procedure aimed at maximizing the revenues and at ensuring the future long term viability of the companies sold.

These conditions prove that the Commission is quite sensitive on compensatory measures. However, at the same time the Commission seeks for a balance between these measures and the objective of the aid granted. In other words, compensatory measures undertaken should be sufficient to offset the distortion of competition in the sector. However, these measures should be balanced against the objective of the restructuring aid which the long term viability of the company. Therefore, compensatory measures should be adjusted not to put the long term viability of the company at risk.

The Commission also rejected the French Government's argument that the restructuring of GAN would be less costly for the French Government in its capacity as authority responsible for monetary and financial stability. According to the Commission, acceptance of such an argument would imply an unacceptable discrimination between public and private companies.

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<sup>107</sup> Commission Press Release IP/96/842 of 18 September 1996, Commission approves restructuring plan for GAN.

Finally, GAN case is particularly interesting because the Commission developed some policy considerations on the corporate governance of publicly owned enterprises and on the *moral hazard* involved in their operations. The difficulties encountered by the GAN group revealed that the group's corporate governance was not adequate. The Commission stated that GAN's slowness in reacting to the cyclical downturn and slowness of the recovery process was a result of the confidence which its top management had placed in the State as shareholder. Obviously only the public institutions could count on such State aid but private ones are forced by the market forces to restructure drastically or enter into a composition arrangement. Therefore, State's support, implicit or explicit, to public institutions make it easy for them to follow such speculative and hazardous policies. According to the Commission;  
*"there is reason to believe that, if GAN had not had the implicit or explicit support of the State, it would not have embarked upon the hazardous policy it did embark upon, or that at all events it would have restructured earlier and with greater determination."*<sup>108</sup>

Therefore, State support to GAN delayed the necessary corrective action and increased the final amount of State aid. The Commission emphasized that such unwarranted and excessive protection had *"the effect of encouraging the unsound management of credit institutions"* and resulted moral hazard problems.

### **3.1.4.2 Bankgesellschaft Berlin AG**

The case concerns restructuring aid to the German lending group *Bankgesellschaft Berlin AG* (hereinafter BGB).<sup>109</sup> BGB was formed in 1994 by the incorporation of several credit institutions formerly controlled by the Land of Berlin which was one of the main shareholders holding roughly 81% of BGB's shares. BGB's core business was retail banking for private and corporate customers. Apart from retail banking, real estate financing and real estate services, BGB and its subsidiaries were also operating on capital markets; money and security dealings. BGB was one of the 12 biggest banks in Germany in 2002 and by far the market leader in retail banking in the Berlin area.

However, in the first half of 2001 BGB found itself in acute difficulty mainly because of high-risk real estate transactions such as imprudent rent and repurchase guarantees given to investors in real estate funds. In order to alleviate the financial losses, the majority shareholder Land of Berlin injected a fresh capital amounting to € 1.755 billion. The Commission authorized this measure as rescue aid.

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<sup>108</sup> Commission Decision 98/204/EC of 30 July 1997 conditionally approving aid granted by France to the GAN group, OJ L78 of 16 March 1998

<sup>109</sup> Commission Decision 2005/345/EC of 18 February 2004 on restructuring aid implemented by Germany for Bankgesellschaft Berlin AG, OJ L116 of 04 May 2005, P.001-054.

In the following months, however, further risks were identified, especially in the real estate services operated by BGB's subsidiaries. During this period, BGB was threatened with temporary closure by the Supervisory Office if it did not take measures to provision these risks. Therefore, as a second measure the Land of Berlin provided risk guarantees (the so-called *risk shield*) to cover these new risks up to a theoretical maximum of € 21.6 billion for 30 years. In the worst case scenario, the economic value of these guarantees can be assessed at € 6.1 billion. Germany notified these measures as restructuring aid. Since these measures fall under the restriction laid down in Article 87(1) EC, the Commission started formal investigation procedure. During its first analysis, the Commission drew attention to the fact that a repayment agreement between the Land of Berlin and BGB regarding a potential recovery of a case pending in the Commission could also be considered as a State aid. This agreement was valued at up to € 1.8 billion.

In its analysis, the Commission firstly established that these three measures are considered as aid within the meaning of Article 87(1) EC. However, they might be considered compatible with the common market based on the exemption laid down in Article 87(3)(c) EC. In the Commission's view, the only guidelines applicable for that purpose were those on State aid for rescuing and restructuring firms in difficulty. The Commission then assessed the aid measures against the three main criteria set forth in the R&R Guidelines.

The Commission first demonstrated that BGB should be regarded as a firm in difficulty. The fact that BGB had been supported by its majority shareholder, Land of Berlin, and had benefitted from these measures before its business activities were terminated cannot change this conclusion. It was obvious that a market economy investor would not have provided those resources on the same terms. The Commission then analyzed the structural and operational deficits responsible for the difficulties. Such an analysis was essential to assess the effectiveness of those measures and the restoration of long-term viability of BGB.

Regarding the restoration of long-term viability, the Commission's assessment was based on an expert study clarifying the sufficiency of BGB's risk provisions and risk management. After incorporating those recommendations, the Commission concluded that the restructuring measures already carried out and those planned for the future are reasonable, logical and fundamentally appropriate in order to enable BGB to restore its long-term viability.<sup>110</sup> Although there were some continuing uncertainties for future developments, the restructuring plan provided for a substantial reduction in risky assets and restricted the bank to its core business in the future. The Commission warned that the prospects for viability were dependent to a large extent on future profits, on the ability to generate new

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<sup>110</sup> Commission Notice IP/04/234 of 18 February 2004, Commission approves aid for restructuring of Bankgesellschaft Berlin



business and on the restructuring plan being implemented in full. The Commission also considered that the privatization of the bank after the restructuring period would have a positive effect on further improving BGB's profitability because the Commission assumes that an investor, following the bank's privatization, would take all necessary measures to achieve for the bank a level of profitability that would be acceptable to a market-economy investor. As in *GAN* case, the Commission considers the public involvement as a problem and proposes privatization as a remedy. Underlying assumptions of the Commission regarding privatization are highly questionable. By way of privatization, the Commission might be suggesting market forces to decide for each and every company. However, as mentioned before, adoption of R&R Guidelines in principle eliminates the role of market forces in a market to a large extent.

Regarding the avoidance of undue distortions of competition, the Commission considered that the sales, closures, and reduction of subsidiaries, assets and lines of business offered as compensatory measures were sufficient to mitigate the distortive effects of the aid measures. These compensatory measures included the commitments to reduce BGB's strong position in the Berlin retail banking market by the divestment of *Berliner Bank*, one of BGB's two retail brands, and attached business, to hive-off the real estate services subsidiaries, and, finally, to sell BGB by the end of 2007. The restructuring plan also provided several other commitments such as divestment of Berlin-based *Wederbank* and the sale or closure of national and foreign branches and subsidiaries. Divestiture of real estate services, which was the main reason of the crisis, reveals the Commission's concern for the balance; adequacy of compensatory measures on the one hand and long-term viability of the company on the other. The abundance of these measures shows not only the Commission's harshness while assessing compensatory measures but also the fact that the Commission takes into account of the relative importance of the firm on its market.

Regarding limitation of the aid to the minimum, the Commission concluded that the amounts of three aid measures granted – the capital injection, the risk shield and the agreement on the treatment of any claims to repayment brought against the bank by the Land of Berlin – are limited to the strict minimum necessary to enable BGB's restructuring. Existing financial resources of BGB and its shareholders were taken into account by the Commission. The Commission also considered the fact that the bank did not receive any surplus cash or surplus own resources which it could have misused for the purposes of an unreasonable expansion of its business at the expense of its competitors.

As a result, the three aid measures totaling to EUR 9.7 billion were considered as aid within the meaning of Article 87(1) EC but declared compatible with the common market based on the R&R Guidelines.

## 3.2 State Guarantees

Another common type of State aid to financial institutions is the aid granted in the form of guarantees. State guarantees do not imply a direct injection of funds from the State to the guaranteed firm. Within the context of financial services, it means that the State promises to ensure the well functioning of the credit institution by injecting funds when the bank faces liquidity problems or by responding directly against the claims of his creditors when the assets of the bank were not sufficient to repay all the debts. However, for many governments, guarantees are seen as convenient instruments not only because they do not involve any funding but also they allow the governments to pursue a fair amount of development policy.<sup>111</sup> Governments could easily support the development of companies and facilitate their access to finance which is particularly important for SMEs.

In many cases, guarantees are non-transparent aid because it is very difficult to quantify a guarantee especially when it has not been called. Since these guarantees are in a way invisible and do not appear explicitly as aid –but guarantees- in the national budget, they often escaped the scrutiny of the Commission.<sup>112</sup> However, when the Commission accidentally came upon guarantees in *EFIM* case<sup>113</sup>, it had realized that something has to be done. For that purpose, the Commission collected the applicable rules in its first Commission Notice on guarantees.<sup>114</sup> Since its adoption, the Commission dealt with several major cases which drew the public attention to State aids awarded by means of State guarantees.<sup>115</sup> These cases also proved how difficult it is for the Commission to determine the existence and amount of aid granted through explicit or implicit guarantees. Unfortunately, the text of this Notice was unnecessarily complex and some issues of crucial importance were left open to different interpretations.<sup>116</sup> In view of that, State Aid Action Plan (SAAP)<sup>117</sup> drew attention to the necessity of the revision of Notice on guarantees for clarification and simplification of State aid rules. Finally, in 2008, the rules applicable to aids in the form of guarantees are contained in a revised Commission Notice.<sup>118</sup> The revised Commission Notice on guarantees aims to provide additional guidance and

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<sup>111</sup> Feltkamp, R. (February 2002), *Comments from the Standpoint of the Commission*, Supplement on Application of the European Community Rules on State Aid to State Guarantees, Butterworths Journal of International Banking & Finance Law, pp.56-58

<sup>112</sup> Ibid.

<sup>113</sup> Case C-349/88 *Commission v Italy (EFIM)*, [1995] ECR I-343

<sup>114</sup> Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ C71, 11.03.2000, p.14

<sup>115</sup> See the case analysis section below.

<sup>116</sup> Prete, L., (2006) *State Aid Reform: Some Reflections on the Need to Revise the Notice on Guarantees*, Kluwer Law International, World Competition 29(3), pp.421-439

<sup>117</sup> State Aid Action Plan – Less and better targeted State aid: a roadmap for State aid reform 2005-2009, Consultation document, available on DG Competition web-site.

