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European State Aid Policy in
Relation to Financial Institutions
and the Financial Crisis

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Sammanfattning

Stabiliteten på finansmarknaden har visat sig vara en viktig fråga för Kommissionen och en integrerad del av EU:s konkurrenspolitik. Den globala finanskrisen, med ursprung i USA, har påverkat de flesta av EU:s medlemsstater och framförallt skadat banker. Ett minskat förtroende för de finansiella marknaderna ledde till att utlåningen mellan banker totalt uteblev. Detta ledde i sin tur till en kreditåtstramning av aldrig tidigare skådat slag. Som en reaktion på de ekonomiska svårigheterna som de finansiella institutionerna upplevde började medlemstater genomföra olika statliga stödåtgärder för att öka stabiliteten på de finansiella marknaderna.

Statligt stöd är dock generellt förbjudet inom EU i enlighet med artikel 107 (1) EUF. I artikeln förbjuds statliga stöd och det fastställs att statliga stöd är oförenliga med den gemensamma marknaden. Icke desto mindre är detta förbud inte absolut eller ovillkorligt och Kommissionen har befogenhet att bevilja undantag enligt artikel 107 (2) och 107 (3) EUF. Finansiella institut beviljades statligt stöd av artikel 107 (3)(b) EUF efter att Kommissionen kom fastställt att de statliga stöd som beviljats av medlemsstaterna ansågs vara förenliga med den inre marknaden. Stödåtgärderna ansågs vara utformade för att avhjälpa de allvarliga störningar i medlemstaternas ekonomier som den globala finansiella krisen hade skapat.

Kommissionen har spelat en aktiv roll i den ekonomiska återhämtningen inom den europeiska unionen. Genom att kommunicera riktlinjer och ett tillfälligt regelverk för statligt stöd, har Kommissionen lyckats att skapa en ökad rättssäkerhet och därigenom förebygga negativa effekter av statligt stöd som annars skulle ha påverkat hela den europeiska ekonomin. Den roll som Kommissionen har haft inom detta område undersöks i denna examensuppsats. Historiskt har Kommissionen alltid krävt begränsningar av statliga stöd till företag och finansiella institutioner i ekonomiska svårigheter. Kommissionen policy har sannolikt stabiliserat den finansiella marknaden och dess tillvägagångssätt har mer eller mindre legat i linje med deras tidigare policy. Den höga graden av samordning som Kommissionen i och med sin policy i beslut om statligt stöd har skapat och den tillsyn de haft har troligen varit avgörande för att återställa livskraften på de finansiella marknaderna. Kommissionen har därmed aktivt förhindrat stödkapplöpning mellan medlemstater.

Å andra sidan kan frågan ställas huruvida statligt stöd är en lämplig åtgärd för att hantera och reglera den finansiella sektorn. Den bakomliggande orsaken till att statliga stöd är förbjudna och att det finns en kontroll av statligt stöd är att statliga ingripanden anses vara snedvridande av sund konkurrens. Det är ostridigt att statliga ingripanden skapar marknadsmisslyckanden och s.k. moralisk risk. Det kortsiktiga målet att återskapa den finansiella stabiliteten har varit viktigare än det långsiktiga målet om sund konkurrens på Europas finansiella marknader.

Summary

The stability of the financial market has proven to be an important issue for the European Commission and an integral part of European competition policy. The global financial crisis, originating from the U.S., has affected most of the European Union's Member States. A loss of confidence in the financial markets led to a freeze in interbank lending and an unprecedented credit crunch. As a response to the financial difficulties that the financial institutions experienced, Member States started to implement various State aid measures to increase the stability of the financial markets.

State aid is however generally prohibited within the European Union pursuant to Article 107(1) TFEU. The article generally prohibits State aid and lays down the incompatibility with the common market. Nonetheless, this prohibition is not absolute or unconditional and the Commission has the power to grant exemptions under Article 107(2) and 107(3) TFEU. Financial institutions have been granted State aid on the basis of Article 107(3)(b) when the Commission came to the conclusion that State aid granted from Member States was considered to be compatible with the internal market. The aid measures were believed to remedy the serious disturbance in the economies that the financial crisis had created.

The Commission has played an active role in the financial recovery of the European Union. By communicating guidelines and a temporary framework for State aid, the Commission has managed to provide legal certainty and thus preventing negative effects from State aid to affect the entire European economy. The role of the Commission in this field is examined in this thesis. Historically the Commission has always called for limitations of aid to financial institutions in difficulties. The State aid policy advocated from the Commission has probably stabilized the financial market and the policy has more or less been in line with their previous policies. The high level of coordination from the Commission in state aid decisions and enforcement has probably been crucial for the return to viability of the financial markets and has effectively prevented Member States to engage in subsidy races.

On the other hand, it could be argued whether State aid is an appropriate policy instrument for tackling and regulating the financial sector. The underlying reason for the State aid control is that governmental intervention is held to be distortive of healthy competition. It is undisputed that governmental intervention could create market failures and moral hazard. The short-term goal of financial stability has been more important than the long-term goal of healthy competitive European markets.

To Jan and Gustav.

Abbreviations

CFI	Court of First Instance
ECJ	Court of Justice of the European Union
ECOFIN	Economic and Financial Affairs Council
EU-15	Member States that Joined the EU before 2004
EU-27	All member states of the EU
EUR	Euro
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
GC	The General Court, previously called the Court of First Instance
R&R	Rescue and Restructuring aid
R&D&I	Research, Development and Innovation
SAAP	State Aid Action Plan
SMEs	Small and Medium-sized enterprises
TFEU	Treaty on the Functioning of the European Union
TBTF	Too Big To Fail
TITF	Too Interconnected To Fail
VAT	Value Added Tax
MEIP	Market Economy Investor Principle
OJ	Official Journal

1 Introduction

Competition policy within the European Union has three main pillars. The heart of the competition framework is the antitrust rules defining and prohibiting agreements that restrict competition, dominant positions and merger rules. State aid policy is also included in the competition policy, something that is very rare on the international arena. At a first glance, this may seem as an awkward way to regulate this specific area. However, if put together with the single market objective, part of the competition policy, the logic of combining state aid policy with competition policy is not difficult to understand.¹

To be able to create a single economic market out of all the 27 Member States called for a coordination of competition rules as well as rules on governmental intervention on the market. Article 107 of the TFEU (previously Article 87 of the EC Treaty) effectively limits Member States power to grant aid measures to individual undertakings or business sectors within the common market.² This should ensure that irrespective of where a company is established, the market conditions should be the same. It also effectively prevents Member States from engaging in harmful subsidy races.³ The objective and origin of the State aid policy is in other words dual. Preserving competitive markets is one objective and maintaining the functioning of single market is the other objective.⁴ Likewise, the internal market is a pillar of the European Union, and national aid measures are undermining the functioning of the internal market and harming other Member States.⁵ The notion of the functioning of the internal market tends to be in everybody's interest, but when the going gets tough, it seems as Member States have a hard time abiding by the rules.

There are however a number of exemptions from the general prohibition of State aid. The Member States must notify all new and renewed state aid measures that fall within the scope of Article 107(1) TFEU to the Commission before being implemented. The Commission has the exclusive competence to declare notified measures as "appropriate measures" compatible with the common market.

1.1 Purpose

This thesis examines the Commission's decision-making in relation to State aid measures taken in relation to the financial crisis. The majority of State aid decisions delivered as a response to the financial crisis have been

¹ Coates, 2009, p.2

² Coates, 2009, p.3

³ MEMO/07/151, p.1

⁴ Biondi et al, 2004, p.108

⁵ Friederiszick, 2006, p. 26

directed towards financial institutions (hereinafter simply referred to as banks). Banks have a special role in the economy and are one of the foundations for the entire economy. When the stability of the financial system is jeopardized, Member States tend to act swiftly in order to restore the stability. As a response to the financial crisis many banks have received substantial amounts in order to be able to stay in business. The total State aid granted by all Member States, with crisis measures included, was approximately EUR 279.6 billion in 2008.⁶ This thesis focus accordingly on aid to financial institutions and aid to other sectors is only briefly discussed.

This thesis aims to analyze the potential trade-offs between restoring the stability on the financial markets and distortions of competition on the internal market. Furthermore, an analysis of the temporary state aid framework is conducted as well as a brief analysis of the legal shortcomings in the legal field. The Commission's approach is quite unique compared to how the rest of the world has decided to solve the financial crisis. The thesis will also try to answer the question whether competition law and state aid policy is the solution to rescue and stabilising the financial system. The justification for State aid is far from a strictly legal issue. It is partly a political and economic question, not entirely legal. The legal shortcomings in the area are evident, which is highlighted throughout the thesis.

There is of course a global dimension to State aid policy issues. The financial markets are interdependent. WTO has a framework for state aid policy which was recently activated in the Boeing/Airbus proceedings.⁷ Nevertheless, the anti-subsidy provisions of the WTO are far from as elaborate as the European State aid framework. Please note that the global dimension of state aid policy does not fall within the scope of this thesis.

First, the applicable legal framework is explained, followed of a brief description of the characteristics of the financial market. Basic economic rationales for the Commission's policies of granting state aid and then the applicable exemptions and aid that is held to be compatible with the internal market is explained together with a summarized analysis of the current legal situation and how to tackle the problem in the future.

1.2 Method and Material

From a general point of view, the Treaty provides little guidance on how to balance negative effects of State aid against positive effects. In order to understand the different aspects of State aid policy a review of the applicable legal framework has to be done. Due to very limited printed material available on State aid in relation to the financial crisis the foundation of this thesis consists of guidelines and information from the Commission. The nature of the Commission's legislative process through

⁶ SEC(2009) 1638, Commission staff working document, 2009, p.6

⁷ For a brief explanation of the WTO framework see Hancher et al, 2009, p. 167

soft law such as guidelines, frameworks, notices, communications and decisions from the Commission have justified the selection of sources.

A wide array of law review articles and political economy articles have been selected to, as far as possible, give the most balanced view on the topic. It should also be noted that this area of law is very political; hence, articles and comments that have been held to be too biased have been omitted.

A great deal of hours searching for legal material for this thesis has made it very clear that the legal shortcomings of the area are evident. At a first glance, these shortcomings could be considered devastating, but at the end of the day, the fact that political and economical considerations are taken into account in

1.3 Delimitations

This thesis is focusing on State aid to financial institutions since the vast majority of measures have been streamlined against the financial market and the players of that market.

There are of course, as these thesis among other things conclude, a global perspective of the financial crisis and a interconnectivity between financial markets that is unequalled. There have been different approaches on how to tackle the financial crisis and the European approach have been quite unique. Although other approaches to solve the financial crisis might be of interest, they have been excluded for the purpose of this thesis and the primary focus is on how the Commission have chosen to act.

2 The General Framework

To be able to understand the state aid rules in the context of the current financial crisis you have to have a thorough understanding of the general framework. State Aid Control provisions are laid down in the Treaty, secondary legislation and soft law from the Commission and of course, there is an immense amount of interesting case law.

The central provision regulating state aid control is Article 107 of the TFEU. (former Article 87 of the EC Treaty). All new state aid as well as any alterations of existing state aid measures has to be notified to the Commission pursuant Article 108 TFEU (former Article 88 of the EC Treaty) before being implemented. In addition, a stand still clause provides that no aid can be effectively implemented by the Member State before the aid measure has been evaluated and approved by the Commission.

State aid measures that are granted without a positive decision of the Commission is deemed illegal and the beneficiary may be forced to repay the illegal state aid.

2.1 Article 107(1) TFEU

The central provision regulating state aid control is Article 107(1) of the Treaty on the Functioning of the European Union (TFEU)

Article 107(1) TFEU states the following:

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

Article 107 TFEU stipulates an incompatibility with state aid and the common market. The article generally prohibits state aid, however all state measures is not per se prohibited.

First of all, it must be established if the state measure at hand is considered to be “State aid” within the scope of Article 107 TFEU, otherwise the State aid control framework is not triggered. Thereafter there is the question of compatibility or rather the incompatibility with the common market.