<sup>118</sup> Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, (2008/C 155/02) which replaces the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ C71, 11.03.2000, p.14

legal certainty to Member States and stakeholders when assessing whether a guarantee contains an element of State aid.<sup>119</sup>

### 3.2.1 Scope of the Commission Notice

The Notice applies to all economic sectors, including financial services sector, without prejudice to specific rules adopted for the guarantees in the sector concerned. Furthermore, the Commission keeps neutrality as regards public and private ownership. Thus, in compliance with the Article 295 of the Treaty, the Notice does not prejudice the rules governing the system of property ownership in the Member States. The Notice also sets out particular rules for SMEs which will allow them to assess the aid element of a guarantee in a simple way. However, the scope of this study does not cover those specific rules.

The scope of application of the Notice is very wide. It covers all forms of guarantees where a transfer of risk takes place<sup>120</sup>. Although, the Notice does not delineate what exactly has to be understood from a transfer of risk, it suggests taking into consideration whether the risk of the lender is diminished following the granting of a guarantee by the State. In other words, the risk associated with the guarantees should be carried, partially or wholly, by the public entity<sup>121</sup> providing the guarantee.

The most common guarantees are associated with a loan or another financial obligation contracted by a borrower from a lender. They may be granted as individual guarantees<sup>122</sup> or within guarantee schemes<sup>123</sup>. Guarantees may take various forms depending on their legal basis, the type of transaction covered or their duration. The Commission provides a non-exhaustive list of common forms of guarantees.<sup>124</sup> Accordingly, in addition to explicit guarantees such as a contractual guarantee, the Commission pays special attention to implicit forms of guarantees, sometimes referred as “*soft guarantees*”. Letters of comfort or political declarations might contain a transfer of risk when announcing that a company can rely upon the support of the State.<sup>125</sup> Oral commitments and side letters are also caught with the same provision. Such commitments constitute a guarantee as soon as it becomes obvious that the State intervention diminishes the risk to be borne by the lender.

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<sup>119</sup> EU Focus (2008), *Commission Updates Rules on Guarantees*, 2008, 235 pp.27-29

<sup>120</sup> Only export credit guarantees are exempted from the application of Notice.

<sup>121</sup> It might be either the State through its central, regional or local authorities, or other economic undertakings operating under the dominant influence of the public authorities.

<sup>122</sup> *Individual guarantee* means any guarantee provided to an undertaking and not awarded on the basis of a guarantee scheme. See Commission Notice §1.3

<sup>123</sup> *Guarantee scheme* means any tool on the basis of which, without further implementing measures being required, guarantees can be provided to undertakings respecting certain conditions of duration, amount, underlying transaction, type or size of undertakings (such as SMEs). See Commission Notice §1.3

<sup>124</sup> See Commission Notice §1.2

<sup>125</sup> EU Focus (2008), pp.27-29

### 3.2.2 Aid Element

The Notice does not lay down any new principles of assessment by which the Commission will apply the State aid rules to State guarantees. As mentioned before, the Commission's main goal was to make the basis on which the Commission applies existing principles more transparent. Thus, general criteria set forth in Articles 87 and 88 of the EC Treaty equally apply to guarantees.

Even though the Commission used a fairly broad language in the Notice, it does not mean that all State guarantees amount to aid. The basic jurisdictional requirements of Article 87(1) EC should be satisfied to consider a guarantee as an aid. In that respect, the Commission confirms that the assessment of whether a State guarantee entails any State aid should be based on the Market Economy Investor Test.<sup>126</sup> Accordingly, the guarantees provided by the State authorities can be considered to be compatible with the EC State aid rules, if they are made under conditions that a private market investor would have accepted. As stated before, in case of guarantees the risk associated with the guarantee is generally carried by the State. Therefore, State's act of carrying such risks should be compensated by an appropriate premium which is acceptable by a private investor operating under normal market economic conditions. In that regard, an evaluation of borrower's creditworthiness would be essential to determine the market premium of the guarantee he has to pay. If the State forgoes all or part of such a premium, then there is both an advantage to the recipient and transfer of State resources. Thus, actual State payments under a guarantee are not necessarily a requirement for a guarantee to fall under Article 87(1) of the Treaty and be considered as State aid. Such general approach to guarantees is confirmed by the CFI in *EPAC* case where it held that:

*“with regard to the absence of a transfer of State resources, the advantage conferred will entail an additional burden for the State budget in the event of implementation of the guarantee. (...) Accordingly, the grant of a guarantee by the State cannot avoid the prohibition in Article 87 of the Treaty merely because that advantage was not conferred on the beneficiary undertaking by way of a direct and clear mobilisation of State resources.”*<sup>127</sup>

The Commission considers that the aid is granted at the moment when the guarantee is given, not when the guarantee is called upon nor when payments are made under the terms of the guarantee.<sup>128</sup>

The Notice mentions two types of possible beneficiaries of the guarantees; borrower and lender. State aid is normally involved if the borrower is able to raise funds at lower costs than would be possible without the guarantee or when the borrower could not get the loan at all without State guarantee. However, under certain circumstances, a State guarantee might equally give

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<sup>126</sup> See Chapter 2.1.2 above for details of this test.

<sup>127</sup> Joined Cases T-204/97 and T-270/97 *EPAC* [2000], ECR II-2267 pars 80-81

<sup>128</sup> This principle is also confirmed by the CFI in Case T-318/00 *Freistaat Thüringen v Commission* [2005] ECR II-4179 pars 125-126

rise to State aid to the lender. Both of these cases are relevant for the financial services sector. Firstly, the credit institutions can be the direct beneficiaries of the aid, for example, when they operate under a public guarantee, the so-called “*refinancing guarantees*”, to such an extent as to allow them to reduce their cost of lending;<sup>129</sup> or when the State acquired a holding in a credit institution where unlimited liability is accepted instead of limited liability.<sup>130</sup> Such direct advantage to credit institutions is so typical for the financial services sector because only beneficiaries professionally engaged in the financial sector can derive a significant amount of reduction in their lending costs structure from such guarantees.

Credit institutions can also be the indirect beneficiaries of the guarantee especially when they grant financing to their clients who provide them with public guarantees, the so-called “*loan guarantees*”. In this case, the guarantee advantage is transferred to the undertakings being financed through a reduced interest rate for the loan. However, credit institutions still get the benefit because they derive additional loan intermediation and transaction costs due to the attractiveness of a loan backed up by a public guarantee.<sup>131</sup> In other words, because of public loan guarantees credit institutions grant loans which they would not have granted under normal market conditions. When the guarantees contains aid to the lender, the Notice calls attention to the fact that such aid might, in principle, constitute operating aid which may be incompatible with the common market.<sup>132</sup>

### **3.2.3 Conditions Excluding the Existence of Aid**

Although it can be argued that payment of premium for a State guarantee should be enough to exclude the existence of aid, the Notice adopts a stricter approach and identifies a list of conditions that have to be satisfied for reaching such a conclusion.

In the case of an individual State guarantee, the Notice sets out four conditions to be fulfilled<sup>133</sup>:

- the borrower is not in financial difficulty<sup>134</sup>;
- the guarantee is linked to a specific financial transaction, for a fixed maximum amount and limited in time;
- the guarantee does not cover more than 80% of the outstanding loan or other financial obligation<sup>135</sup>; and

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<sup>129</sup> Rossi, P. & Sansonetti, V. (October 2007). Aids in the form of refinancing guarantees will be examined in case analysis section below.

<sup>130</sup> Delfino, R., (2004).

<sup>131</sup> Rossi, P. & Sansonetti, V. (October 2007).

<sup>132</sup> Commission Notice §2.3.1

<sup>133</sup> Commission Notice §3.2

<sup>134</sup> The Notice does not define the phrase “firm in difficulty” but refers to Community Guidelines on State aid for rescuing and restructuring firms in difficulty, (OJ 2004 C244, p.2). See Chapter 3.1.1 for details.

<sup>135</sup> This limitation does not apply to guarantees covering debt securities or to public guarantees granted to finance a company whose activity is solely constituted by a properly

- the market price is paid for the guarantee.

The last two conditions need further clarification. The 80% rule for guarantees as mentioned in third condition is established to encourage lenders to assess the creditworthiness of borrowers properly and to make sure that the proper collateral is provided. The Commission believes that if a financial obligation is wholly covered by a State guarantee, the lender will have less incentive to properly assess, secure and minimize the risk arising from the lending operation. Consequently, loans will be contracted at a greater risk than the normal commercial risk and as a result the amount of higher-risk guarantees in the State's portfolio will increase.<sup>136</sup> For the purpose of ensuring that the lender bears part of the risk, when the loan starts to be reimbursed, the guaranteed amount has to decrease proportionally. So that at any time the guarantee will not cover more than 80% of the outstanding loan or financial obligation. In a similar manner, losses incurred should be borne by the lender and guarantor proportionally. Any revenue generated from securities has to be attributed to the lender and guarantor on a proportional basis. Transactions where losses are fully attributed to the guarantor first, without immediate and proportional recourse to the lender, do not fulfil the 80% criterion. However, in case of a failure to satisfy 80% condition, there is no automatic assumption of the existence of aid. If Member States want to provide such a guarantee, the only thing they have to do is to notify the Commission and explain the reasons of the chosen structure. If the guarantee concerned fulfils the Market Economy Investor Principle (MEIP), it will still be considered to be free of aid.<sup>137</sup>

With regard to the assessment of the market price, the Notice refers to two possibilities. As mentioned before, risk-carrying by a State guarantor should be remunerated by an appropriate premium. When the price paid for the guarantee is at least as high as the corresponding guarantee premium benchmark<sup>138</sup>, which can be found on the financial markets, the guarantee does not contain aid. However, if there is no matching guarantee premium benchmark on the financial markets, the total financial cost of the guaranteed loan, including the interest rate of the loan and the guarantee premium should be compared to the market price of a similar non-guaranteed loan.<sup>139</sup>

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entrusted Service of General Economic Interest where the guarantee has been provided by the public authority having put in place this entrustment.

<sup>136</sup> Commission Notice §3.2 (c)

<sup>137</sup> EU Focus (2008).

<sup>138</sup> A guarantee from a State arguably has greater value to a lender than a guarantee provided by a private sector bank, as the former will provide the lender with zero-risk weighting on its balance sheet. See Mark Friend in his contribution to Biondi, A., Eeckhout, P., & Flynn, J., (2004), *"The Law of State Aid in the European Union"*, Oxford University Press, p. 243

<sup>139</sup> Commission Notice §3.2 (d)

In the case of guarantee schemes, the conditions that must be fulfilled in order to rule out the existence of aid are as follows<sup>140</sup>:

- no guarantee can be provided to borrowers in financial difficulty;
- the guarantees must be linked to specific financial transactions, for a fixed maximum amount and limited in time;
- the guarantees cannot cover more than 80% of the outstanding loan;
- the terms of the scheme must be based on a realistic assessment of the risk, so that the premiums make it self-financing;
- the adequacy of the level of the premiums has to be reviewed at least once a year;
- the premiums charged have to cover the normal risks associated with granting the guarantee, the administrative costs of the scheme, and a yearly remuneration of an adequate capital;
- the scheme must provide for the terms on which future guarantees will be granted.

Self-financing nature of the guarantee schemes is the key element in the valuation of schemes. This condition refers to the market price premium condition within the context of individual guarantees. The Commission pays special attention to risk-adjusted premiums while assessing whether a guarantee scheme might be considered as self-financing. By this way, it is ensured that all projects are charged with premiums that correspond to their respective risk levels. Accordingly, a potentially higher rate of default incurred with riskier projects is remedied by higher revenues gathered through higher premiums. Similarly, the lower premiums charged to lower risks ensure that the scheme is still attractive for those projects. That is why, the Notice requires that the risk of each new guarantee has to be assessed on the basis of all the relevant factors such as quality of the borrower, securities, duration of the guarantee etc. Based on this risk analysis, risk classes have to be defined, the guarantee has to be classified in one of these risk classes and the corresponding guarantee premium should be charged.<sup>141</sup>

### **3.2.4 Improvements and Some Practical Difficulties**

The new revised version of the Notice on Guarantees eliminates many problems encountered with the older version.<sup>142</sup> Most of the unclear formulations have been improved and inconsistencies have been removed. For instance, the new Notice emphasizes the importance of MEIP and provides further clarification on that. At some certain points, there are clear references to market price and acts of private investor operating under normal market economy conditions. The new Notice also adopts a risk differentiation mechanism and adjusts the premiums accordingly. Moreover, the new Notice provides sufficient guidance on implicit guarantees or other

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<sup>140</sup> Commission Notice §3.4

<sup>141</sup> Commission Notice 3.4 (d)

<sup>142</sup> See Biondi, A., Eeckhout, P., & Flynn, J., (2004), pp. 241-244 and Prete, L., (2006) pp.421-439 for the problems of old Notice on Guarantees.

equivalent forms of support and their various forms. Now, there is a clear reference to R&R Guidelines for the definition of “*firms in difficulty*”.<sup>143</sup> However, there are still some problematic points which need further attention.

To start with, one should ask whether it is appropriate and desirable to put a list of conditions which exclude the existence of an aid element in any given State guarantee. It is obvious that the circumstances surrounding the company and the public body and also terms and conditions attached to a guarantee can be extremely diverse. Therefore, it might not be a totally effective exercise to put an exhaustive and comprehensive list of conditions which exclude the existence of aid.<sup>144</sup>

Secondly, although there are certain criticisms in the literature,<sup>145</sup> the Commission preferred to keep 80% rule in the revised version. The rationale of this rule, as explained before, is clear but it should be emphasized that the 80% rule is an “*arbitrary limit invented by the Commission, which has no firm legal basis*”.<sup>146</sup> Actually, it may be thought as pure and simple application of the MEIP. Indeed, a guarantee covering a higher percentage of a loan could still be considered to be free of aid, if the premium paid by the beneficiary is adequate reflecting all the risks incurred by the State. Again, this is simply the application of the MEIP. Then, why the Notice is providing these unnecessarily complex and perhaps not fully correct ratios instead of giving further guidance on the general application of the MEIP with regard to guarantee measures? Therefore, the EC legislator should consider whether it would not be more useful and simple with the latter one while skipping the 80% rule.

### 3.2.5 Case Analysis

The section below provides an analysis of the Commission decision for the provision of Anstaltslast and Gewährträgerhaftung used in Germany. This case reveals the Commission’s general approach with regard to State guarantees. This is approved in later decisions of the Commission such as State guarantee of *Ausfallhaftung* in Austria<sup>147</sup> and State guarantee by the *Caisse des Depots et Consignations* in France<sup>148</sup>.

#### 3.2.5.1 Anstaltslat and Gewährträgerhaftung

The German banking system comprises various credit institutions specialized on diversified functions. Beside the large private banking

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<sup>143</sup> There are still some doubts on the definition of this phrase. See Chapter 3.1.1.

<sup>144</sup> Prete, L., (2006).

<sup>145</sup> See Biondi, A., Eeckhout, P., & Flynn, J., (2004) and Prete, L., (2006) pp.421-439

<sup>146</sup> See Mark Friend in his contribution to Biondi, A., Eeckhout, P., & Flynn, J., (2004), p. 242

<sup>147</sup> See Commission Decision C(2003) 1329 final, OJ C 175, 24.7.2003, p.8

<sup>148</sup> See Commission Decision of 30 April 2003 in Case E 50/2001, C(2003) 1328 final.



groups, the system includes a great number of public banks. These public banks had always been an important tool for the municipalities and Landers to provide a variety of public services such as serving local and less structured clients, particularly SMEs, sole entrepreneurships and farmers.<sup>149</sup> The public banks in Germany enjoy various advantages compared to private banks. Firstly, they do not face liquidity problems and do not have to go to the capital market in search of equity capital because the State provides these loans when they are necessary. Secondly, the rates of return paid by public banks to their owners (the State or municipalities) are usually much lower than the rates of return paid by private banks to their shareholders. Finally, the public banks can also retain a higher amount of profit. No private investor can have as much resources as the State. This gives the public banks an extra advantage for expanding their business at the expense of their private counterparts.<sup>150</sup>

Apart from these obvious advantages, two guarantees had been traditionally used in the German public banking sector; “Anstaltslast” and “Gewährträgerhaftung”. The Anstaltslast corresponds to a maintenance obligation where “the guarantor is obliged to secure the economic basis of Anstalt, to maintain it functioning for the complete duration of its existence and to cover possible financial gaps through the use of subsidies or other appropriate means”.<sup>151</sup> Since this guarantee is provided without remuneration and is unlimited both in duration and time, it is almost impossible for public banks to go bankruptcy. However, if it happens, then the creditors and depositors of the bank are covered by a second type of guarantee, the so-called Gewährträgerhaftung. Gewährträgerhaftung refers to a guarantee obligation which creates the obligation for the guarantor to step in during the insolvency or liquidation of the credit institution and creates direct claims of the creditors of the credit institutions against the guarantor.<sup>152</sup> The existence of these two types of guarantees improves the creditworthiness and the financing conditions of German public banks in comparison to their private competitors. A public bank backed up by these guarantees can take higher risks and invest in some risky derivatives that cannot be carried out by the private banks. In exchange for public support, the German public banks had carried out some certain public interest lending activities. However, at the end, this resulted in a reserved market where public banks assumed a dominant position to provide local loans.<sup>153</sup>

Having this background, in 1991 the European Banking Federation filed a complaint against the public guarantees granted by Germany. Following its examination, the Commission reached a preliminary conclusion that both guarantees fulfill the conditions laid down in Article 87(1) of the Treaty and

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<sup>149</sup> Rossi, P. & Sansonetti, V. (October 2007)

<sup>150</sup> Taboas, M. M., *Law and Economics of Guarantees for Banks: An Economic Analysis of Gewährträgerhaftung and Anstaltslast in Germany*, Master Thesis, Erasmus Programme in Law and Economics, supervised by Prof. Dr. Jochen Bigus

<sup>151</sup> See Competition policy newsletter no. 2 June 2002, p.5

<sup>152</sup> Ibid.

<sup>153</sup> Rossi, P. & Sansonetti, V. (October 2007)

consequently should be regarded as aid. Moreover, the Commission considered that no possible exemption under the State aid rules was applicable in this case. Germany argued that these guarantees were a kind of compensation for the public services carried out by the public banks. However, the Commission had certain doubts on whether these guarantees could be represent a compensation for the provision of services of general economic interest. Further more, since these guarantees existed before the entry into force of the EC Treaty, they have to be treated as *existing aid* within the meaning of the Procedural Regulation.<sup>154</sup> Therefore these guarantees should be eliminated provisionally following a transitional period determined by the Commission.

After that, the Commission requested Germany to bring State guarantees for public banks into line with EC law and provided several recommendations in that regard.<sup>155</sup> Germany agreed on the implementation of these recommendations.<sup>156</sup> Pursuant to the agreement, a “*platform model*” had been adopted. Accordingly, Gewährträgerhaftung would have been abolished and Anstaltslast would be replaced with a normal commercial owner relationship governed by the market economy principles just like between a private shareholder and a limited liability company. Furthermore, any obligation of the public owner to grant economic support to the public credit institution would be excluded. There would be no unlimited liability of the owner for the liabilities of the public credit institution. Also any declaration of intent or guarantee to ensure the existence of public credit institutions would be abolished. Finally, same insolvency rules shall apply both to the private credit institutions and public ones. In other words, creditors of public credit institutions should be treated equally as the creditors of private credit institutions.<sup>157</sup> The agreement anticipated a four year transition period ending on 18 July 2005 during which Anstaltslast and Gewährträgerhaftung can be maintained in their present form. Liabilities existing before the date of acceptance of the agreement will continue to be covered by Gewährträgerhaftung until their maturity runs out based on the condition that its maturity does not go beyond 31 December 2015.

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<sup>154</sup> According to Article 1(b) of the Procedural Regulation No 659/1999 of 22 March 1999 (OJ L83 of 27 March 1999) *existing aid* is the aid which existed prior to the entry into force of the Treaty; aid authorized in the meantime; aid with regard to which the limitation period of ten years to recover unlawful aid has expired; aid which was no aid when put into effect and which became aid in the meantime because of the evolution of the market (unless the changes in the market are due to liberalization acts by Community legislation; then it becomes *new aid*).

<sup>155</sup> Press release IP/01/665 of 8 May 2001, Commission requests Germany to bring State guarantees for public banks into line with EC law.

<sup>156</sup> Press release IP/02/343 of 28 February 2002, Germany agrees on the implementation of the understanding with the Commission on State guarantees for Landesbanken and Saving banks.

<sup>157</sup> Ibid.