Only where state measures are held to be distortive of the competition, selective and affecting trade between Member States the aid is held to be incompatible with the common market.⁸ Overall, there is a negative presumption to most forms of state aid. The Commission is given the power

⁸ Hancher, p. 31

to control State aid in Article 108 TFEU and the notification requirement are stated in the same article. Member States are required to notify the Commission of any plans regarding to grant State aid.

The concept of what is considered State aid is not further defined in the TFEU. There is however an immense amount of case-law from the European Court of Justice and the Court of First Instance defining the concept. The Treaty provision refers to any form of aid whatsoever which distorts competition and the Courts have, repeatedly, identified *aid by reference to effect*. The form is hence not the critical part in assessing whether or not a state measure is considered to be State aid, it is instead the effects of that measure that are interesting. The concept of aid is not only restricted to direct subsidies. Aid is a much wider concept than subsidies. Aid measures with similar financial advantages are also covered by the notion of “aid”, and accordingly there is a wide spectrum of different types of aid. Examples of measures that at a first look does not seem as State aid but de facto is State aid are; sale of public property under market value, tax exemptions and state guarantees.⁹

In the past, Member States often tried to circumvent the state aid rules by being creative. Instead of granting direct subsidies, Member States gave enterprises indirect grants such as tax privileges, exempted social security contributions or sold public property under market value.¹⁰ As mentioned above, the definition of state aid is much broader and compromises the creative ways of circumventing the state aid rules, which have the same effect as a direct subsidy.¹¹ This was affirmed in the *Steenkolenmijn*¹² case and has been reaffirmed in many cases after that.

If a State measure is going to fall within the scope of Article 107(1) TFEU it has to fulfil the four cumulative conditions stipulated. It is also necessary that the specific grant provide a benefit or advantage to the recipient. The four cumulative conditions are listed below.

The measure must:

- (i) be a measure financed by the State or through *State resources*;
- (ii) be able to *affect trade* between Member States;
- (iii) be *selective and create an advantage* for the recipient; and
- (iv) distort or threaten to distort competition by favouring certain undertakings or the production of certain goods.

⁹ Blauberger, 2009, p. 1034.

¹⁰ Blauberger, 2009, p. 721.

¹¹ As stated in Case 30/59 *De Gezamenlijke Steenkolenmijnen in Limburg v High Authority of the European Coal and Steel Community* [1961] E.C.R., p.19

“The concept of aid is nevertheless wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking, and which, without, therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect.”

¹² Case C-390/98 *Banks v British Coal* [2001] E.C.R. I-6117 , para 30

2.2 State resources

The concept of state aid within the TFEU includes state aid granted in any form whatsoever. This broad interpretation is also true for the concept of what a state resource is. To constitute state aid a measure must be granted from state resources. When a central or local authority of a State grants the aid there is little discussion of the real source of the funding.

It is not necessary that the aid is granted directly by the State, even if the measure is granted by a private or public intermediate body which is administered by the government it is obvious that the money originates from state resources.¹³ The ECJ concluded further in the *Preussen Elektra*¹⁴ case that it must be a *transfer of state resources*. A regulatory privilege, without a budgetary burden for the state, will not be considered to fulfil the state aid criteria. The regulatory privilege in *Preussen Elektra* was a federal law that stipulated a minimum price for electricity distributors. The federal law gave economic advantages to producers of renewable energy, these advantages were however financed by the distributors and the operators and not from state resources. No direct or indirect governmental expenditure, i.e., no transfer of State resources was involved and consequently the measure did not fall within the scope of Article 107 TFEU.¹⁵ *Winter* has argued that a broader interpretation of Article 107(1) TFEU would be recommended from a teleological point of view, since there should be no difference if a measure distorts competition if it is funded publicly or privately, the anti-competitive effects of the measure would still be the same.¹⁶

Advocate General Jacobs, on the other hand, argued in his opinion to the *Preussen Elektra* case that the narrower interpretation of what a transfer of State resources was recommended because it gave greater legal certainty on the application of State aid rules.¹⁷ According to *Jacobs* this view fitted better with the intention of Article 107 TFEU, the scope of State aid rules should be to protect competition from State measures that are financed through taxpayer's money only. Furthermore, *Jacobs* held that the possibility that States to a large extent would start to circumvent the rules by using measures financed by private resources was exaggerated.¹⁸

2.3 The selectivity criteria and economic advantage

It must be established that the measure confers a selective advantage on certain undertakings or the production of certain goods. The very basic

¹³ Biondi et al, 2004, p. 17.

¹⁴ Case C-379/98, *Preussen Elektra AG v Schleswig AG*, [2001] E.C.R. I-2099

¹⁵ *Winter*, 2004, p. 480.

¹⁶ *Ibid.* at, p. 483.

¹⁷ Opinion of Mr. Advocate General Jacobs delivered on 26 October 2000, para. 157

¹⁸ *ibid.* at para. 156

implication of this prerequisite is that the undertaking or production of a product receives an advantage that it normally would not have received under normal market conditions.¹⁹ An example could be that an undertaking is relieved of costs which they, under normal conditions, would have been forced to bear. Instead these costs are taken by the State and in most cases these costs would have been much higher for the undertaking without the intervention by the State. It must be underlined, that from an economic point of view it is all the same if the measure is a direct subsidy/positive payment or a State income forgone/ cancellation of debt, if it is advantageous for the undertaking it will still fall within the scope of the state aid control. Ultimately, the measure must generate an advantage to a specific undertaking and as stated above, state aid are defined by reference to effect.

Furthermore, the State aid must be selective; it must create an imbalance between the different market players. If the measure only benefits certain undertakings within a region it is deemed to be selective. Hence, the “selectivity criteria” is one of the defining features of state aid. The selectivity criterion is what differentiates state aid from general measures. Aid that generates an advantage to a specific undertaking or a specific sector within the economy of a Member state is generally prohibited. Therefore, argued *e contrario*, general measures that are given to all undertakings within a Member state are not considered to be State aid within the meaning of Article 107 TFEU.²⁰ Nation-wide fiscal measures are most often held to be general measures since they are applicable to all undertakings and all economic sectors within a Member State. The reduction of VAT is another general measure that is not caught by the general prohibition since it is not selective.²¹ Moreover, interventions of central banks related to national monetary policy are either not caught by the prohibition.²²

If the awarding authority has discretionary power in authorizing the aid, the measure will be considered to be selective.²³ If the authority has a freedom to determine under which circumstances aid will be granted under a scheme, the selectivity criteria will be satisfied and measures will be characterized as aid.²⁴ Undertakings, that are given an advantage from a state measure, compared to undertakings in a comparable legal and factual situation, are given a more favorable position and a competitive advantage. A competitive advantage that could distort competition and be detrimental to the common market. It is irrelevant how this position is obtained, when an undertaking is put in a better position than its competitors because of a state measure, the measure falls within the scope of the state aid rules.²⁵ This is more or less an application of the fundamental community principle of equal treatment.²⁶

¹⁹ Case 39/94, *SFEI v La Poste*, [1996] ECR I-3547, para 60

²⁰ Quigley, 2009, p. 43.

²¹ Editorial comments, 2009, p. 9.

²² Banking Communication, para. 51.

²³ Vademecum, p. 6.

²⁴ Biondi et al, 2004, p. 22.

²⁵ Winters, 2004, p. 488.

²⁶ Quigley, 2009, p. 41.

2.4 The Market Economy Investor Principle

Financial support from Member States that does not meet the Market Economy Investor Principle will inevitably constitute State aid. The Market Economy Investor Principle (“MEIP”) has proven to be an appropriate way to distinguish state aid and applies to all public enterprises whether profitable or loss-making.²⁷ All forms of market transactions are covered by the principle, not only investments.²⁸ It is the key test to determine whether or not governmental action constitutes state aid within the scope of Article 107(1) TFEU.

Whenever a public authority grants aid to an undertaking on the same terms as private investor would have done under normal market conditions, the aid measure is not considered to be State aid.²⁹ The reasoning has to do with the criterion of advantage. The beneficiary does not gain an advantage from the state resources if it de facto could obtain the same finance from a private investor under normal market conditions.³⁰ The presence of an advantage is thereby analyzed in relation to the situation of the non-existence of an aid measure and not in relation to competitors on the same market in the same situation.³¹ The strongest argument for the absence of State aid is that the beneficiary could find financing from the ordinary market. Many scholars are of the consensus that this is what defines State aid, a non-commercial transaction of a Member State engaging in non-commercial transactions were no private investor would go.³²

Accordingly, there must be an objective commercial justification for the transaction, i.a. an acceptable return on the investment within a reasonable period of time.³³ The application of the principle can be rather straight forward when it comes to certain transactions. Consideration must be taken to if a private investor, with the same information as the State, would have made a corresponding commercial transaction. For that very reason, all commercial aspects of the transaction must be thoroughly assessed.³⁴

The MEIP is not laid down in the Treaty. It has been constructed by the Commission in order do establish what “favour” means as laid down in Article 107(1) TFEU. Since the existence of aid is based on the effect of the measure, the most important is still the *effect* on the specific undertaking concerned that is important and not the behaviour of the Member State at

²⁷ Hancher, 2008, para. 15.013

²⁸ Quigley, 2009, p. 102

²⁹ Biondi, European State Aid Law, p. 101

³⁰ Case 39/94, *SFEI v La Poste*, [1996] ECR I-3547, para 60

³¹ Slocock, 2009, p. 23.

³² Quigley, 2009, p. 110.

³³ Hancher, 2008, para. 15.013.

³⁴ Quigley, 2009, p. 102.

hand. It is noticeable in many decisions that the arguments is based on how financially advantageous the measures were from a Member State perspective. This is of course at the heart of the principle, but an alternative perspective could be useful in some cases.³⁵

A State guarantee in respect of another financial obligation entered into by an undertaking is likely to constitute an aid unless a private investor in the situation of the State would have been prepared to provide the guarantee.³⁶ The MEIP in the context of state guarantees are further discussed under Chapter 4.3

The MEIP can be problematic to apply when the undertaking is operating in an “*aid environment*” and have been granted aid previously. If additional aid is going to be granted and the undertaking is dependent on the previous aid for the adequate remuneration for the new aid it is difficult to escape the definition of aid pursuant to Article 107(1) TFEU using the MEIP.³⁷

Public shareholders are often criticized for being less demanding on dividends and less interested in efficiency. Even if the short-termism have been one of the problems leading up to this financial crisis, the long term interest exercised by state shareholders may be the other extreme of inefficiency.³⁸

The short-termism in European business have been criticized and said to be one of the elements leading up to the financial crisis. The opposite, long term investments is said to be more sustainable and in line with better corporate governance. There are doubtlessly benefits of longer time horizons, but the question is if it is in an undertakings long term interest to have a lax, State shareholder, as a majority shareholder.³⁹ This implies that it is not in the interest of States to manage commercial profit-driven undertakings.

A loan on the same terms as a commercial lender would give contains no State aid element. In order to establish if loans are given on commercial rates the Commission has created reference interest rates. The MEIP can in this aspect give important guidance; a market price on capital is the key to the minimising of distortion. Even if the MEIP is developed from an investor principle it is therefore sensible to talk about an equivalent Market Economy Lender Principle.⁴⁰

The question remains if it is harder to establish a Market Economy Guarantor Principle? Application of the “Guarantee Notice” makes certain guarantees fulfilling certain criteria free from state aid element. If the

³⁵ Slocock, 2002, p. 26.

³⁶ Hancher, 2008, para. 15.038.

³⁷ Slocock, 2002, p. 26.

³⁸ Slocock, 2002, p. 24.

³⁹ Slocock, 2002, p. 23.