## 4 State Aid Rules in the Context of the Current Financial Crisis

European Union is now experiencing a “*once-in-a-lifetime crisis*”. The financial turmoil started in August 2007 with reckless real estate lending in the USA. People believed that there was no reason to be concerned about the stability of the European financial system. However, this illusion disappeared in mid-September 2007 with the images of British people queuing to withdraw their deposits from branches of UK mortgage bank Northern Rock. Northern Rock was a warning that the crisis could cross the Atlantic. Policy makers in the Union were aware of the horrific consequences of financial markets’ seizure as experienced during 1930s.<sup>158</sup> However, Northern Rock signal was not recognized fully and in the following months the crisis dispersed to credit institutions with a particular risk profile. Member States and the Commission were dealing with these failing credit institutions on case-by-case basis instead of uniting and adopting a general measure. The European Central Bank and the central banks of the Member States started to inject huge amounts of liquidity into markets to prevent a severe credit crunch.<sup>159</sup> However, trust among financial institutions continued to disappear and there were serious risks that the fear might spread to other industries and hit the real economy in general. The European banking sector was clearly in difficulties.

In the second phase, the collapse of Lehman Brothers on September 2008 started a general crisis of confidence. Credit institutions were in need of refinancing measures due to the extraordinary freeze in inter-bank lending. The crisis was no longer one of individual banks, but a systemic one of the entire banking system.<sup>160</sup> Due to the vital role played by the credit institutions in the economy, the crisis spilled into other sectors as well. Jobs and businesses have been destroyed on a massive scale. In short, the European Union is experiencing a real economic downturn.

During the ongoing crisis, the State aid rules played an important role in tackling the financial and economic crisis and enabled the Commission to be involved in the management of crisis. The State aid rules emerged as a tool for “*positive*” economic policy coordination rather than solely for

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<sup>158</sup> Alesina A. et al., (September/October 2008) *Open Letter to European Leaders on Europe’s Banking Crisis: A Call for Action*, Intereconomics, p.267

<sup>159</sup> Almunia Joaquin, (11 November 2008), *A Recipe for Recovery: the European Response to the Financial Crisis*, SPEECH/08/601, 2<sup>nd</sup> Brussels’ International Economic Forum

<sup>160</sup> Gros Daniel, (September/October 2008), *Financial Crisis: High Cost of “non Europe”*, Intereconomics, pp. 254-255

“negative” control of compliance with the EC Treaty.<sup>161</sup> In that respect, the message delivered by the Commissioner *Neelie Kroes* was clear enough: “by applying the EU’s State aid policy and working together with Member States, the European Commission is determined to ensure that fewer jobs are lost and that the recession is shorter and shallower than it would otherwise be. (...) The best way to limit job losses and economic damage is to maintain the integrity of Europe’s Single Market through, amongst other things, the application of the EU’s State aid policy.”<sup>162</sup>

However, the Commission’s response to the crisis differed depending on the time and how harsh the crisis is. Indeed, two phases can be identified chronologically so far. Phase I covers a period of September 2007, when the crisis hit Europe by Northern Rock, and September 2008, the Chapter 11 bankruptcy filing of Lehman Brothers. Phase II covers the period after the collapse of Lehman Brothers. The next two chapters provide an analysis of how the Commission reacted to the crisis during these periods.

## 4.1 Phase I – Adherence to Existing Measures

In phase I, the primary concern of the Commission was to ensure consistent implementation of the EC State aid rules. The Commission reacted to the subprime crisis by taking necessary actions to reassure markets that the rescue measures adopted by the Member States were “*not going to be jeopardized by EU rules*”.<sup>163</sup> Notwithstanding the exceptional nature of the crisis and the calls for greater flexibility from the Member States, the Commission has preferred to rely on established practices in dealing with the cases have arisen within the context of financial crisis. The Commission stated that, contrary to what some Member States argued, the existing legal framework is flexible enough to accommodate exceptional and country-specific circumstances.<sup>164</sup> Therefore, up until September 2008, the Commission examined rescue measures adopted by Member States to address the difficulties of their credit institutions on the basis of the R&R Guidelines. As mentioned before, this Guidelines are adopted pursuant to Article 87(3)(c) EC. Therefore, during the phase I period, the Commission was keen on using the exemption laid down under Article 87(3)(c) EC while constantly refusing to authorize rescue measures pursuant to Article 87(3)(b) of the Treaty.

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<sup>161</sup> Gerard Damien, (December 2008), “*Managing Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of a Problem*”, Global Competition Policy

<sup>162</sup> Kroes Neelie, (8 December 2008), “*The Role of State Aid in Tackling the Financial & Economic Crisis*”, SPEECH/08/683, eGov Monitor

<sup>163</sup> Kroes Neelie, (6 October 2008), “*Dealing with the Current Financial Crisis*”, addressed to the Economic and Monetary Affairs Committee, SPEECH/08/498, European Parliament, Brussels

<sup>164</sup> Gerard Damien, (December 2008).

Over phase I period, the Commission has adopted six decisions and authorized six individual rescue packages on the basis of the R&R Guidelines.<sup>165</sup> One common property of all these cases was that the Commission approved respective rescue measures on the basis of Article 87(3)(c) EC under strict conditions<sup>166</sup> and refused to apply Article 87(3)(b) EC. According to the Commission, the justification under Article 87(3)(b) “needs to be applied restrictively so that aid cannot be benefitting only one company or one sector but must tackle a disturbance in the entire economy of a Member State.”<sup>167</sup> Obviously, the Commission did not consider the risk that bank failures in UK, Denmark or Germany could start a systemic crisis.<sup>168</sup> Instead, the Commission viewed those cases as “individual problems” requiring “tailor made remedies, which can be addressed under the rules for companies in difficulty”.<sup>169</sup>

The sections below provide two case analyses to exemplify the Commission’s approach during Phase I period. Cases are selected to give a complete picture of the Commission’s attitude for rescuing and restructuring firms during this time period. Therefore, Northern Rock case refers to a rescue aid package while Sachsen LB deals with restructuring aid.

#### **4.1.1 UK Rescue Aid Package for Northern Rock**

Northern Rock is the 5<sup>th</sup> biggest mortgage bank in UK with a total balance sheet of £ 101 billion as of 31.12.2006.<sup>170</sup> Northern Rock’s main activity is residential mortgage lending which represents more than 90% of all outstanding loans. Lending activities of the bank have increased significantly over the last 8 years. Whole sale funding and in particular securitization of assets constituted the main source of financing during the growth period which means a change in the structure of the bank’s liabilities unlike most UK banks.

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<sup>165</sup> Commission Decision of 5 December 2007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue Aid to Northern Rock*, C(2007) 6127 final; Commission Decision of 30 April 2008 in Case NN 25/2008 (ex. CP 15/08) *WestLB risk shield, Germany*, C(2008) 1628 final; Commission Decision of 4 June 2008 in Case C 9/2008 (ex. NN 8/2008, CP 244/2007) *Sachsen LB, Germany*, C(2008) 2269 final; Commission Decision of 31 July 2008 in Case NN 36/2008 *Denmark – Roskilde Bank A.S.*, C(2008) 4138; Commission Decision of 1 October 2008 in Case NN 41/2008 *UK – Bradford & Bingley*, (see also Press Release IP/08/1437); Commission Decision of 2 October 2008 in Case NN 44/2008 *Germany – Hypo Real Estate Holding AG* (see Press Release IP/08/1453).

<sup>166</sup> See Chapter 3.1 and 3.2.

<sup>167</sup> See Commission Decisions in Case NN 25/2008 *WestLB risk shield, Germany*, para.41; and Case C 9/2008 *Sachsen LB, Germany*, para.94

<sup>168</sup> Gerard Damien, (2009), “*EC Competition Law Enforcement at Grips with the Financial Crisis: Flexibility on the Means, Consistency in the Principles*”, Concurrences No: 1-2009, pp. 46-62

<sup>169</sup> See Commission Decisions in Case NN 25/2008 *WestLB risk shield, Germany*, para.42; and Case C 9/2008 *Sachsen LB, Germany*, para.95

<sup>170</sup> Commission Decision of 5 December 2007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue Aid to Northern Rock*, C(2007) 6127 final

As a result of the crisis in the world's financial markets, a significant rationing of funds in the sterling markets occurred and the mortgage securitization market virtually closed. Since Northern Rock's business model is reliant on raising finance in the financial markets, the bank started to suffer from severe liquidity problems. On 14 September 2007, the Bank of England granted the so called emergency liquidity assistance to Northern Rock. However, after the grant decision was made public, the difficulties of Northern Rock were further aggravated by a "bank-run". Then the Treasury announced guarantee arrangements for all existing accounts in Northern Rock. These assumed liability guarantee would be backed by State resources. Later, the guarantee was extended to cover new retail deposits.

On December 5, 2007 the Commission adopted a decision on all the measures which the UK authorities took since 14 September. According to the Commission, the initial provision of emergency liquidity assistance by the Bank of England was provided against high quality collateral, bearing a premium interest rate and without a government indemnity.<sup>171</sup> Also these measures were taken at the Bank of England's own initiative independently from other measures. Therefore, the Commission concluded that liquidity assistance does not constitute State aid within the meaning of Article 87(1) EC. However, the Commission asserted that later measures, guarantees and further extensions, constitute State aid.

The Commission analyzed two exemptions, Article 87(3)(b) and Article 87(3)(c), in its assessment of compatibility. As regards compatibility under Article 87(3)(b), the Commission considered that "*an aid benefitting one operator or one sector only could not address the kind of situation targeted by this clause*".<sup>172</sup> Although the UK authorities argued that a systemic crisis might have arisen because of the reaction of the market and the behaviour of depositors, the Commission did not conclude in that way and considered the aid package for Northern Rock as designed to resolve the problems of a single recipient rather than remedy serious economic disruption.

As regards the compatibility under Article 87(3)(c), the Commission referred to the R&R Guidelines. The Commission concluded that the aid measures for Northern Rock can be authorized as rescue aid in line with the R&R Guidelines. The Commission also applied an exception for banking sector laid down in the R&R Guidelines.<sup>173</sup> Accordingly, rescue aids must be given in the form of loans and guarantees lasting no more than six months. However, an exception is made in the case of rescue aid in the banking sector, in order to enable the credit institution in question to continue temporarily carrying on its banking business in accordance with the prudential legislation in force. Finally, in line with the rules, the UK

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<sup>171</sup> See MEMO/07/545, "*State aid: Commission approves UK rescue aid package for Northern Rock – frequently asked questions*", 5 December 2007, Brussels

<sup>172</sup> Commission Decision of 5 December 2007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue Aid to Northern Rock*, C(2007) 6127 final

<sup>173</sup> R&R Guidelines, §25(a)

authorities committed to present a restructuring plan for Northern Rock going beyond the short term rescue by 17 March 2008.<sup>174</sup>

### 4.1.2 Sachsen LB

Sachsen LB was the central institution for savings banks in Saxony, with a group balance sheet total of € 67.8 billion by the year 2006.<sup>175</sup> As a commercial bank, Sachsen LB executed all kinds of banking transactions. However, in 2007 Sachsen LB ran into difficulties due to its investments in US subprime markets. Three major rating agencies downgraded a huge part of assets backed by mortgages which ranged from A+ to BB, to as low as CCC because of high default and foreclosure rates. During that period, hedge funds and institutional investors refused to reinvest in mortgage-backed commercial papers. Therefore, in August 2007 Sachsen LB was unable to refinance itself any longer and needed liquidity of up to € 17.1 billion in order to avoid fire sales.

On 19 August 2007, a group of 10 German Landesbanken and DekaBank<sup>176</sup> granted Sachsen LB a liquidity facility through commitment of buying its commercial papers up to an amount of €17.1 billion if these could not be placed on the market. One week after signing of this contract, Sachsen LB was sold to LBBW. According to the sales agreement, Sachsen LB would be sold with effect from 1 January 2008 and the price would be determined by an evaluation of an independent expert by the end of 2007. At the time of the sale, the parties expected that the crisis would be over by the end of 2007. However, towards end of 2007, further risks involved in Sachsen LB's structured investment portfolio appeared.<sup>177</sup> This has jeopardized the final sale of the bank because LBBW was neither capable nor willing to assume such huge losses.

After intensive negotiations, a final agreement was concluded. Accordingly, the entire structured investments of Sachsen LB were divided into two portfolios. One portfolio with a nominal value of € 11.8 billion was sold with Sachsen LB to LBBW. The second portfolio with a nominal value of € 17.5 billion remained in a special investment vehicle, the so-called "Super SIV". To this end, the Free State of Saxony granted a guarantee to the amount of € 2.75 billion for losses from the Super SIV. LBBW had also produced a restructuring plan covering a period of four years until the end of 2011.

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<sup>174</sup> Commission Press Release, IP/07/1859, "State aid: Commission approves UK rescue aid package for Northern Rock", 5 December 2007, Brussels.

<sup>175</sup> Commission Decision of 4 June 2008 in Case C 9/2008 (ex NN 8/2008, CP 244/2007), *State aid implemented by Germany for Sachsen LB*, C(2008) 2269 final.

<sup>176</sup> An agency under public law which is jointly held by the German Landesbanken and by DSGVO.

<sup>177</sup> Commission Press Release, IP/08/849, "Commission approves restructuring aid of Sachsen LB", 4 June 2008, Brussels.

The Commission questioned the liquidity support and sale of Sachsen LB and started the formal investigation procedure. The Commission acknowledges the fact that public authorities might need to react to threats to the stability of the financial markets. However, the Commission should ensure that such interventions do not distort trade in the markets. Otherwise, it would be very “*hard for European citizens to understand why they have to suffer from the economic downturn, while taxpayers’ money is poured into once profitable banks that took excessive risks and might now avoid paying for their risky strategies*”.<sup>178</sup>

Germany claimed that these measures were adopted on the basis of market economy investor principle and therefore do not constitute State aid. As regards to the liquidity measure, the Commission firstly stated that the credit facility which had been made available by the banking pool to Sachsen LB is attributable to the State. Then, the Commission concluded that considering the conditions attached to the liquidity measure, a market economy investor would not have granted the credit to the Sachsen LB. Therefore, the measure constitutes aid. As regards the State guarantee in the context of the sale, its effect was to render the sales price negative for the Land of Saxony because the potential losses were higher than the proceeds of sale. The Commission mentioned that in such a case a private owner would have opted for liquidation of Sachsen LB rather than a sale. As a result guarantee measure also constituted State aid. Then the Commission analyzed the compatibility of these measures with the common market on the basis of Article 87(3)(b) and (c) EC.

For the application of Article 87(3)(b), the Commission emphasized that the “*aid cannot be benefitting only one company or one sector but must tackle a disturbance in the entire economy*”.<sup>179</sup> The Commission also relied on the fact that this provision of the EC Treaty has not been used for the cases of banks in difficulty until that time. According to the Commission, the problems of Sachsen LB are due to company-specific events and thus require tailor-made remedies. The Commission, therefore, found no ground for compatibility of these measures on the basis of Article 87(3)(b).

The Commission then analyzed the compatibility of the measures under Article 87(3)(c) EC. The Commission considered the liquidity support as compatible rescue aid on the basis of R&R Guidelines because it meets all the necessary conditions such as being in the form of liquidity support and being limited to six months. The Commission considered the second measure as restructuring aid and assessed compatibility on that basis. Since the restructuring aid provided to Sachsen LB satisfies the conditions laid down in the R&R Guidelines such as restoration of long-term viability, limitation of aid to the minimum necessary, significant own contribution

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<sup>178</sup> Commission Press Release, IP/08/314, “*State aid: Commission launches probe into state bail-outs of IKB and Sachsen LB*”, refers to a speech of Competition Commissioner Neelie Kroes, 27 February 2008, Brussels.

<sup>179</sup> Commission Decision of 4 June 2008 in Case C 9/2008 (ex NN 8/2008, CP 244/2007), *State aid implemented by Germany for Sachsen LB*, C(2008) 2269 final.



and compensatory measures, the measure was deemed compatible with the State aid rules.

## 4.2 Phase II – Acknowledgement of the Systemic Nature of the Crisis and Adoption of New Measures

After the collapse of Lehman Brothers, the crisis intensified both in scope and scale and turned out to be a systemic one. At that point, even the fundamentally sound financial institutions in Europe faced refinancing difficulties. These developments forced the Commission reconsider its attitude towards the financial crisis. Finally, the Commission acknowledged the likelihood that the bank failures and liquidity shortage in the market could lead to a serious disturbance in the economy of Member States.<sup>180</sup> The Commission recognized that the financial services sector has a pivotal role in providing financing to the rest of the economy. Consequently, “*there is a systemic crisis that affects not only the entire functioning of the financial market but of the economy as a whole.*”<sup>181</sup> In this context, the Commission considers that, beyond emergency support for the financial system, the current global crisis requires exceptional policy responses.<sup>182</sup>

As a result, the Commission started to refer “*a rarely-used and more lenient provision*” to authorize national recovery plans and individual rescue measures, namely Article 87(3)(b) of the Treaty.<sup>183</sup> However, there was no established practice to derive the necessary conditions for the compatibility of aid granted under that provision. Therefore, the Commission issued a guidance on how Member States might comply with Article 87(3)(b) while respecting the State aid rules on 13 October 2008, namely the Commission 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* (hereinafter the Banking Communication).<sup>184</sup> The Banking Communication covers measures to guarantee the liabilities of financial

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<sup>180</sup> Kroes Neelie, (6 October 2008), “*Dealing with the Current Financial Crisis*”, addressed to the Economic and Monetary Affairs Committee, SPEECH/08/498, European Parliament, Brussels

<sup>181</sup> See Commission Decision of 27 October 2008 in Case N 512/2008 *Germany – Rescue Package for Credit Institutions in Germany*, C(2008) 6422, par.46; Commission Decision of 29 October 2008 in Case N 533/2008 *Sweden – Support Measures for the Banking Industry in Sweden*, C(2008) 6538, par.36; and Commission Decision of 17 December 2008 in Case NN 60/2008 *Guarantee Schemes for Credit Institutions in Portugal*, C(2008) 8686, par.29.

<sup>182</sup> Communication from the Commission – Temporary framework for State aid measures to support access to finance in the current financial and economic crisis, April 7, 2009, C(2009) 8301

<sup>183</sup> Gerard Damien, (December 2008).

<sup>184</sup> Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ 2008 C 270/2.

institutions, recapitalizations, controlled winding up and other forms of liquidity assistance. On December 2008, the Commission released a second 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*<sup>185</sup> (hereinafter the Recapitalization Communication), which complements the Banking Communication. Since then, these two sets of guidelines have been used as the basis for the approval of every Member State financial sector rescue or general support scheme.<sup>186</sup> The next chapters provide a detailed analysis of these two Communications.

## 4.2.1 Banking Communication

Banking Communication indicates how the Commission intends to apply State aid rules to State interventions in the form of either general schemes or individual assistance to credit institutions within the context of current crisis. The underlying principle of the Communication is the recognition by the Commission that Article 87(3)(b) EC is available as a legal basis for aid measures undertaken to address the current systemic crisis. Apparently, Article 87(3)(b) EC gives the Commission a new basis to authorize exceptional aid measures that goes well beyond its established practices and pre-existing guidelines such as the R&R Guidelines. However, the Commission emphasizes that this exemption cannot be applied without restrictions.

The Commission intends to make an individual assessment of each case and confirm the risk of serious disturbances in each case. Furthermore, the Commission particularly favours the general schemes available to several or all financial institutions. However, the Commission considers it an essential element for the compatibility of any general scheme that the Member State carries out a review at least every six months and terminates as soon as the economic situation permits.<sup>187</sup> The Banking Communication also makes a clear distinction between the treatment of financial institutions that due to the global financial crisis are illiquid but otherwise fundamentally sound and financial institutions characterized by endogenous problems such as inefficiencies, poor asset-liability management or risky strategies.

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<sup>185</sup> Communication from the Commission – The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, December 5, 2008, C(2008) 8259 final.

<sup>186</sup> There is also another Commission Communication published on 17 December 2008 and amended on 25 February 2009, namely temporary framework for State aid measures to support access to finance in the current financial and economic crisis (OJ 2009, C/16/01). This guidance is outside the scope of this paper. Generally, in this Communication the Commission's focus moved from financial sector measures to real economy measures. The Commission set out a number of possibilities for Member States to grant aid until 31 December 2010. This Communication covers subsidized loans for the production of green products, risk capital for SMEs, loan guarantees at a reduced premium and direct aids up to €500,000. There are several conditions, similar to the ones in Banking Communication and Recapitalization Communication, attached to these different types of measures

<sup>187</sup> Banking Communication, §13

Distortions of competition resulting from schemes supporting the viability of the institutions in the first group will be more limited and require less substantial restructuring. On the other hand, institutions in the second group would fit with the normal framework of rescue aid and as a result need a far-reaching restructuring and compensatory measures.<sup>188</sup> Moreover, by reference to the general principles underlying the State aid rules, the Banking Communication requires that all aid measures must: (i) comply with the principle of non-discrimination; (ii) avoid or minimize distortions of competition as far as possible; and (iii) be limited to what is strictly necessary.

#### **4.2.1.1 Guarantees Covering the Liabilities of Financial Institutions**

As explored before, guarantees have been used extensively to support financial institutions in difficulty.<sup>189</sup> However, the Commission Notice on Guarantees introduces strict conditions for the compatibility of these guarantees. It is very likely that guarantees developed during the financial crisis would not meet these conditions. The innovative and the flexible part of the Banking Communication is that the Commission may still authorize such guarantees on the basis of Article 87(3)(b) EC.