⁴⁰ Slocock, 2002, p. 25.

guarantee is adequately remunerated, i.e. the cost is equal to what a commercial guarantor would give; the guarantee would not constitute State aid. The obvious question is therefore if there is an equivalent Market Guarantor Principle. It would be easy to draw the conclusion that there is, but since State guarantees are followed by very favorable effects, the probable answer is no or at least it cannot be assumed that only because the guarantee is adequately remunerated that no advantages is given to the beneficiary. State guarantees are namely worth more than any other guarantees available on the market.⁴¹

2.5 Distortion of Competition

State interventions must distort competition or threaten to do so. The aim of the State aid rules is to prevent trade between Member states from being distorted by harmful governmental intervention. As implied above, it is sufficient to show that there measure would threat the competition on the common market.⁴²

Similar to how effect on trade is interpreted, distortion of competition is also defined very broadly. Small amount of aid, involving small-size beneficiaries with small market shares does not render the state aid rules inapplicable.⁴³ The State aid *de minimis* rules⁴⁴ compared to the *de minimis* rules covered by Article 101 TFEU are much rigorous. Under Article 101 TFEU, *de minimis* rules deals with companies with market shares up to 15 percent and undertakings with a turnover less than EUR 40 million escapes further investigation.⁴⁵ This should be compared with the *de minimis* rule for state aid where the thresholds are EUR 200 000⁴⁶ over 3 years.

State aid has proved to be more distortive in markets that are more competitive. Markets that are more competitive have proven to be more sensitive to State aid. Markets already affected by competition and were e.g. profit margins already are slim, will have a greater impact of selective state aid to specific undertakings.⁴⁷ A fact that should be considered when discussing State aid to financial institutions.

Even if the relevant market must be properly assessed, the importance of making a detailed analysis of the structure and competitive relationships is less common. If the Commission finds that the aid measure affects intra-community trade it will also most often decide that the measure distort or threatens to distort competition.⁴⁸ Consequently, distortion of competition is

⁴¹ Slocock, 2002, p. 25.

⁴² Quigley, 2009, p. 51.

⁴³ Coates, 2009, p. 6.

⁴⁴ See below Chapter 2.3.5.1.

⁴⁵ Coates, 2009, p. 15.

⁴⁶ Temporarily increased to EUR 500 000 by the "Temporary Framework".

⁴⁷ Friederiszick, 2006, p. 10.

⁴⁸ Quigley, 2009, p. 52.

most often easily presumed but a real analysis of the impact of state aid on competition is rare.

Some types of aid are in their very nature distortive. Operational aid is almost always highly distortive. Operational aid covers the daily operating expenses, the variable costs, of a business and as a result, it gives businesses considerable advantages.⁴⁹ *Coates* compares operational aid with cartels as “violations with no realistic arguments in favour of their beneficial effects”.⁵⁰

2.6 Effect on trade

State aid falls within the scope of Article 107 (1) TFEU only if it affects intra-community trade. The effect on trade is defined very broadly and it is a question of potential effect on trade.⁵¹ The Commission states in their *Vademecum* that it is sufficient that the beneficiary is conducting economic activity within a market that has trade between Member States for the condition to be fulfilled. Furthermore, the nature of the economic activity is irrelevant, e.g. non-profit organizations can undertake economic activities in its daily business.⁵²

The Commission and the ECJ have given the effect on trade and competition a very broad definition. It have been so extensively interpreted that cases often discusses issues on the selectivity criteria and the market investor principle instead of the effects on trade and distortion of competition.⁵³ A thorough analysis of the competition or the effect on trade is actually seldom carried out.

The wording is different in Article 101 TFEU and 102 TFEU when laying down “the effect on trade criteria”. Article 101 and 102 construes the criteria as “may affect trade between Member States” when the wording in Article 107 TFEU is “in so far as it affects trade between Member States”. It could be interpreted as if the threshold is different in the different Articles, but such a differentiation is not found in the case law. The effect on trade in State Aid cases is as broadly defined as in cases involving Article 101 and 102 TFEU.⁵⁴

However the real assessment of the negative effects of state aid on intra-community trade is relatively basic. The main focus of the economic analysis is on whether or not an economic advantage is given. *Friederiszick et al* makes a bold statement that the approach of the Commission is not to identify the effectiveness of State aid measures or the actual impact on the

⁴⁹ Friederiszick, 2006, p. 10.

⁵⁰ Coates, 2009, p. 6.

⁵¹ Biondi et al., p. 32.

⁵² Vademecum, p. 7.

⁵³ Coates, 2009, p. 5.

⁵⁴ Coates, p. 6.

market, the state aid policy is just a way to get the job done.⁵⁵ Another plausible explanation for why the economic analyses of the effectiveness of aid are underdeveloped is the fact that European State aid policy is a highly political area. Political considerations are given priority at the expense of discussions of economic efficiency.⁵⁶

2.7 De minimis aid

It is the assumption of the Commission that small amount of aid does not have a potential effect to distort competition and trade between Member States. The *de minimis* regulation covers small amounts of aid that does not have the potential to effect competition and accordingly these measures does not constitute State aid under Article 107(1) TFEU.⁵⁷ The threshold indicated in the *de minimis* regulation is EUR 200 000 to any undertaking over a period of three fiscal years.⁵⁸ All types of aid and all objectives pursued are covered by the *de minimis* regulation.⁵⁹ Measures below this threshold must not be notified in advance to the Commission since it is held to be a compatible limited amount of aid. It is a very effective way for Member States to grant aid measures of limited amount to SMEs, since the notification requirement and the administrative procedure is not necessary.

The financial crisis is not only affecting structurally weak companies. Fundamentally sound undertakings may find themselves in problem of finding credit. As a result, the Commission has temporarily raised the threshold for *de minimis* aid. The Temporary Framework introduce that aid measures that usually would have exceeded the threshold laid down in the *de minimis* Regulation and consequently would have fallen within the scope of Article 107(1) will nevertheless be approved by the Commission. Measures that exceed the original threshold will be seen as compatible with the common market on the basis of Article 107(3)(b). The new threshold is set to EUR 500 000 per undertaking, and the aid must be granted within a scheme.⁶⁰ However the most important difference is if such aid constitutes State aid within the scope of Article 107(1) and that corresponding aid under the *de minimis* Regulation does not.

Notwithstanding, it could be argued that all aid measures that effects intra-community trade and on competition should fall within the scope of the

⁵⁵ Friederiszick, 2006, p. 11.

⁵⁶ Ibid, p. 2.

⁵⁷ Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid” OJ L379, 28.12.2006

⁵⁸ Article 2 of the *de minimis* Regulation

⁵⁹ Handbook on Community State Aid Rules for SME, p. 8.

⁶⁰ Temporary Framework, para. 4.2.

state aid rules and should only be allowed when declared compatible with the common market by the Commission.⁶¹

2.8 Exemptions

As seen above there is negative presumption to all types of State aid and State aid measures are incompatible with the common market. Without notification and approval by the Commission or the Council state aid can be prohibited.⁶² Nonetheless, this prohibition is not absolute or unconditional. A number of exemptions are allowed under the Treaty. Obviously, State aid measures can be compatible with the common market in various forms. The common element of the exemptions is that they have to pursue a common interest. The obvious question is what the common interest is and how it is assessed. *Friederiszick et al.* defines the general common interest for justification of State aid as “maximizing total (European) welfare, subject to redistributive objectives”⁶³ The answer is hard to answer but State resources that contribute to well-defined objectives of common European interest without unjustifiably distortions of competition are often considered to be “appropriate measures”. Aid to restore the financial stability and ensure the long-term viability of the European market has repeatedly been held to satisfy these criteria.

The Commission has the power to grant exemptions under Articles 107(2) and 107(3) TFEU. Article 107(2) TFEU provides for automatic exemptions of State aid that should be declared compatible with the common market. Article 107(3) TFEU defines the discretionary exemptions where the Commission may declare aid to be compatible with the common market.

The Council on their part can declare further types of aid measures to be compatible under Article 107(3)(e) TFEU. The Council can also decide that measures that normally would not be compatible with the common market should be justified if exceptional circumstances lay at hand. However, the powers of the Council is not further discussed in this thesis.

The ECJ has adopted the approach that when any measures falls within the scope of Article 107(1) TFEU it must be decided if any of the exemptions are applicable. As stated above, the burden of proof lies on the Member state. As always, when dealing with derogatory rules, any exemptions from the general prohibition must be given a narrow interpretation.⁶⁴ Any granted measure cannot be contrary to other EU legislation or general principles of community law.

⁶¹ Quigley, 2009, p. 30.

⁶² Quigley, 2009, p. 124.

⁶³ Friederiszick, 2006, p. 27.

⁶⁴ Quigley, 2009, p. 125.

The objective is to keep measures that are known not to have any distortive effects on competition out of the Commission workload, thereby increasing efficiency of other investigations.

2.8.1 Main types of exempted State aid measures

In the General Block Exemption Regulation⁶⁵, certain types of state aid measures are held to be compatible with the common market and are automatically excluded from the investigation of the Commission. Such *block exempted aid* measures are not bound by the notification requirement stated in Article 108(3) TFEU. Member states are free to implement measures that fulfill all the requirements stated in the block exemptions regulation. This said, measures are not exempted from possible assessment from the Commission, block exempted measures are subject to random inspections. *De minimis* aid is also under this category of aid. In terms of aid volume, 19 % is granted through block exemptions.

Aid granted through schemes is one of the most common in state aid procedures, 76% of state aid is assessed by the Commission under aid schemes.⁶⁶ The Commission examines the scheme according to their “balancing-test” as stated above and are allowed to add additional conditions to their decisions that have to be met when aid are granted according the specific scheme. If an aid scheme is authorized by the Commission, aid granted through the scheme to individual undertakings, are not subject to the requirement of notification.

Individual aid measures and ad hoc cases. Specific ad hoc measures or individual applications within a scheme needs prior notification and are individual assessed and authorized by the Commission.

Article 107(3), with its discretionary exemptions, is the most important provision in practice for granting State aid measures on a legal basis.⁶⁷ Most of the recent measures originating from the financial crisis have been approved on the basis of Article 107(3) TFEU. Article 107(2) is, for the purpose of this thesis, just briefly presented and a more in-depth presentation is given of Article 107(3).

⁶⁵ Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Article 87 and 88 of the Treaty, OJ L 214/3 of 9.8.2008.

⁶⁶ State Aid Scoreboard, Autumn 2009, p. 28.

⁶⁷ Friederiszick, 2006, p. 7.

2.8.2 Article 107(2) TFEU, automatically compatible aid

The following types of state aid are according to Article 107(2) automatically exempted from the general prohibition.

Article 107(2) of the TFEU

2. The following shall be compatible with the internal market:

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

(b) aid to make good the damage caused by natural disasters or exceptional occurrences;

(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point.

Aid with the purpose of remedying problems with a social character, damage caused by natural disasters and exceptional occurrences and measures concerning the division of Germany is covered by the provision.

Since these exemptions are automatic, the Commission has no discretion concerning the compatibility of the aid measures. On the other hand, all proposed measures must be notified to the Commission according to Article 108(3) TFEU before being implemented in order to give the Commission a possibility to examine if the criteria for exemption are fulfilled.⁶⁸

2.8.3 Article 107(3) TFEU, aid which may be compatible

Article 107(3) of the TFEU

3. The following may be considered to be compatible with the internal market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;

⁶⁸ Quigley, 2009, p.128

(b) 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;

(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;

(d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest;

(e) such other categories of aid as may be specified by decision of the Council on a proposal from the Commission.

It is obvious, when reading the exemptions that the discretionary powers of the Commission and the room for interpretation are quite extensive. Yet, even if measures distort competition, the possible types of compatible State aid are numerous.⁶⁹

The most relevant exemption clause for most state aid decisions is Article 107(3) TFEU. The Commission may deem the following categories compatible with the common market. The most relevant paragraphs for State aid cases have long been paragraphs (a) and (c), but because of the severity of the current financial crisis, Article 107(3)(b) TFEU has been allowed as a justification for State aid.

Until just recently, State aid to individual undertakings in financial difficulties was normally granted pursuant to Article 107(3)(c) TFEU in combination with the R&R guidelines.⁷⁰ The R&R Guidelines are the Commission's interpretation of how to apply Article 107(3)(c) TFEU in accordance with such above mentioned aid. In addition, the Commission has acknowledged that Article 107(3)(b) TFEU could be used to remedy a serious disturbance in the economy. The gravity of the economic and financial crisis and the fear of further deterioration of the European economy made the Commission to consider Article 107(b) TFEU as an alternative legal basis for aid measures addressing the financial crises. Especially aid aimed at financial institutions was supposed to be granted. If Member states are able to demonstrate such "serious disturbance", the Commission when reviewing the measure will take this special consideration into account.⁷¹

⁶⁹ Blauburger, 2009, p. 722.