According to the Banking Communication, the State guarantees might cover liabilities extending beyond retail deposits based on the condition that they are in line with the general principles of State aid law. The Commission also recognizes that the drying-up of interbank lending may justify guaranteeing certain types of wholesale deposits and even short- and medium-term debt instruments.<sup>190</sup> However, such guarantees should not include hybrid or subordinated debt considered as Tier 2 capital because in such a case merely shareholders and investors would benefit from such guarantees.<sup>191</sup>

The Commission emphasizes that the conditions of eligibility must be objective and non-discriminatory. Particularly, there should be no discrimination on the grounds of nationality. Therefore, all institutions incorporated in the Member State concerned, including subsidiaries and institutions having significant activities in that Member State should be covered by the guarantee scheme.<sup>192</sup>

Regarding temporal scope of the guarantee schemes, the Commission asserts that the schemes extending beyond retail deposit guarantees must be limited to the minimum necessary. Member States should also carry out a review every six months to establish the justification for the continued application of the scheme.<sup>193</sup> The approval of the scheme may cover a

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<sup>188</sup> Banking Communication, §14

<sup>189</sup> See Chapter 3.2

<sup>190</sup> Banking Communication, §21

<sup>191</sup> Banking Communication, §23

<sup>192</sup> Banking Communication, §18

<sup>193</sup> Banking Communication, §24

period longer than six months and up to two years as long as the financial crisis requires so. Therefore, the Banking Communication adopts a more flexible approach as regards duration of guarantees. The Commission states that guarantee schemes during the financial crisis may be granted for a period of two years as opposed to six months limit under the R&R Guidelines.<sup>194</sup>

In order to ensure that the aid is kept to a minimum, the Commission reaffirms the principle of private sector contribution. Accordingly, Member States must take appropriate steps to ensure a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee.<sup>195</sup>

The scheme should also contain certain behavioural constraints to minimize distortions of competition and avoid moral hazard problem. These behavioural constraints may vary from restrictions on commercial conduct, and the limitations to the size of the balance sheet of the beneficiaries to the prohibition of the share repurchases and issuance of new stock options.<sup>196</sup>

Finally, where the guarantee scheme has been invoked for the benefit of individual credit institutions, it has to be followed up by adequate steps leading to restructuring or liquidation of the beneficiary. That is to say, after the payment has been done within six months, a restructuring or liquidation plan should be submitted for the Commission's assessment.

#### **4.2.1.2 Recapitalization of Financial Institutions**

The Banking Communication provides further guidance for the establishment of recapitalization schemes as a second measure which could be taken in response to the financial crisis. Member States may use these schemes to support financial institutions that are fundamentally sound but experienced distress due to the extreme conditions in financial markets.

The main novelty of the Communication is that recapitalization schemes could be launched as emergency measure now. Under the R&R Guidelines, these capital interventions were allowed only after a restructuring plan was submitted and assessed by the Commission. Rescue aid measures were the only emergency measure and limited to six months but now Member States could use recapitalization schemes as emergency measures.<sup>197</sup>

The conditions introduced above in relation to guarantee schemes apply, *mutadis mutandis*, also to recapitalization schemes. This covers objectivity and non-discrimination criteria for eligibility, duration up to two years, keeping aid to minimum necessary, behavioral constraints, requirement for a

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<sup>194</sup> Hatton, C. & Coumes, J.M., (2009) *Commission Adopts Guidance on State Aids to the Financial Sector*, European Competition Law Review, 2009, 30(2), pp.51-52

<sup>195</sup> Banking Communication, §25

<sup>196</sup> Banking Communication, §27

<sup>197</sup> Cleary Gottlieb Steen & Hamilton LLP, (10 December 2008), *The New Commission Guidance on State Aid and the Financial Crisis*, Brussels

restructuring plan to be presented and assessed by the Commission. Moreover, Member States should receive rights whose value corresponds to their contribution to the recapitalization. Market-oriented valuation must be used while determining the issue price of new shares. In that regard, the Commission considers preferred shares with adequate remuneration and claw-back mechanisms positively.<sup>198</sup>

#### **4.2.1.3 Controlled Winding-up and Other Forms of Liquidity Assistance**

Controlled winding-up is usually seen as forming part of a general guarantee scheme or as being taken in relation to individual institutions. For individual institutions, controlled winding-up could be either a second step after a failing rescue aid to allow for restructuring or could be done immediately when the need was identified.<sup>199</sup> In this context, the Banking Communication provides that the assessment of such a scheme or individual liquidation measures should follow the same rules as in the case of guarantee schemes.<sup>200</sup> Moreover, the liquidation phase should be limited to the period strictly necessary for the orderly winding-up. During this period, the beneficiary undertaking should not pursue any new activities and its banking license should be withdrawn as soon as possible. In order to avoid the possibility of granting aid to the buyers of the credit institution, the Banking Communication lays down a number of criteria to be followed by the Commission. Accordingly:<sup>201</sup>

- the sales process should be open and non-discriminatory;
- the sale should take place on market terms;
- the sales price for the assets and liabilities should be maximized; and
- any aid granted to the economic activity to be sold should be examined under R&R Guidelines.<sup>202</sup>

In addition to recapitalization and guarantee schemes, Member States might also wish to provide liquidity support to the credit institutions. These supports generally include funds from central bank. The Commission clarifies that the general, non-selective measures open to all comparable market players in the market (e.g. lending to the whole market on equal terms) are outside the scope of State aid rules.<sup>203</sup> Dedicated support to a specific financial institution may still be considered outside the scope of State aid rules based on the condition that the following non-exhaustive criteria are met:<sup>204</sup>

- the financial institution is solvent at the moment of the liquidity

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<sup>198</sup> Banking Communication, §39

<sup>199</sup> Hall Mathew, (January/February 2009), “*Competition Law and the Credit Crunch: Do the Usual State Aid Rules Still Apply?*”, PLC Magazine

<sup>200</sup> Banking Communication, §44

<sup>201</sup> Banking Communication, §49

<sup>202</sup> The best example of such controlled winding-up process is Roskilde Bank. See Commission Press Release IP/08/1633, “*State aid: Commission approves Danish liquidation aid for Roskilde Bank*”, 05 November 2008, Brussels.

<sup>203</sup> See for example Northern Rock, OJ C43, 16.02.2008, p.1

<sup>204</sup> Banking Communication, §51

- provision;
- the facility is fully secured by collateral to which “haircuts” (margins) are applied;
- the central bank charges a penal interest rate on the beneficiary; and
- the measure is taken at the central bank’s own initiative.

Any liquidity support failing to satisfy these criteria may still be considered as compatible, provided that it fulfills the conditions under the R&R Guidelines. Again, the approval of the liquidity scheme may cover a period up to two years with the possibility of further extension.

Finally, the Banking Communication puts in place a fast track procedure for State aids which comply with the rules set out. The Commission, motivated with the legal certainty concerns and avoidance of undue distortions, aims to take a decision on notified measures within 24 hours.

## 4.2.2 Recapitalization Communication

Since the nature, scope and conditions of recapitalization schemes may vary significantly, both the Member States and potential beneficiaries have asked for more guidance on the compatibility of specific forms of recapitalization. It was also very difficult to calculate a proper remuneration rate for these varying types of schemes. Member States also started to pursue diverse objectives in their grant of recapitalization schemes. For instance, they started to aim not primarily to avoid insolvency of individual credit institutions but rather to facilitate the recovery of inter-bank lending and to ensure lending to the real economy.<sup>205</sup> The Commission then adopted a Recapitalization Communication to provide guidance for new types of recapitalization schemes.

In the Communication, the Commission refers to the three possible competition concerns; competition between Member States, competition between banks and return to normal market functioning. Therefore, any proposed recapitalization scheme should take into consideration these concerns. Ideally proposed schemes should strike a balance between competitive effects at three levels and the different objectives of the scheme pursued. In that respect, a proper remuneration rate, combined with appropriate behavioral safeguards, is a critical tool to arbitrate among these various objectives and concerns.<sup>206</sup> The Recapitalization Communication states two factors to consider while calculating the remuneration rate of capital injections: (i) closeness of pricing to market prices, and (ii) incentives for the bank to redeem the State as soon as the crisis is over.<sup>207</sup>

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<sup>205</sup> See Commission Press Release IP/08/1900 of 8 December, 2008: “*State aid: Commission authorizes French scheme to inject capital into certain banks*”.

<sup>206</sup> Gerard Damien, (2009), pp. 46-62

<sup>207</sup> Recapitalization Communication, §19

The Communication also makes a more clear-cut distinction between banks in difficulties (distressed and less-performing banks) on the one hand and banks that are fundamentally sound and well-performing on the other. The Commission follows two different methods for the calculation of remuneration and assessment of commitments for each of these categories. The details of those calculations are outside scope of this paper but it is safe to say that the Commission imposes much stricter requirements for the recapitalization of credit institutions that are not fundamentally sound. The extent of commitments sought by the Commission in the case of fundamentally sound credit institutions is clearly more limited than for distressed banks. For instance, the Commission asks for less strict safeguards to avoid undue competition distortions for fundamentally sound institutions because it assumes that the distortion of competition will be limited in such a case. The Commission also considers this distinction in remuneration rate calculations and enforces a lower remuneration rate for the well-performing credit institutions.

The cases below provide an analysis of the Commission's approach during Phase II where the Commission started to recognize the systemic effects of the crisis and started to refer Article 87(3)(b) EC for compatibility. The Commission even recognized that in some cases difficulties encountered by a single credit institution might create a serious disturbance in the economy of a Member State. A detailed list of aid measures authorized by the Commission pursuant to Article 87(3)(b) EC during the financial crisis can be found in Appendix.

### **4.2.3 Guarantee Scheme for Banks in Ireland**

As a reaction to the impact of recent international market turmoil on Irish Banking system, the Irish scheme introduced a guarantee arrangement to safeguard all deposits (retail, commercial, institutional and interbank), covered bonds, senior unsecured debt and dated subordinated debt (lower tier II) with certain banks.<sup>208</sup> The six banks covered by the scheme were Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society and such specific subsidiaries. Later, the Irish government confirmed that the scheme would also be applicable to certain foreign banks' subsidiaries in Ireland "with a significant and broad based footprint in the domestic economy".<sup>209</sup> In particular, Ulster Bank, First Active, Halifax Bank of Scotland, IIB Bank and Postbank would be eligible for the scheme.

The Credit Institutions (Financial Support) Act 2008, which came into force on 2 October 2008, provides a legislative framework to underpin the guarantee arrangement for depositors and lenders to Irish financial institutions. According to the Act, financial support can be provided to the

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<sup>208</sup> Commission Decision of 13 October 2008 in Case NN 48/2008, *Ireland – Guarantee scheme for banks in Ireland*, C(2008) 6059.

<sup>209</sup> *Ibid.* par.7

credit institutions in order to maintain the stability of the financial system in Ireland. However, the financial support cannot be granted for a period longer than two years.

Institutions covered by the scheme should pay a quarterly charge which will be calculated by reference to the aggregate cost to the State, the institution's risk profile and the composition of the institution's covered liabilities. The institutions should also indemnify the Irish government in respect of any payments made under the guarantee or any other costs incurred in that regard. The scheme also introduced a claw-back clause. Accordingly, where the guarantee is activated and a payment is made but the payments cannot be recouped in full from the credit institution concerned, it would be recouped in full from the covered institutions over time, "in a manner consistent with their long-term viability and sustainability".<sup>210</sup>

The scheme also provides the power to direct the commercial conduct and competitive behaviour of covered credit institutions to minimize any potential competitive distortion. In particular, the rate of expansion of their activities must not exceed certain limits. These credit institutions must comply with all directions given and requirements made by the Minister of Finance or Irish Regulatory Authority. They must conduct their affairs in a manner that progressively reduces the risk undertaken by the guarantee. Appropriate balance sheet management, application of improved structures to ensure long-term stability of funding, restructuring executive management responsibilities, and improving liquidity, solvency and capital ratios are examples of such measures which have to be taken by the covered institutions. Finally, in the event of a default of a covered institution, it will have to draw up a restructuring plan within six months and comply with the directions.

In its assessment, the Commission firstly mentioned that the commercial terms of the guarantee are not in accordance with the market economy investor principle. Therefore, the guarantee confers selective advantage to the banks concerned and should be regarded as State aid within the meaning of Article 87(1) EC. Regarding the compatibility of the measure, the Commission applied Article 87(3)(b) EC because even the fundamentally sound banks were having troubles getting access to liquidity and the guarantee scheme is designed to overcome this difficulty. The Commission also took into account the fact that difficulties of the banking sector might have a systemic effect for other industry sectors and the entire Irish economy due to its pivot role in providing funds to other sectors. Hence, the scheme tends to remedy a serious disturbance in the Irish economy.

For further analysis, the Commission refers to the Banking Communication and three specific conditions laid down there: appropriateness, necessity and proportionality. First, as regards appropriateness, the Commission found that the guarantee scheme is an appropriate measure to restore confidence in

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<sup>210</sup> Ibid. par.23



the financial markets and overcome a market failure for wholesale funding that affects even healthy credit institutions.<sup>211</sup> Secondly, the Commission examined whether the guarantee was limited to the minimum necessary in scope and time to reach the objective. Regarding the scope of the guarantee, the Commission considered the “*drying-up of interbank lending due to an erosion of confidence between financial institutions*” in the context of the current wide spread crisis and held that inclusions of retail deposits, wholesale deposits and subordinated debts were necessary.<sup>212</sup> Specific restrictions adopted by the Irish government to avoid undue competition distortions within the context of subordinated debt were found sufficient. Regarding the time, the Commission acknowledged that two-year period was the minimum necessary for such a scheme to safeguard financial stability. Finally, as regards proportionality, the distortions of competition were properly balanced via various safeguards against the positive effects of the scheme. The Commission considered that the beneficiaries would contribute, as much as possible, to the costs of the scheme and as a result any distortions would be limited to the minimum. The Commission also referred to the appropriate behavioural safeguards against abuse of the scheme, including restrictions on commercial conduct and restrictions on balance-sheet growth.<sup>213</sup> Consequently, the Commission found the Irish support scheme for financial institutions compatible with the EC Treaty and approved it.

#### **4.2.4 Aid to ING Groep N.V.**

ING Groep N.V. is a global financial institution based in Netherlands.<sup>214</sup> ING operates in more than 50 countries in all around the world and provides diversified financial services such as banking, investments, insurance and retirement services. During the crisis, the adequacy level of capital for financial institutions raised significantly mainly due to a sudden and dramatic increase in the market’s view of the risks contained in the banks’ balance sheets. Although ING is a fundamentally sound credit institution, it needed to reinforce its core tier 1 capital<sup>215</sup> position in order to reassure the financial markets of its stability. Therefore, the Dutch authorities made an emergency intervention to recapitalize ING with € 10 billion via a special type of securities which were issued on 12 November 2008. After the capital injection, core tier 1 capital position of ING would increase from 6.5% to 8%.

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<sup>211</sup> Commission Press Release, IP/08/1497, “*State aid: Commission approves revised Irish support scheme for financial institutions*”, 13 October 2008, Brussels.

<sup>212</sup> Commission Decision of 13 October 2008 in Case NN 48/2008, *Ireland – Guarantee scheme for banks in Ireland*, C(2008) 6059, pars. 61-64

<sup>213</sup> MEMO/08/615, “*State aid: Commission welcomes revised Irish guarantee scheme*”, 12 October 2008, Brussels.

<sup>214</sup> Commission Decision of 12 November 2008 in Case NN 528/2008, “*The Netherlands aid to ING Groep N.V.*”, C(2008) 6936 final.

<sup>215</sup> The capital that from a loss-absorption perspective is equal to shareholders’ equity, does not carry the risk that it has to be redeemed when the institution most needs it and is able to absorb losses on a going concern basis.

These perpetual securities will produce an annual coupon equal to the higher of:<sup>216</sup>

- € 0.85 per security, non-cumulative, payable annually in arrears;
- 110% of the dividend paid on the ordinary shares in 2009;
- 120% of the dividend paid on the ordinary shares in 2010;
- 125% of the dividend paid on the ordinary shares from 2011 onwards.

The coupon is to be paid only if a dividend is paid on the ordinary shares. In the event that ING decides to repurchase the securities, the Dutch State will receive 150% of the issue price. The Dutch State will also have some rights in the corporate governance such as the right to nominate two members for ING's supervisory board at the group's next annual general meeting. Furthermore, ING's supervisory board will develop a sustainable remuneration policy for the group's executive board and senior management.

In its analysis, the Commission first assessed whether the measure constitutes aid within the meaning of Article 87(1) EC. The Commission concluded that ING could not have raised such financing in such time frame at comparable conditions without the State intervention, and thus the recapitalization constituted State aid.<sup>217</sup> However, in line with the conditions in Banking Communication, the measure could be held compatible with the common market on the basis of Article 87(3)(b) EC. In that regard, as in Irish guarantee scheme, the Commission set out three main conditions to be fulfilled: appropriateness, necessity and proportionality. Since the Banking Communication states that these conditions should apply equally for recapitalization schemes and also for individual cases, the Commission then assessed the compatibility of the measure with these criteria.

Regarding necessity condition, the Commission recognized that ING has a pivotal function within the Dutch financial sector. Thus, "*a loss of confidence in such a core institution would have led to a further disturbance of the current financial situation and harmful spill-over effects to the economy as a whole*".<sup>218</sup> As a result, a public sector intervention in ING is considered to be an appropriate mean to strengthen and restore market confidence in the Dutch financial sector. The Commission made a distinction between fundamentally sound institutions, as in this case, and institutions that are additionally suffering from more structural solvency problems. As mentioned before, the Commission is said to impose more lenient conditions in the former case.

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<sup>216</sup> Commission Decision of 12 November 2008 in Case NN 528/2008, "*The Netherlands aid to ING Groep N.V.*", C(2008) 6936 final, par.12

<sup>217</sup> Commission Decision of 12 November 2008 in Case NN 528/2008, "*The Netherlands aid to ING Groep N.V.*", C(2008) 6936 final, pars. 36-51

<sup>218</sup> Commission Press Release, IP/08/1699, "*State aid: Commission approves Dutch emergency recapitalization of ING*", 13 November 2008, Brussels.

Moreover, the measure was limited in time because the Dutch authorities and ING have committed to submit a restructuring plan within six months.

The Commission has also verified that ING would be making an appropriate own contribution even with the uncertainty inherent in such core tier 1 securities. The expected return on securities was in excess of 10%, taking into account the annual coupon and repurchase premium. According to the Commission, this rate would be an adequate remuneration to the State.

In order to avoid undue distortions of competition and prevent abuse of the State support, the measure introduced sufficient behavioral safeguards including balance sheet growth constraints, the maintenance of a certain solvency ratio and the limitation of expansion of ING's business activities that it would have not pursued if it had not received the capital injection. In the case of any deviations, the Commission would be informed and could impose additional behavioral constraints if necessary.

Since the above mentioned criteria are fulfilled, the Commission considered the measure compatible with the common market pursuant to Article 87(3)(b) EC and authorized it as emergency intervention in the face of the current financial crisis for a period of 6 months.

## 5 Conclusion

Financial services play a critical role in supporting economic growth and development. These services help private citizens save money, guard against uncertainty, and build credit. On a more macro level, financial services oil the wheels of other industrial sectors by encouraging investment and improving the quality of that investment. As a result, businesses are able to start up, expand, increase efficiency, and compete in local and international markets. These qualities, which are highly important for the development and competitiveness of a nation, render the financial services sector a specific one. Due to the specific nature of this sector, a serious downturn encountered in this sector might result in a systemic crisis and have disastrous effects on the real economy.

In the EU, the competitiveness in this specific sector increased significantly with the adoption of banking Directives. Credit institutions were trying to survive in a broader market while ensuring the full compliance to strict EU banking rules. The need for public financing was the inevitable consequence for many credit institutions. On the other hand, Member State governments motivated with the importance of this sector were intervening this sector via public instruments, notably State aid measures.

However, the peculiarities of the financial services sector and the possible risk of systemic crisis resulting from the financial difficulty of large credit institutions did not justify the adoption of a specific guideline to govern the application of State aid rules in this sector. Neither the EC Treaty nor the banking Directives contains any specific provisions or exemptions for the financial services sector. Therefore, any aid to credit institutions should be examined under the Treaty rules on State aid. Article 87(1) EC lists five criteria to be fulfilled to consider a State aid measure incompatible with the common market.