⁷⁰ Communication from the Commission, Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C244, 1.10.2004, p. 2.

⁷¹ 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 C270, 25.10.2008, p. 9.

Nevertheless, the Commission is still very cautious to use paragraph (b) and underlines that a restrictive interpretation of what a “serious disturbance of a Member State is still valid.

The characteristics of the financial sector make it more probable that a crisis in the specific sector is going to have a direct impact on the entire economy of a Member State. Economic crises in other sectors of the economy is less likely to cause systemic crises in the same way as the financial sector and the usage of the exemption in paragraph (b) is therefore less likely to be held compatible by the Commission. If other sectors than the financial is going to be rescued pursuant to paragraph (b) a comparable risk must be established. The provision will only be put into effect if exceptional circumstances call for it, when the entire functioning of the financial market is in danger, and only as long as the economy is in a crisis.⁷² When a withdrawal of aid should be made is of course hard to predict and secondly, should it be done as a coordinated Member State withdrawal or when national market conditions permit?

The justification for many of the temporary measures taken by the Commission is on the legal basis of paragraph (b). The provision has rarely been used, only during the recession in the 1970s⁷³ and as a part of a Greek economic recovery plan have Member States used this exemption.⁷⁴ The economic problems must affect the whole national economy. Naturally, there are a very limited amount of precedents on the use of Article 107(3)(b) and the Commission published a set of communications in order to establish a framework for the analysis.⁷⁵

Due to the financial and economic crisis the Commission promptly issued three different Communications in order to clarify and create guidance on how to apply State aid rules for the design and implementation of State aid measures directed to financial institution. The justification for the drawing up of these communications was to ensure that emergency measures would be treated the same way across the European union.⁷⁶ ”The Banking Communication”⁷⁷, “The Recapitalisation Communication”⁷⁸ and the

⁷² Ibid, p. 9.

⁷³ See Fifth Report on Competition Policy April 1976, p. 93.

⁷⁴ Quigley, 2009, p. 135.

⁷⁵ Coppi, 2009, p.78.

⁷⁶ DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis

⁷⁷ Communication from the Commission, The application of the State aid rules to measure taken in relation to the financial institutions in the context of the current global financial crisis, OJ C 270, 5.10.2008, p.8-14, adopted the 13 October 2008 (“the Banking Communication”)

⁷⁸ Communication from the Commission, The Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2-10, adopted 5 December 2008 (“the Recapitalisation Communication”)

“Impaired Assets Communication”.⁷⁹ For the purpose of this thesis the first two Communications are of importance. The Impaired Assets Communication has only been applied a few times, for this reason it is hard to determine the importance of the implemented measures. Furthermore measures taken under the Impaired Assets Communication have just recently been implemented or announced and are still under assessment by the Commission and accordingly outside the scope of this thesis.

⁷⁹ Communication from the Commission on the treatment of Impaired Assets in the Community banking sector, OJ C 72, 26.3.2009, p.1, adopted 25 February (“the Impaired Assets Communication”)

3 EU State Aid Control

3.1 The Financial Crisis in a nutshell

The financial crisis and the approach from the Commission can be divided into two different phases of Commission policy. The distinct first phase (Phase I) between September 2007 and September 2008 were the Commission dealt with cases under Article 107(3)(c) TFEU and the Rescue and Restructuring Guidelines (“R&R Guidelines”). A real estate bubble in the US market starting in 2007 triggered the financial crisis.⁸⁰ The real estate bubble was largely created by the sub-prime mortgage defaults, the “sub-prime crisis” first affected the European financial markets in September 2007. This led to the “credit crunch”, a sharp fall in lending and a decrease in investment and consumer demand.

The Commission authorized at least six individual rescue measures in accordance with the R&R Guidelines to banks that was more or less directly affected by the sub-prime crisis. The problems of the banks were identified as individual problems, which required tailor-made interventions.⁸¹

Approximately a year later the entire financial system was affected which led to the second phase of the financial crisis. The second Phase (Phase II) originated from the fear of a worsening of the financial crises and the fear of a systemic crisis. A general crisis of confidence and a freeze in interbank lending, initially attributed to the bankruptcy filing of Lehman Brothers, soon affected the entire financial system. Fundamentally sound banks started to have troubles finding access to liquidity and the Commission started to doubt that the R&R guidelines would be sufficient to meet a systemic crisis.

The Commission started to apply Article 107(3)(b) TFEU for the approval of a large number of aid measures. The rapidity of action was emphasised and decisions were given in an extraordinarily short amount of time under what appeared to be quite lax conditions.⁸² The Commission stated in their 2009 Spring Scoreboard “The world economy is currently experiencing its severest financial and economic crisis in almost a century, with European economy not being spared”⁸³

At the end of 2009 a significant amount of measures to the financial sector had been approved. State guarantees to the amount of EUR 3 trillion have been provided to European banks and approved by the Commission. In

⁸⁰ Mateus, 2009, p. 1

⁸¹ State Aid Scoreboard, 2009 Spring Update, p. 6

⁸² Ahlborn and Piccinin, 2009, p. 4

⁸³ State Aid Scoreboard, Spring 2009, p.3

addition over EUR 300 billion in direct capital injections has been provided by Member States governments.⁸⁴

3.2 The Reason for State Aid Control and Basic Economic Concepts

State aid control is an important part of European competition policy and one of the instruments to ensure effective competition and free trade. A common legal framework is essential for a level playing field to avoid that Member States subsidy race. Subsidy races are unquestionable non-sustainable for Member states and above all harmful for the common good of the European Union. Instead, the Commission encourage member states to strengthen their competitiveness in other ways. Both economical social and regional cohesion is desirable.⁸⁵ The objective of European State aid control is to prevent Member States to use public resources in an inefficient way. In 2005 a new State Aid Action Plan was adopted since the old regime was held to be too complex and the many different documents adopted by the Commission made the application of the rules difficult.⁸⁶

As stated above, the financial crisis has highlighted the State aid policy. Demands for changes and amendments of the current legislation came from different ranks. Increased intervention from Member States in various forms has been seen in a wide variety forms. A temporary framework for State aid measures to support access to finance in the current financial and economic crisis has been adopted and is valid until the end of 2010. The temporary framework is established in direct response to the financial crisis.

It is questionable whether State aid is an appropriate policy instrument to achieve the objects of common interest; it is also questionable whether it is the appropriate policy instrument for “regulating” the financial sector. The underlying reason for the State aid control provisions are to prevent aid to distort the competition on the common market and “at the same time allowing beneficial, non-distortive use of public resources”.⁸⁷ There is a basic consensus that State intervention can alter the behaviour of firms and create market failures. Efficiency incentives of the future are abandoned since future and more State aid is anticipated. In that sense, State aid creates moral hazard.⁸⁸

The State Aid Action Plan (SAAP) was adopted in 2005 and had the intention to solve a couple of known problems within the State Aid Policy

⁸⁴ DG Competition, Tackling the financial crisis, http://ec.europa.eu/competition/recovery/financial_sector.html (last accessed: 20 January 2010)

⁸⁵ Vademecum, 2008, p.5

⁸⁶ SAAP, p. 6

⁸⁷ Livingston, 2008, p. 33

⁸⁸ Coppi, 2009, p.81

framework. Almost all the EU's state aid rules and procedures were reviewed in hope of making State aid a more efficient and effective tool for dealing with growth and jobs.

The SAAP introduced new investigations methods; a standard assessment was introduced to find out whether the notified measure had potential to distort competition and to assess the compatibility with EU competition rules. If the measure was likely to distort competition or if there were any doubts, a more detailed assessment would be carried out. Accordingly, the Commission was supposed to focus on measures that were considered to be the most distortive and at the same time effective State aid control would be held up through the standard assessment. The reforms that followed after the SAAP still bear fruit. The administrative burdens and the workload of the Commission have been reduced, especially exemptions from the ex-ante scrutiny applied by the de minimis Regulation and the GBER have given the Commission a lighter work load. The objective is to keep measures that are known not to have any distortive effects on competition out of the Commission workload, thereby increasing efficiency of other investigations.

The SAAP called for:

- Less and better targeted state aid
- A refined economic approach
- More effective procedures, better enforcement, higher predictability and enhanced transparency
- A shared responsibility between the Commission and Member States

The State aid reform package that derives from the SAAP, allows for a more economic approach to settle State aid cases.⁸⁹ Economic analysis of the state measure is used both when evaluating if the measure falls within the scope of Article 107(1) and when deciding if the measure is compatible with the common market.⁹⁰ Deciding whether or not a specific State aid is compatible with the common market is a delicate task of balancing the negative effects on competition against the possible positive effects on the common market.⁹¹ Negative effects mainly concern possible distortion of competition and trade. Positive effects on the other hand are closely linked to how well the aid fulfils the well-defined objective of common interest.⁹²

There are a number of acceptable exemptions to the general prohibition to State aid; some aid schemes are held to have beneficial properties compatible with the overall objective within the European Union. If the State aid measure meets the terms of the clearly defined objectives of common interest and provided that no intra-community competition and trade are distorted; certain State aid could be held to be compatible. Even if

⁸⁹ Vademecum, p.10

⁹⁰ Vademecum p.11

⁹¹ SAAP, p. 4

⁹² Vademecum, p. 12

the general assumption is that the use of other means than State aid is preferable for solving intra-community problems and that state aid could occasionally be an effective tool for fulfilling common interests.⁹³

State aid has proven to be a useful tool to correct market failures, especially within the field of R&D&I. Allowing State aid in the field of R&D&I could improve the functioning of the market and in longer perspective enhance the European competitiveness on the global arena. It is important that such aid is addressed towards a well-defined market failure. Furthermore, such measures must be well targeted, have an incentive effect and be proportionate to the market failure at hand.⁹⁴ Finally, the negative effects, the distortion of competition, must be balanced and limited in order to be compatible.⁹⁵ To summarize, state aid should consequentially only be used when it is the appropriate instrument to achieve a predisposed common interest. It must be *necessary, proportionate* and create the right incentives and most importantly, the *positive effects must outweigh the negative effects* to the competition. The burden of proof is on the Member State and evidence must be provided to the Commission before any attempts to implement the measure is carried out.⁹⁶

The liquidation of inefficient firms is normal on a functioning market and could be considered to be inherent in the notion of a functioning market economy. The functioning of the market economy would be at risk if every company in difficulty would be rescued by state interventions such as State aid. The direct implication of rescuing all firms would be tolerating inefficient business models and creating adverse incentives in the market, thus creating moral hazard.⁹⁷

Excessive risk-taking, bad management, defective supervision and questionable risk behaviour is part of the reason that firms run into financial difficulties.⁹⁸ Part of the “*Restructuring Guidelines*” aims at changing this behaviour by increasing and requiring transparency, predictability and equality of treatment within the system of financial institutions.⁹⁹

A crucial part of the State aid system is the restructuring of firms; in that process, it is fundamentally important that viable business models are implemented.¹⁰⁰

⁹³ SAAP, p.4

⁹⁴ Community framework for state aid for research and development and innovation, OJ C 323, 30 December 2006, p. 1

⁹⁵ IP/06/1600, State aid: Commission adopts new state aid Framework for Research, Development and Innovation, 22/11/2006

⁹⁶ SAAP, p.6

⁹⁷ The moral hazard principle, *Moral hazard* is the situation where a party insulated from risk may behave differently from the way it would behave if it would be fully exposed to the risk.

⁹⁸ MEMO/08/363, p.1

⁹⁹ SPEECH/09/385, p. 1

¹⁰⁰ Ibid.

The Commission's state aid objectives distinguish between sectoral and horizontal aid. Horizontal aid, i.e. measures that address horizontal objectives of common interest are considered less distortive than sectoral and ad hoc measures and are therefore encouraged by the Commission. Market failures are better targeted by horizontal aid and meets the redistributive goals better, why it is less distortive.¹⁰¹ The most common horizontal objectives pursued with state aid within the European Union are regional development, environmental protection, R&D&I, support to SMEs, employment and training aid and.¹⁰²¹⁰³ Horizontal aid is accordingly, in line with the State aid policy advocated by the Commission, it has become synonymous with "good" State aid measures.¹⁰⁴ As the framework is set up, R&R aid is not discriminating between different sectors. However, since it is regarded as particular distortive it is held as sectoral aid.¹⁰⁵

Member states are more likely to support national producers than foreign. Domestic opposition to State aid are often low and domestic support is on the other hand large, as long as any negative externalities are kept outside the domestic market.¹⁰⁶

According to the most recent State Aid Scoreboard, the 2009 autumn update, the total amount of horizontal aid in 2008 was EUR 46.3 billion, approximately 88% of the total granted aid within the Union. This figure is however calculated without including any of the crisis measures. If crisis measure were to be included in the calculation, the share of horizontal aid would drop to only 17.5%. In recent years, there has been an increase of aid towards horizontal objectives and more and more aid is directed towards the same horizontal objectives. Only 12 % of the total aid, EUR 6.5 billion, was granted as sectoral aid and it is a clear trend to reorient aid towards horizontal objectives.¹⁰⁷ Accordingly, the deep financial crisis has temporarily constrained the positive trend of pursuing horizontal objectives.

3.3 The Role of the Commission

The Commission is competent to decide conflicts of what is admissible state aid and they have quite an extensive discretion in doing so.¹⁰⁸ The enforcement of the State Aid policy has been through *soft law* such as guidelines, frameworks, notices and communications. There are a number of issues that should be discussed in relation to the choice of soft law.

¹⁰¹ Scoreboard, Autumn 2009, p.6

¹⁰² Scoreboard, Autumn 2009, p.7

¹⁰³ See, e.g. Community Guidelines on State aid for environmental protection, Community framework for State aid for research and development

¹⁰⁴ Friederiszick, 2006, p. 27

¹⁰⁵ Friederiszick, 2006, p. 728

¹⁰⁶ OECD, 2001, p. 7

¹⁰⁷ Scoreboard, Autumn 2009, p.7

¹⁰⁸ Blauburger, 2009, p.724

The Commission has developed a specific model of what is good State aid which is based on the common interest on a European level, not the Member State level. The ultimate decision to grant State aid is however still within the national competence of the Member States. Subsequently, the Commission in its development of State aid policy cannot issue and enforce soft law provisions against strong member state opposition. The State aid policy advocated by the Commission is not *the* European State aid policy. The Commission lacks the competence to set the agenda to force Member states to spend state resources on various predetermined measures.

This is clearly illustrated by the Commissions view on aid to undertakings in financial difficulties. Historically and especially according to the present policies, the Commission has always called for limitations of aid to undertakings in financial difficulty. Nonetheless, accordingly and in this sense Member States continue to grant such aid measures. In this sense, the Commission's policy may seem as a blunt tool for policy-making.

The choice of developing the state aid rules through soft law was initially not the Commission's first choice. The Council effectively undermined the possibility to implement secondary legislation in the area.¹⁰⁹ This mirrors the political implications of the area. State aid policy is often more about political considerations than economic and legal considerations. Because of the deadlock in the Council, the Commission had to resort to soft law for the development on how to exercise their discretion in relation to the State aid rules. Therefore, the main instruments left for the Commission to work with were their soft law guidelines and individual state aid decisions.

These guidelines primarily deal with how the Commission will exercise its discretion in relation to the exceptions to the general prohibition of state aid. The guidelines define "*appropriate measures*" compatible with the common market. By providing guidance on how to apply the State aid policy system, the Commission created a form of legal certainty for the economic operators of the market.¹¹⁰ Clarity and stability of the legal framework is necessary for providing legal certainty.

However, soft law provisions are to be seen as non-binding recommendations and soft law provisions have no legally binding force upon Member States.¹¹¹ At the same time, soft law provisions are binding upon the Commission and their own guidelines must be followed in their decision-making.¹¹²

The individual State aid decisions are on the other hand binding upon the Member States. When soft law rules are only self-binding for the Commission, their decisions is binding for the Member States. Member states are free to design State aid measures that do not match the guidelines,

¹⁰⁹ Blauburger, 2009, p. 725

¹¹⁰ Gerard, 2008, p.7

¹¹¹ Craig and De Búrca, p. 87

¹¹² Blauburger, 2009, p.72

but it is in their own interest to follow the established criteria in order to get swift approval from the Commission in order to be able to implement aid to their beneficiaries. Most often, the Member state is forced to adapt their aid schemes to the criteria set up in the guidelines or otherwise a negative decision is delivered. There are clear advantages for the Member States to draw up their aid measure in accordance with the Commission's policy. At the end of the day, this system creates legislation that is as binding as traditional secondary legislation.¹¹³

Decisions taken on incorrect application of the guidelines can be rejected by the ECJ, something that further strengthens the credibility of the self-binding rules.¹¹⁴

At a first glance, soft law may seem as a non-favourable way to control the legal area but in this case, the opposite is true. The use of soft law have increased the efficiency of the procedures, increased legal certainty and furthermore, increased the transparency of the Commission's work.¹¹⁵ From the Commission's perspective, it also gives them more discretion and flexibility to set the agenda than a system with hard law would have done. It is also easier to adapt the State aid policy to changes in the society and the common market, as we have seen in the context of the financial crisis. The soft law approach without legally binding force has accordingly proved to have practical effects in reaching State aid policy goals.¹¹⁶

3.4 The Commission and Issues Raised in Context of the Financial Crisis

As prompted above, State aid policy is a very political field. Member States have different opinions on how to solve national problems and when to apply national aid measures. Levels of state aid have always been below the EU average in countries as the Netherlands and the UK. Aid measures are almost never used in Estonia whereas, compared to Sweden and Denmark were significant amounts in State aid is granted, even if it is towards acceptable goals of market correction such as e.g. environmental objectives.¹¹⁷

Thus, there is no consensus among the Member States on the compatibility of different types of acceptable aid measures with the internal market. The inherent problem is the different industrial policy traditions between different Member States that range from very restrictive to very favourable terms on when governmental intervention is acceptable.

¹¹³ Blauberger, p. 730

¹¹⁴ Blauberger, 2009, p.726

¹¹⁵ Lehmkuhl, 2008, p. 139

¹¹⁶ Craig and De Búrca, 2008, p. 162

¹¹⁷ Blauberger, 2009, p.724

What is clear on the other hand is that the Commission has the competence to decide what admissible state aid is, notwithstanding the heterogeneous State aid policy traditions of the Member States. Historically, the Commission's attempts to organize their State aid policy by setting up general criteria for admissible aid measures were met by heavy resistance. The development has however been changing to a more positive view in recent years. In the long run, clarification of admissible state aid measures improves legal certainty and reduces conflicts of national admissible state aid measures.¹¹⁸

It has proven to be of uttermost importance to save banks. The failure of one bank that is Too Big Too Fail can have disastrous effects on the entire banking system. The bankruptcy of Lehman Brothers is the best example of this.

Because of the systemic crisis and the interconnectivity of the financial sector, the Commission concluded that there was a need for special measures. The banking sector is like no other sector of the internal market. Banks are dependent on other banks in a total different way that other companies in other sectors are. Furthermore, banks are central to the functioning of the entire economy.

An interdependence unseen in other sectors is created by inter-bank lending and other interactions between banks hence a loss of confidence in one financial institution on the market can easily affect the whole market, as was seen with the bankruptcy of Lehman Brothers.¹¹⁹

Since the financial crisis was considered to be of an unseen magnitude, the Commission held that the previous application of the R&R Guidelines to tackle the admissibility of state aid measures was inadequate. The use of the exemption in Article 107(3)(b) TFEU was instead seen as a better way of handling the analysis and the decision making and was held as the appropriate legal basis for State intervention during such deep financial crisis.¹²⁰

The rationale for accepting state aid under Article 107(3)(b) TFEU is different from the rationale of Rescue and Restructuring aid measures under Article 107(3)(c) TFEU. The focus of Rescuing aid is to rescue banks that under normal market conditions would have failed. Such type of aid is undoubtedly the most controversial and distortive type of State Aid.¹²¹ From an economic point of view, the rationale for R&R rescue is questionable. Keeping failing firms alive is a serious intervention in the market economy and serious distortion of the market is therefore likely¹²².

¹¹⁸ Blauburger, 2009, p. 725

¹¹⁹ Coppi, 2009, p. 81

¹²⁰ State Aid Scoreboard, Spring 2009, p. 10

¹²¹ R&R Guidelines, para 4

¹²² Coppi, 2009, p. 81

Consequently the established criteria for assessing measures under the R&R guidelines is not directly applicable for the analyses of aid given under Article 107(3)(b).

As stated above, the focus of aid measures are different under Article 107(3)(b) is different. The prerequisite of a “*serious disturbance*” is of importance. A serious disturbance is most likely caused of a serious market failure and the correction of market failures is justified from an economic perspective. The remedying of serious disturbances creates economic efficiency and is overall positive for the market.¹²³ The objective of the analyses, i.e. the “common interest” of State interventions should instead be restoring viability of the financial sector and future protection of the financial stability. This said, such type of aid can of course also have negative effects, and these negative effects must be balanced against the positive effects, just as the practice of rescue aid.

State aid given in the circumstances of the financial crisis must be aimed at stabilizing the financial markets, keeping aid to the minimum necessary and at the same time minimizing any possible distortions of the competition. But Is State aid an appropriate tool for remedying this indicated market failure, can State aid solve the market failure? In addition, perhaps the most important aspect, is it proportionate?

The Commission has approved state guarantees, liquidity facilities and other types of aid instruments that have been adopted by Member States in order to avoid further bank failures. There is a consensus that these approved aid measures have been necessary in order to avoid a further deterioration and the risk of a systemic crisis.¹²⁴ The financial markets have been stabilised and the economic situation has improved. Correspondingly, it seems as if State aid is an appropriate tool for remedying the identified market failure. It is too soon to conclude whether the market failure is solved. Furthermore, the “proportionateness” of the implemented measures is even harder to evaluate. If one bank fails, more banks are probable to fail in the wake of the first bank. The first failure produces *negative externalities* on other banks. A negative externality is the spill over effects of an economic transaction to third parties not involved in the transaction.

In this context, the implication of the negative externality is that banks that would normally not fail could fail which is not efficient from an economic perspective. On the other hand this is the harsh reality of the financial sector, what rendered the recent financial crisis exceptional was the large number of banks that was exposed to the externality, i.e. the large number of banks that could have failed.

When there is evidence of a market failure the Commission has taken the view that State aid is an acceptable remedy to the problem. Actually, market

¹²³ Coppi, 2009, p. 81.

¹²⁴ Coppi, 2009, p. 85, State Aid Scoreboard 2009 Autumn update, p. 42, Interim forecast September 2009, p. 1.

failures are the justification for most State aid, even if it sometimes is not explicitly stated. Textbook examples of when aid is granted for R&D and environmental protection, these are situations when market failures are the source of the problem.¹²⁵

The legal framework for European State aid can be said to be flexible enough for taking care of such exceptional financial problems as we have seen in Europe.¹²⁶ As stated above, during times of financial and economic distress, Member states tend to be more tempted to grant measures in favour of their own interests.¹²⁷ National competition authorities also tend to be more lax on the enforcement of competition rules.¹²⁸

But the Commission has maintained their State aid policy, at least in the beginning of the crisis, and abstained from being more “flexible” in their application of the competition rules.¹²⁹ During the first period of the financial crisis, the Phase I, the Commission did not approve any measures following the application of Article 107(3)(b) TFEU, standing by the precedents of their previous decisions and the decisions of the CFI and the ECJ.

Instead of creating new ways to interpret the legislation, the Commission used their well-tried methodology of applying the R&R guidelines for its decisions, some especially designed for the financial sector. When the crisis deteriorated, the Commission recognized that the potential consequences could be disastrous and accordingly measures would be able to be granted on the basis of Article 107(3)(b) TFEU.