Exceptions to this general rule can be found in Article 87(2) and (3) EC. In the financial services sector, the two provisions laid down under Article 87(3) EC are generally considered to be highly relevant for potential justifications of aid measures to credit institutions: Article 87(3)(b); “*aid to remedy a serious disturbance*” and Article 87(3)(c); “*aid to facilitate the development of certain economic activities or of certain economic areas*”. Until the recent financial crisis, the Commission was firm on not applying Article 87(3)(b) EC derogation for financial services sector. The Commission was trying to ensure a level playing field in financial services and promote competition. Therefore, in spite of the pressures from Member States, the Commission refused to apply this derogation. The Commission asserted that the failure of one or more credit institutions does not necessarily lead to a systemic crisis. In some cases, the Commission argued that the difficulties of the credit institutions were company-specific and aid

measures concerned were not designed to remedy a serious disturbance in the economy but only to remedy the difficulties of a single undertaking.

On the other hand, Article 87(3)(c) EC is more often relied as a possible justification of the State aid granted in financial services sector. On that basis, the Commission adopted 2004 R&R Guidelines and 2008 Commission Notice to provide guidance on rescue and restructuring aid and State guarantees. These legislative acts are most commonly applied by the Commission in financial services sector while assessing the compatibility of aid measures with the Treaty. However, the Commission sets forth rather strict conditions to be fulfilled in these acts.<sup>219</sup>

The recent financial crisis raised the question of application of State aid rules in the financial services sector once more. Up until the collapse of Lehman Brothers, the Commission did not realize how big the impact of crisis could be. During this time period, the Commission examined case-by-case rescue measures aimed to address liquidity difficulties of credit institutions on the basis of established practices e.g. by referring to the R&R Guidelines. Despite the exceptional nature of the situation, the Commission stated that the existing legal framework is flexible enough to accommodate exceptional and country-specific circumstances.<sup>220</sup> The Commission constantly refused to authorize rescue measures pursuant to Article 87(3)(b) EC. According to the Commission, the problems encountered in the financial services sector were individual problems of the institutions and thus, any measure adopted to solve the problems of these institutions cannot be considered as a remedy to a serious disturbance in the economy.

It took almost one year for the Commission to acknowledge that the financial crisis might lead to systemic effects when the financial crisis actually spilled into the real economy. The Commission finally recognized the pivotal role of financial services sector and accepted that exceptional policy responses, far beyond emergency support, should be adopted to tackle the current global crisis. The Commission then started to apply Article 87(3)(b) EC derogation for general remedial schemes of the Member States. It even recognized that in some cases difficulties of a single credit institution might create serious disturbance in the economy of a Member State. This shows a huge difference in the Commission's attitude.

In order to promote legal certainty, the Commission adopted a detailed guidelines on the application of Article 87(3)(b) EC to the current global crisis. The so-called Banking Communication focuses on guarantee schemes, recapitalization schemes, controlled winding-up and other forms of liquidity assistance. Just a few months later, the Commission adopted a second guidelines (the Recapitalization Communication) to lay down detailed rules for recapitalization schemes.

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<sup>219</sup> See Chapter 3 for details of these rules.

<sup>220</sup> Gerard Damien, (2009).

Compared to the R&R Guidelines, the Banking Communication has a broader scope and brings some flexibility. As regards the scope, the Commission acknowledged that Member States might adopt general measures to remedy the problems of the whole financial services sector. In the R&R Guidelines, Member States should limit themselves to individual rescue and restructuring aid for certain institutions.<sup>221</sup> Regarding the flexibility, obviously the Member States have now another derogation ground, Article 87(3)(b) EC in addition to Article 87(3)(c) EC. Apart from that, the Commission adopted a more flexible approach for the duration of certain rescue measures including guarantee schemes. The Commission accepted to authorize these measures for up to two years as long as the financial crisis requires so. The time limit was six months under the R&R Guidelines. Finally, the Banking Communication puts in place a fast track procedure for State aids which comply with the conditions set forth. The Commission aims to take a decision on notified measures within 24 hours or over a weekend. In the R&R Guidelines, a simplified procedure was also introduced and the Commission was prepared to adopt a decision within a month. However, considering the limitations attached to this procedure<sup>222</sup>, it is very hard to conclude that it would be beneficial for the large companies in difficulty.

Apart from these novelties, the Guidelines adopted during the financial crisis can be defined as the consolidation of the EU general principles or the Commission's existing practices. An overview of the conditions laid down in these guidelines show that the Commission stick to the EU general principles such as non-discrimination and proportionality; to the conditions already mentioned in the R&R Guideline and 2008 Commission Notice on guarantees such as submission of restructuring plan, contribution from the beneficiaries and restoration of long-term viability. Moreover, while assessing the own contribution or appropriate remuneration rate, the Commission refers to a well-established test, the so-called market economy investor test.

Therefore, the Commission brings nothing new except for some small flexibility measures. These measures were enough to include the Commission into the management of current financial crisis. However, the sufficiency of them is highly doubtful. Enforcement of EC State aid rules during the crisis has been largely consistent with the established principles because according to the Commissioner Kroes these measures are "*sophisticated enough to cope with the differences and strong enough to cope with the difficulties*".<sup>223</sup> Obviously, it will take a while to conclude whether she is right or wrong.

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<sup>221</sup> Catriona Hatton, (20 November 2008), "*Rules on Rescue: European Commission issues guidance on state aid to banks*", Legal Week, State Aid Bailouts.

<sup>222</sup> Aid measure should be notified, the amount should be based on past operating cash flows and should not exceed € 10 million.

<sup>223</sup> Kroes Neelie, (8 December 2008).

# Appendix

## Aid Measures Authorized Pursuant to Article 87(3)(b) EC During the Financial Crisis<sup>224</sup>

Member State	Case Number	Decision Date	Title	Aid Instrument
Austria	N557/2008	09.12.2008	Austrian Scheme	Direct grant, guarantee, other forms of equity intervention
Belgium	NN42/2008	03.12.2008	BE – Fortis	Provision of risk capital
Belgium	NN49/2008	13.03.2009	Dexia – (BE/LU/FR)	Guarantee, other forms of equity intervention
Belgium	N574/2008	19.11.2008	Garantie Fortis – BE	Guarantee
Belgium	N602/2008	18.12.2008	KBC	Provision of risk capital
Denmark	NN51/2008	10.10.2008	Liquidity support scheme for banks in Denmark	Guarantee
Denmark	N31a/2009	03.02.2009	Recapitalization of financial institutions and amendment of the Guarantee Scheme	Guarantees, other forms of equity intervention
Denmark	NN39/2008	05.11.2008	Aid for liquidation of Roskilde Bank	Winding-up
Finland	N567/2008	13.11.2008	Finnish Guarantee Scheme for banks' funding	Guarantee
France	NN50/2008	13.03.2009	Dexia – FR (transferred to C9/09)	Guarantee, other forms of equity intervention
France	N548/2008	20.11.2008	Financial support measures to the banking industry in France	Guarantee, other forms of equity intervention
Germany	N512/2008	27.10.2008	German banks rescue scheme	Financing of the aid (accumulated services, public enterprises, and other), guarantee, other forms of equity intervention
Germany	N17/2009	21.01.2009	State aid to German deposit guarantee scheme for private banks	Guarantee

<sup>224</sup> Cases are adopted from the European Commission website, State Aid Register.

Germany	N655/2008	22.12.2008	NORD-LB – Besichertes Garantiertes Medium Term- Programm	Financing of the aid (public enterprises and other), guarantee
Germany	N639/2008	22.12.2008	Gewährung einer SoFFin-Garantie an die <b>IKB</b> . Die Maßnahme wird im Rahmen einer Beihilferegelung (FMStG) gewährt. Die Anmeldung erfolgt daher vorsorglich.	Guarantee
Germany	N615/2008	18.12.2008	Bayern-LB	Guarantee, provision of risk capital
Greece	N560/2008	19.11.2008	Greek financial support measure	Guarantee, provision of risk capital
Ireland	NN48/2008	13.10.2008	Guarantee scheme for banks in Ireland	Guarantee
Ireland	N61/2009	16.02.2009	The taking of Anglo Irish Bank Corporation plc into public ownership	
Italy	N520a/2008	09.12.2008	Piano di sostegno per le banche (d.l. 157/08)	Guarantee
Italy	N648/2008	23.12.2008	Urgent measures to support the financing of the real economy in Italy	Financing of aid (public enterprises and other), other forms of equity intervention
Latvia	NN68/2008	24.11.2008	Public support measures to JSC Parex Banka	Guarantee, soft loan, other forms of equity intervention
Latvia	NN3/2009	11.02.2009	Amendments to the Public support measures to JSC Parex Banka	Guarantee, soft loan, other forms of equity intervention
Latvia	N638/2008	22.12.2008	Procedure for issuing and supervision of guarantees for bank loan and take- over of banks	Guarantee
Luxembourg	NN45/2008	13.03.2009	Dexia – LUX (case transferred to C9/09)	Provision of risk capital
Luxembourg	NN46/2008	03.12.2008	Fortis banque Luxembourg S.A.	Soft loan
Netherlands	NN53a/2008	03.12.2008	Restructuring aid to Fortis Bank S.A./N.V.	Soft loan
Netherlands	N524/2008	30.10.2008	Dutch credit guarantee scheme	Financing of the aid (accumulated reserves and other),



				guarantee
Netherlands	N569/2008	27.11.2008	Investment in the capital of AEGON N.V.	Soft loan
Netherlands	N611/2008	10.12.2008	Investment in the capital of SNS REAAL N.V.	Financing of the aid (public enterprises and other), other forms of equity intervention
Netherlands	N528/2008	01.12.2008	Participatie in het kernkapitaal van ING	Financing of the aid (public enterprises and other), other forms of equity intervention
Portugal	NN60/2008	17.12.2008	Portugal - Concessão extraordinária de garantias pessoais pelo estado, para o reforço da estabilidade financeira e da disponibilização de liquidez nos mercados financeiros	Financing of the aid (public enterprises and other), guarantee
Portugal	NN71/2008	13.03.2009	Concessão de garantia pessoal da república portuguesa a uma operação de financiamento, sob a forma de empréstimo bancário, concedida ao Banco privado português, S.A.	Guarantee
Slovenia	N531/2008	12.12.2008	Slovénie - Public support measures to the financial sector	Guarantee
Slovenia	N637/2008	20.03.2009	Liquidity scheme to the financial sector	Soft loan
Spain	NN54a/2008	23.04.2009	Fund for the acquisition of financial assets in Spain	Other forms of equity transfer
Spain	NN54b/2008	23.04.2009	Spanish guarantee scheme	Guarantee
Sweden	N533/2008	29.10.2008	Sweden – Bank guarantee scheme	Guarantee
Sweden	NN64/2008	15.12.2008	Public support measures to Carnegie	Soft loan
United Kingdom	N507/2008	13.10.2008	Financial support measures to the banking industry in the UK	Guarantee, other forms of equity intervention

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