The time frame for a *preliminary examination* of a notification shall according to Article 4(5) the “*Procedure Regulation*”¹³⁰ not exceed two months. If the notification requires a *formal investigation* procedure, the investigation period is, at least, another 18 months and this period can be extended by a jointly agreement between the involved parties according to Article 7(6).

Due to the often complex issues and the inherent impact on competition from public intervention, decisions from the Commission has historically only been taken after the opening of a formal investigation.¹³¹ The Commission promised to shorten the investigation periods in the Banking Communication, to ensure legal certainty, and some of the decisions originating from the financial crisis were taken within two weeks and other decision were adopted within only 2 days. Some measures were not even notified to the Commission, but were approved after the Commission ex

¹²⁵ Slocock, 2001, p. 2.

¹²⁶ Gerard, 2008, p. 9.

¹²⁷ Adler et al, 2009, p. 2.

¹²⁸ Report from the Nordic Competition authorities, 2009, p.9.

¹²⁹ Gerard, 2008, p. 9.

¹³⁰ Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ L 83/1

¹³¹ Editorial Comments, p. 8.

officio contacted the respective Member State.¹³² An explanation of the rapidity of the action and the obvious shortening of the decision-making could be the result of increased clarity of the applicable State aid framework.

The purpose of opening a formal investigation according to Article 108(2) TFEU is to get an in-depth investigation of the whole situation, to get further information from the Member State and the views of different stakeholders involved in the process.¹³³

To sum up, if legal certainty is conditional upon clarity in the applicable framework and rapidity of action from the decision makers, the Commission has been successful in their approach to the State aid rules and the financial crisis.

¹³² Ibid, p.8

¹³³ MEMO/08/363, 2008, p. 1.

4 Appropriate Measures in the Financial Sector

4.1 Solving a Market Failure

Justification for State aid can be taken either on grounds of *pareto efficient allocation* or on *grounds of redistributive justice*. Questions of redistributive justice are less of an economic or legal question and more of a political question and are therefore not further discussed in this thesis. The truth of when State aid actually increases pareto efficient allocation by correcting a market failure is far from carved in stone.¹³⁴

One way of measuring economic efficiency is to look at the total welfare generated. A theory put forward by *Friederiszick et al.* states that public intervention in the form of State aid should only be implemented when the total welfare is increased by more than the cost of the intervention. The cost includes not only the actual cost of the measure but also the opportunity cost of the funds used and the costs of raising the funds such as costs for taxation.¹³⁵ As mentioned under Chapter 2.3.1, government interventions are the most efficient when correcting “market failures” and good State Aid Policy should correct market failures balancing the benefits with the costs of the intervention.¹³⁶ The European State Aid Policy is based on this argument and acknowledges that the main economic rationale for State aid is to correct market failures.¹³⁷

The financial crisis must be labelled as a market failure. There are of course various explanations for what led to the outbreak of the financial crisis and a consensus is hard to point out. However, some specific market failures can be dissected such as mispricing, unrealistic expectations, short-termism, asset price bubbles, excessive risk-taking and moral hazard are elements that could lead to the financial crisis.¹³⁸ All of these elements led to the breakdown of the financial markets in late 2008 and even financially sound financial institutions found themselves in trouble.

There are a number of identified market failures that could be addressed with public intervention in the form of State aid. These are *externalities*, *public goods*, *information asymmetries*, *coordination problems* and *market power*.

Market power, is the direct failure of competition. State aid measures may in fact reduce market power of dominant firms by aiding smaller

¹³⁴ Friederiszick et al., 2006, p. 14.

¹³⁵ Friederiszick et al., 2006, p. 1.

¹³⁶ Friederiszick et al., 2006, p. 13.

¹³⁷ Coppi et al, 2009, p. 82.

¹³⁸ Coppi et al, 2009, p. 83.

competitors or providing enough financing to get over barriers of entry. On the other hand, State measures could also create dominant actors and national champions. Beneficiaries of aid will strengthen their market position compared to companies that does not receive any aid.¹³⁹

Information asymmetry is a characteristic of the financial sector and is one of the reasons for the recent financial crisis.¹⁴⁰ Information asymmetries are created when one party to a market transactions have more information about the transaction than the other party. A discrepancy between the information available on the supply-side and the information available on the demand-side is the key to understanding information asymmetries.¹⁴¹ Information asymmetries are known to be able to cause market failures and ultimately the breakdown of markets.¹⁴²

The problem is twofold when discussing the financial market and it is also the reason for the severity of the crisis. First, we have the typical problem of information asymmetries between the borrower and the bank. Most often, the company that seeks a loan is better informed of its own financial situation than the bank or other investors. It is also more difficult for SMEs to convince banks of their creditworthiness. Consequently, it could be hard for banks to distinguish good loans from bad loans or investments and ultimately hard for SMEs to get proper financing¹⁴³

Secondly, we have the problem of toxic assets and the loss of confidence, often referred to as the “lemon market problem”.¹⁴⁴ Some of the assets on the financial market were considered “toxic” i.e. they could not be sold or they guaranteed a loss of money. The problem was that these toxic assets were not able to be distinguished from other “healthy” assets. As a result, fundamentally sound banks, with valuable assets and without toxic assets could not or at least they had a hard time to gain acceptable prices for their assets. The “lemon problem” first affected single assets but later affected entire financial institutions with a terrible result. The market for assets shrank and eventually the market completely collapsed. This development led to a massive loss of confidence by investors and the public in the financial markets.

Because of the confidence problem investors stopped lending to financial institutions, which lead to that financial institutions stopped lending to each other. This effectively led to the breakdown of the entire financial market and a resulting liquidity crisis.¹⁴⁵

¹³⁹ Friederiszick, p.15.

¹⁴⁰ Friederiszick, p.14.

¹⁴¹ Ippolito, 2005, p. 284.

¹⁴² Coppi et al., p. 83.

¹⁴³ Friederiszick, p. 14.

¹⁴⁴ The “Lemons market problem” – When product quality is not apparent at the point of sale and sellers cannot find an economic way to show that they are offering high quality and thus deserving a high quality price. - Richard A. Ippolito, *Economic for Lawyers*, Princeton University Press, 2005, p. 286.

¹⁴⁵ Coppi et al., 2009, p. 83.

Therefore, providing the financial sector with incentives to lend money and making investments in SMEs is good state aid policy from an economic efficiency point of view.

Measures can, *prima facie*, be deemed to be efficient from a national point of view, but if investigated further, the same measure could produce negative externalities in other Member States and the total benefit is not compatible with the European common interest.¹⁴⁶

4.2 Special Characteristics of the Financial Market

It is difficult to compare financial instruments traded on the financial market with other, everyday traded goods and services. Prices of financial instruments are much more fluctuating than the prices on ordinary goods. The return on investments is also uncertain compared to other goods. Market expectations on future streams of income make it more likely that financial market bubbles are created. Furthermore, the key-players on the financial market, the banks, differ in their structure from other companies.¹⁴⁷

Banks are exposed to relatively high risks of illiquidity because of the environment in which they operate. Problems arise when banks create long-term investments on short-term funds. Together with unsound business practices the risks taken are tremendous. A bank's liquidity is at stake when the bank is forced, for some reason or other, e.g. an unexpected increase of withdrawals, to sell assets at prices below their real value. In that case, the bank is not going to be able to meet its customers' withdrawals and thereby becoming insolvent. This can be explained as a market coordination failure and as we have seen, this insolvency problem can be remedied through a governmental intervention by granting liquidity assistance or other state guarantees.¹⁴⁸ The downside of granting State aid is the increased moral hazard that is created by the aid measures. An appropriate burden sharing of the costs between Member State and beneficiaries could to some extent address the problem of increased moral hazard. It could be argued that the whole unsustainable business system is supported when the banks do not have to take full responsibility for unfavourable realisations and in the end, this would generate even more excessive risk taking.

Nonetheless, the overall risk exposure within the sector is high and management and shareholders is expected to take risks. Expectations of short-term profits and risk taking are inherent to the banking system, and are present with or without State aid.

¹⁴⁶ Blauburger, 2009, p. 722.

¹⁴⁷ Maes and Kiljanski, 2009, p. 2.

¹⁴⁸ Maes and Kiljanski, 2009, p. 1.

Banks are also able to quickly expand and contract their balance sheet thereby altering the volume of their business. Ordinary firms are not able to adjust their balance sheet in the same way.¹⁴⁹ Accordingly, an analysis of a balance sheet of a Bank may prima facie not be significant for the actual financial situation of the institution.

Thus, for the above reasons, the financial market is subject to significant risk of systemic crises. A bank failure or an anticipated bank failure creates negative externalities on other banks. It is more or less the direct opposite of other markets. A failure of an undertaking in a different sector of the economy often favours its competitors.¹⁵⁰ Increased market shares could be beneficial for the remaining competitors and the market is overall strengthened by the failure of an inefficient undertaking. The failure of a bank on the financial market, on the opposite, weakens its competitor and creates loss of confidence in the entire financial sector.¹⁵¹ Naturally, the interdependence of the market, the web of financial instruments, is also a big part of this particular situation.¹⁵²

Another disturbing factor is the fact that a bank failure or a financial crisis has direct effects on the real economy and private individuals.

The effects of increased competition must be weighted against the possibility of financial instability. Something that has been highlighted in the current financial crisis is that here is a possible trade-off between competition and financial stability.¹⁵³ For that, it does not follow that competition is not desirable in the financial sector, a healthy degree of competition is worth aiming for. How this is obtained, is a subject for another thesis. However, considering the recent financial crisis, State aid policy has become a way for the Commission to regulate the financial sector. Additionally, there is already an abundance of ex ante financial regulation, this framework is of importance, but outside the scope of this thesis and will not be further discussed.¹⁵⁴ The focus will instead be on the

¹⁴⁹ Ibid., p. 2

¹⁵⁰ A failure could be due to difficulties in an entire business sector and increased market shares for competitors may be less advantageous or of little importance for the overall competition.

¹⁵¹ Maes and Kiljanski, 2009, p.2

¹⁵²The term TBTF, Too Big to Fail was coined in the financial crisis, in relation to the alleged interconnectivity/interdependence of the financial market, the term TITF Too Interconnected to Fail is interesting and a telling argument.

¹⁵³ Casu and Girardone, 2009. p. 119

¹⁵⁴ A special group, the "Larosière group" has been set up to investigate the need for a new supervisory system for the European financial sector. They recently presented a report on how to reform the financial markets, "*The High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, Report, Brussels 25 February 2009*". As a response, The Commission has presented a proposal in accordance with the Larosière group's recommendations for reforming the regulation and control of the financial markets.

governmental interventions done as a result of the financial crisis in the form of State aid.

4.3 Rescue and Restructuring Aid under Article 107(3)(c)

During Phase I, of the financial crisis the Commission based their decisions on Article 107(3)(c) TFEU and the “R&R Guidelines” for the approval of rescue measures. European financial markets started to be affected by the problems with sub-prime mortgage lending in the US and in response, Member States started to draw up rescue measures in order to help individual banks. Some European banks were affected due to their unsustainable business models and other banks because of their exposure to so-called Collateralised Debt Obligations (CDOs¹⁵⁵).¹⁵⁶ Irrespective of the reason for the banks difficulties, measures to prevent insolvency and potential contamination or negative spill over effects were adopted by several Member States.

Banks in financial difficulties can be given temporary assistance in the form of rescue aid. Rescue aid is given either in the form of loans or guarantees, and cannot last longer than six months. The total amount must be kept to the minimum necessary for the bank to survive the rescue period under which a restructuring or liquidation plan is set up.

Restructuring aid has somewhat a different approach. Restructuring aid is intended for the restoration of a banks long-term viability and is often more comprehensive in relation to rescue aid. The focus is to take on the very reasons for why the firm came into financial difficulties and thereby avoiding unsustainable business models. Measures to limit distortion of competition are also an essential part of the restructuring aid.¹⁵⁷ Compensatory measures to limit the distortions must be taken or otherwise the measure will be seen as contrary to the common interest.¹⁵⁸ The compensatory measures are almost punitive in nature, but justified as a guarantee for a normal functioning of the market despite state intervention.¹⁵⁹

¹⁵⁵ CDOs are investment-grade securities that are backed by a pool of bonds, loans and other assets.

¹⁵⁶ State Aid Scoreboard, Spring Update 2009.

¹⁵⁷ In the Sachsen LB decision, fn 91, compensatory measures included the sale or liquidation of two subsidiaries active on the financial markets and the commitment to cease with proprietary trading and international real estate activities by the end of 2011. A considerable reduction of the banks financial market activities.

¹⁵⁸ Compensatory measures may i.a. include; the sale of specific assets or investments, capacity reduction in different forms and caps on production.

¹⁵⁹ It has been discussed whether the *compensatory measures* should “compensate” competitors or if the compensatory measures should be aimed at minimizing distortion. The latter position is the preferred view. See, EAGCP Commentary on European Community Rescue & Restructuring Aid Guidelines, 6 February 2008.

Positive effects must always outweigh the negative effects.¹⁶⁰ Restructuring aid also requires a real contribution from the beneficiary towards the restructuring.¹⁶¹ The R&R guidelines establish the one-time last-time principle, rescue aid to undertakings in financial difficulty should only be granted once in order to limit eventual distortive effects and to prevent the use of rescue aid as a mean of keeping firms alive longer than they should.¹⁶² The liquidation of inefficient firms is part of the normal operation of the market and there is no purpose of its own to rescue all firms in financial difficulties.

4.3.1 Restructuring Aid to Sachsen LB¹⁶³

The restructuring measures at hand in the Sachsen LB decision constituted State aid but were held to be compatible with the Treaty rules regulating R&R aid. The decision also included compensatory measures with the goal to limit distortion of competition that followed the aid measures.

After been investing in American sub-prime markets, Sachsen LB got in financial difficulties. In order to continue its business, the bank received State aid. Germany notified the Commission pursuant to Article 108(3) TFEU in regard to a *liquidity facility* and a *guarantee* by the land of Saxony involving the sale of Sachsen LB to another German bank.

German authorities argued that the measures was compatible with the common market and also argued that the aid met the standards of the Market Economy Investor Principle and consequently did not constitute aid. Since the Commission doubted that a private investor would have acted in the same way under equal terms, an in-depth investigation was initiated by the Commission.

The Commission argued that the market economy interest of the liquidity facility had a limited commercial interest and that a private market investor would have been reluctant to engage in such an investment. Even if the bank had good credit rating and the risks were low, there was no commercial interest for such an investment. Accordingly, the liquidity facility was held to constitute State aid. The liquidity facility was attributed to State resources. Cross border activities by the bank, and the advantage given would affect competition in the banking sector, thus affecting intra-community trade. Nonetheless, the measure met the conditions stipulated for compatible rescue aid. The aid measure was limited to 6 months and did

¹⁶⁰ R&R Guidelines, para. 38

¹⁶¹ R&R Guidelines, p. 1.

¹⁶² R&R Guidelines, p. 1.

¹⁶³ Case C 9/2008, Commission decision of 4 June 2008 on state aid implemented by Germany for Sachsen LB.

not exceed the minimum necessary to keep the bank in business until other restructuring plans were to be implemented.¹⁶⁴

The Commission also concluded that the State guarantee involving the sale of the bank had state aid elements. It was questionable if the State was behaving as a market economy investor. Apparently, a liquidation of the bank would have been less costly than accepting the transaction together with the guarantee. When analyzing the sale compared to a market economy investor many different factors must be taken into account with respect to the guarantee. Thus, the potential costs under the guarantee must be compared to the actual sale price. The Commission came to the conclusion that the State of Saxony sold the bank for a negative sales price and thereby granted State aid to Sachsen LB.¹⁶⁵

Neither of the two financial interventions would have been acceptable for a private investor and both measures undisputable constitute state aid. The following question was whether the measure was compatible under Article 107(3)(b) or (c). As stated above, the Commission is of the opinion that Article 107(3)(b) must be applied restrictively and in all other previous decisions relating to banks in financial difficulties the Commission had not relied on that provision. The Commission accordingly held on to their precedents and stated that “a serious economic disruption is not remedied by an aid measure that “resolve[s] the problems of a single recipient [...], as opposed to the acute problems facing all operators in the industry”¹⁶⁶ No grounds for the compatibility of the measure on the basis of Article 107(3)(b) was found. Germany, on the other hand, was of the opinion that all measures met the Market Economy Investor Principle, and if not at least constituted for Rescue aid.

Instead, the Commission held that since the problems of Sachsen LB were a result of company specific events, which instead should be remedied with tailor made restructuring plans according to Article 107(3)(c) and aid to firms in difficulty. As established earlier, the first measure constituted rescue aid. As such, measures must be reimbursed within six months and kept to the minimum necessary as well as that any distortions of competition must be limited. Since Sachsen LB had not benefitted from a similar aid measure in the past, the first measure constituted Rescue aid and was compatible with the common market on the grounds of Article 107(3)(c)¹⁶⁷ Germany was in breach of the notification requirement stipulated in Article 108(3), they had implemented the measures without notification, but if the imposed compensatory measures were fulfilled, the measure would be compatible.

¹⁶⁴ C(2008) 2269 final, COMMISSION DECISION of 4 June 2008 on state aid implemented by Germany for Sachsen LB [Notified under No C 9/2008 (ex NN 8/2008, CP 244/2007)], O.J. L 104 p. 34, 24 April 2009, para. 47.

¹⁶⁵ *Ibid.*, p. 17.

¹⁶⁶ *Ibid.*, para. 94.

¹⁶⁷ *Ibid.*, p. 20.

The R&R guidelines¹⁶⁸ stipulates a set of criteria that must be met and which also was assessed by the Commission.

- Aid must restore the long-term viability of the company in difficulty
- The state aid must be limited to the minimum necessary and the recipient must make a significant contribution of its own
- Compensatory measures must be taken to minimize potential distortion of competition¹⁶⁹

By following these guidelines the Commission wants to create sustainable restructuring and ensure that the beneficiary of the aid does not get competitive advantages compared to its competitors. It was believed that the sale of Sachsen LB to the LBBW group would create a sustainable future for the bank. The aid was also limited to the minimum necessary amount and a significant contribution, more than 50 % of the restructuring costs, had been made by the recipient. As regard to compensatory measures, Sachsen LB's financial market activities had to be reduced. This was held to be proportionate in relation to the distortive effects of the aid granted.

The Commission states that a rapid state intervention during a financial crisis is needed to prevent harmful spill-over effects. The measures taken must be efficient and decisive in order to restore confidence in the market. Furthermore, confidentiality in the process is crucial too ensure effectiveness.¹⁷⁰

When it comes to Rescue aid to banks in financial difficulties under normal market conditions the question is not about market failures such as, externalities, asymmetric information, coordination failures and incomplete markets. The basis for granting measures is simply different. This is valid in the context of a bank that simply has a faulty business model which renders it inefficient and incapable of competing under normal market conditions.

4.3.2 Aid measures to Northern Rock

The Northern Rock decision¹⁷¹ is a very good example of how the Commission tackled aid measures to Banks according to standard rules on Rescue and Restructuring aid during Phase 1 of the financial crisis. In that context, the policy was that Article 107(3)(c) TFEU was an appropriate legal basis for State intervention.

On 5 December 2007, the Commission authorised rescue aid for Northern Rock a British mortgage bank. The core activity of Northern Rock had been residential mortgage lending and these loans represented more than 90 % of

¹⁶⁸ Communication from the Commission, Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, Official Journal C 244 of 1.10.2004

¹⁶⁹ State aid: Commission approves restructuring of Sachsen LB, IP/08/849.

¹⁷⁰ MEMO/08/363.

¹⁷¹ 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.

the outstanding loans made by the bank. Quite elementary, the bank's business model was directly affected by the sub-prime crisis on the US market. The financial crisis created severe liquidity difficulties for Northern Rock. The bank was reliant on frequent financing from the markets and suddenly it was unable to meet its funding needs. As a consequence, Northern Rock requested emergency liquidity assistance from Bank of England. The emergency liquidity assistance was granted to Northern Rock on 14 September 2007. However, things got worse almost immediately when the news leaked to the press and Northern Rock's customers started to fear that the Bank would become insolvent. A "bank-run"¹⁷², further worsened the financial situation of Northern Rock.

As a consequence, the UK authorities immediately granted guarantee arrangements to prevent the effects to spread to the rest of the financial market and the guarantees were underwritten by State resources.

According to the Commission's assessment, the initial emergency liquidity assistance was secured against high quality collateral, bearing a penal interest rate and without government indemnity. The liquidity assistance was taken on the sole initiative of Bank of England and was independent and the first measures to the Northern Rock. Consequently, the first measures were not held to be State aid in accordance with Article 107(1) TFEU.¹⁷³

The guarantee arrangements, on the other hand, were considered to constitute State aid pursuant to Article 107(1) TFEU. All the prerequisites were fulfilled and the Commission specifically underlined that no market economy investor would have engaged in an equivalent transaction. Thus, the market economy principle was not fulfilled.¹⁷⁴

The Commission quite easily concluded that the measures did not fall within the scope of the exemption in Article 107(3)(c) TFEU. Aid measures that that only benefitted one operator or one sector could not be exempted under the exemption in Article 107(3)(c). The UK authorities argued that the failure of Northern Rock could have lead to a systemic crisis as a direct response but the Commission was firm on their opinion that the measures were directed only towards one operator on the financial market. The evidence provided by the UK authorities was simply not enough for the Commission.¹⁷⁵ Furthermore, the Commission made it clear that they rested on previous decision-making in similar cases.¹⁷⁶

¹⁷² A "bank run" is characterized by a large number of withdrawals from a bank's customers because they believe that the bank is going to be insolvent.

¹⁷³ C(2007) 6127 final, para. 35

¹⁷⁴ Ibid., para. 35.

¹⁷⁵ Ibid., para. 38.

¹⁷⁶ See: Commission Decision of 20 May 1998 concerning aid granted by France to the Crédit Lyonnais group, published I OJ L 221 of August 1998, p. 28.

4.4 The Banking Communication and State Guarantees

The Banking Communication establish the general application of Article 107(3)(b) TFEU during the financial/banking crisis. In relation to guarantees the communication lays down useful guidance. During the period from October 2008 to July 2009 the Commission approved 11 guarantee schemes, 6 recapitalisation schemes and 5 schemes providing for both guarantees and recapitalisation and the total approved guarantee measures amount to EUR 2.9 trillion.¹⁷⁷ The amount attributed to guarantees is considerable and there are interesting aspects of guarantees in relation to State aid.

A state guarantee in respect of a loan or other financial obligation entered into by an undertaking is likely to constitute State aid unless a private investor in the situation of the State would have been prepared to provide the corresponding guarantee.¹⁷⁸

The basic reason for why state guarantees should be forbidden is that it improves the borrower's credit position. If the borrower is given cheaper, non-commercial borrowing rates, competition is distorted and companies that have to borrow money at a commercial borrowing rate are put in a disadvantageous position.¹⁷⁹ If the borrower is able to get better financial terms for a loan than it normally would have been able to obtain on the regular financial market it obtains an advantage through the guarantee.

In reality state guarantees reduce the cost of capital, banks will lend more readily and at a lower interest rate against the background of a state guarantee.¹⁸⁰

A direct consequence of a State guarantee is that the borrower often can get a more favorable loan at lower rates and will often need to offer less security compared to the situation without a state guarantee. More importantly, as the Commission states in their Notice, some undertakings would not be able to get a loan from financial institutions without a State guarantee or only at very high rates because the risk associated with the loan would be too high.¹⁸¹

If an undertakings credit rating is poor and consequently their ability to pay their loans is poor, the savings in borrowing costs could be quite substantial if they have a state guarantee to rely on.¹⁸²

¹⁷⁷ DG Competition's review, 2009, p. 2.

¹⁷⁸ Hancher, 2009, para. 15.038.

¹⁷⁹ Friend, 2004, p. 231

¹⁸⁰ Coates, 2009, p.

¹⁸¹ Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ 155/10 20.6.2008

¹⁸² Biondi et al, p. 231.

Most often, the borrower has not paid a commercial rate for the loan and the guarantee is therefore considered to be an aid element. For the most part, the beneficiary of the aid is the borrower. It could however also be the lender that is put in a better position.

Accordingly, the positive side of this is that State guarantees could enable and stimulate the creation of new companies and products. As mentioned above this has been recalled in areas such as R&D&I and in the area of more environmentally friendly products. Furthermore, State Guarantees can help a failing firm from liquidation or from being restructured; when their elimination from the market could possible create distortion of the competition.¹⁸³ The need to undertake an individual assessment of the risk of losses related to each guarantee.

The goal of the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (“the Guarantee Notice”) is to ensure legal certainty by making the Commission’s work as transparent as possible thereby making it easier to predict the outcome of decisions and to ensure equal treatment. The “Guarantee Notice” establishes predetermined safe-harbours for the minimum margin that should be charged for a State guarantee in order to be deemed as not constituting aid within the scope of Article 107(1). Subsequently, this would also be valid for insufficient premiums, and consequently could be held as aid elements.

The most common form of guarantees is associated with loans or other forms of financial obligations to be contracted by a borrower with a lender. The Guarantee notice clarifies that these guarantees are either granted as individual guarantees or within a guarantee scheme.

The general criteria of Article 107(1) TFEU apply for State Guarantees. Any risk associated with the guarantee is carried by the State, something that is clearly beneficial for the recipient. According to the Market Economy Investor Principle, such risk should be taken by the company and be followed by an appropriate premium. Risk-carrying by a market player should usually be remunerated by an appropriate premium. The MEIP can in this aspect give important guidance; a market price on capital is the key to the minimising of distortion.

If an inadequate or a very low premium is taken by the State, it is not only giving the undertaking an advantage but also draining State resources. Accordingly, the state guarantee constitutes an aid element, even if no payments are paid by the state. The aid measure is considered granted when the guarantee is given, it is consequently insignificant whether or not the guarantee is invoked or if any payments are made with reference to the guarantee. The individual assessment whether or not a State Guarantee

¹⁸³ Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ 155/10 20.6.2008.

constitutes aid should therefore be made at the time when the measure is granted.

State guarantees that do not confer any advantages to the borrower will not be considered as state aid. As with other types of State aid, state guarantees must comply with the “market economy investor principle” or otherwise it will be labeled as State aid. Hence, it must be determined whether a private investor under similar circumstances would have given the guarantee given by the State to the borrower or lender.¹⁸⁴ In other words, could the company obtain an equivalent loan solely depending on the capital market? If this would be possible, and the conditions for the loan would be acceptable for a private investor the question of State aid within the meaning of Article 107 TFEU is not raised.¹⁸⁵

In an attempt to increase the predictability and the legal certainty when assessing if the Market Economy Investor Principle is fulfilled the Commission has listed a set of conditions for when a guarantee measure is outside the scope of aid. When these conditions are met, the guarantee measure is most likely not considered state aid.¹⁸⁶

The first condition is crucial. The beneficiary cannot be in financial difficulty. If the beneficiary is, another framework must be used. There is no general Community definition but is for the purpose of the R&R Guidelines defined as firm that 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, outside intervention by the public authorities, will almost certainly condemn it to going out of business in the short or medium term.”¹⁸⁷

Furthermore, the guarantee must be defined and linked to a specific transaction or obligation. Guarantees cannot cover more than 80 % of the outstanding loan or other financial obligation. If a guarantee covers the whole amount of a financial obligation, it is believed that the beneficiary has less incentive to minimize its risk-taking.¹⁸⁸ The cost of the guarantee must be as close to the corresponding market price. This type of burden sharing is a way to address moral hazard.

According to the Commission, behavioural constraints is also important tools for limiting beneficiaries abilities to distortion competition. Beneficiaries must sometimes adhere to limitations of their conduct in relation to the guarantee. Limitations on expansion while making use of the benefits of being under a guarantee scheme are common as well as the removal of the guarantee protection if in non-compliance.

¹⁸⁴ Case C-482/99, France v Commission [2002] ECR I-4397, para. 70-71

¹⁸⁵ Guarantee Notice, 2008, p. 13.

¹⁸⁶ Guarantee Notice, 2008, p. 14.

¹⁸⁷ R&R Guidelines, para. 2.1.9.

¹⁸⁸ Guarantee Notice, 2008, p. 14.

4.5 Aid to remedy a “serious disturbance in the economy of a Member State” under Article 107(3)(b)

Article 107(3)(b)

(b) 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*; (emphasis added)

The “serious disturbance in the economy of the Member States” must affect the entire Member State and not only a specific region. This has been affirmed by the CFI in the *Volkswagen* case¹⁸⁹. The wording and the interpretation has been reaffirmed by the Commission and strictly followed in the recent decisions. As an example, it was also affirmed in both in the West LB decision and in the Sachsen LB decision. Moreover, since the disturbance must be more or less exceptional, the situation must be serious compared the general situation within the community or as it was at the end of 2008, the prevailing situation on the financial market.

The aid must be construed to remedy a serious disturbance in the economy of a Member state, and consequently aid cannot favour a single undertaking by placing it in a better position than they would have been without the economic disturbance.¹⁹⁰ In relation to the Temporary Framework, Member states must also cumulatively establish that the measures taken are necessary (well targeted), appropriate and proportionate in order to combat the serious disturbance.¹⁹¹

With the “Banking Communication”, the Commission established that the situation on the financial market was so severe that the crisis could have an impact on the overall economy of Member States. Accordingly, the circumstances made it possible to use Article 107(3)(b) TFEU as a legal basis for aid measures taken to solve the systemic crisis.¹⁹²

Compared to the R&R Guidelines and aid on the legal basis of Article 107(3)(c), Article 107(3)(b) provides for more flexibility when it comes to the form of acceptable aid instruments. Moreover, the duration of aid measures can go beyond six months and above all, there are no justifications for structural compensatory measures.

Guarantee schemes and recapitalization schemes set up according to the Banking Communication could be extended as long as the crisis continue,

¹⁸⁹ T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, para 167

¹⁹⁰ Quigley, 2009. p. 136.

¹⁹¹ Temporary Framework, p. 6.

¹⁹² Banking Communication, 2009, para. 9.

all schemes must however be reviewed at least every six month.¹⁹³ There is a clear distinction in the Banking Communication between aid to banks “characterized by endogenous problems” (fundamentally sound banks) and aid to banks with “viability problems [...] inherently exogenous” (fundamentally unsound banks).¹⁹⁴

Aid measures to *fundamentally sound banks* will create less distortion of the competition and correspondingly such banks will need less substantial restructuring. On the other hand, inefficient and excessively risk taking *fundamentally unsound banks* that normally would have fallen in the scope of the normal framework for rescue aid will need to undergo thorough restructuring as well as compensatory measures in order to limit distortions of competition. The viability of such banks derives from general inefficiencies, poor asset-liability management and risky strategies.¹⁹⁵

Another important aspect of the applicability of aid schemes under the Banking Communication is the eligibility criteria. The qualification criteria for obtaining aid under a scheme must be objective and non-discriminatory in order to avoid any undue distortions on other markets or the internal market. All banks incorporated in a Member State must be eligible, irrespective of nationality.¹⁹⁶

Aid must also be kept to the minimum and an appropriate way to ensure this is that adequate remuneration by the beneficiaries in e.g. a guarantee scheme. The remuneration should be as close to a commercial market price. Demanding an appropriate remuneration is a way to ensure contribution from the beneficiary, which also in the long run as mentioned above, ensures less problems of moral hazard.

Further “behavioural constraints” may be added as safeguards such as restrictions on commercial conduct, limitations to the size of the balance sheet and prohibition of conduct that would be irreconcilable with the purpose of the aid measure.¹⁹⁷

4.5.1 Rescue aid to the Irish banking system

The granted rescue aid scheme to the Irish banking system¹⁹⁸ exemplifies the Commission’s approach after deciding that the crisis could be tackled with application of Article 107(3)(b) TFEU. It is a good example of the Commission’s intervention in crisis cases and to aid in direct response to the credit crisis.

¹⁹³ Ibid., para. 13.

¹⁹⁴ Banking Communication, para. 14.

¹⁹⁵ Ibid.

¹⁹⁶ Ibid., para. 18.

¹⁹⁷ Ibid., p. 7.

¹⁹⁸ C(2008)6059, Commission Decision of 13 October 2008 in case NN 48/2008 Guarantee scheme for banks in Ireland.

The decision confirms that the state guarantee schemes are to be seen as State aid. The decision was from the beginning attributed to a governmental decision and the scheme clearly involved state resources. The measure initially included six Irish banks¹⁹⁹ and the objective was to boost confidence to the banking system and avoiding any bank failures. The scheme was also intended to increase inter-bank lending and facilitate liquidity.

Initially, the scheme was held to be discriminatory and the Irish government had to make changes in the guarantee scheme. All banks regardless of origin with a systemic significance to the Irish economy had to have access to the guarantee scheme.²⁰⁰

The Irish authorities argued that the scheme did not constitute State aid since the guarantees were made on commercial terms and for that reason met the MEIP. The Commission was of the opinion that the scope of the guarantee was too broad. The guarantee, inter alia, covered all existing deposits, covered bonds, senior debt and dated subordinated debt. A private investor would have hesitated to cover such a broad scope of different financial instruments according to the Commission. Perhaps most importantly, such types of guarantees do not exist in the private market, which makes it hard to make a comparison with a private investor. Furthermore, the likelihood of a private investor accepting to engage in such a guarantee, if it existed, under the current economic context, was very low. Finally, the broad scope and the significant amount covered by the guarantee could only be credible and manageable if given by a State. Last, the Irish authorities failed to provide any evidence that the guarantees were made on commercial terms and the terms provided were, if anything, more advantageous than any private guarantor would give. Thus, the guarantee scheme did not meet the MEIP and together with the selective advantage conferred by the guarantees and the strengthening of the banks' competitive position, the scheme constituted State aid within the scope of Article 107(1) TFEU.²⁰¹

The Commission argued further that if the State aid would be held to be compatible under Article 107(3)(b) TFEU the measure had to fulfil the conditions of: *appropriateness, necessity and proportionality*.²⁰²

To fulfil the condition of appropriateness, the objective of the measure need to be well targeted. In this case, the question was whether the measure would be able to “remedy a serious disturbance in the entire economy”. The Commission argued that the guarantee scheme in the Irish case had the objective of restoring confidence in the banking system. The situation on the

¹⁹⁹ Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society.

²⁰⁰ Commission Decision, NN 48/2009, para. 47.

²⁰¹ Commission decision, NN 48/2009, paras. 48-51.

²⁰² *Ibid.*, para. 58.

financial market with a total loss of confidence, liquidity problems and the risk of failure of sound and unsound banks called for governmental intervention to restore normal market conditions. There was a consensus, that this specific guarantee scheme could be a useful tool to remedy these problems and thus an “appropriate measure”.²⁰³

Under the exceptional circumstances of the financial crisis, the very broad scope of the scheme was held to be limited to the minimum necessary. The guarantee goes further than any previous decisions, but this was acceptable if specific restrictions to avoid distortion of the competition were accompanied to the guarantees. The time frame of two years was also held to be necessary for obtaining full effect of the measure. The usual six month is appropriate in relation to Rescue aid, but measures that target the financial stability of the entire economy of a Member State needs a minimum of two years in order to be efficient.²⁰⁴

Last, as regards to the proportionality, the distortions of competition was held to be minimized by the various safeguards added to the terms of the guarantee. Without doubt, granting such an extensive guarantee scheme would affect the competition on the internal market. The Commission however held that the additional behavioural safeguards included in the scheme would be sufficient enough to minimize distortion of competition.

The final decision was according to the Commission, in compliance with EU state aid principles and a decision not to raise any objections against the scheme was delivered. The scheme is, after alterations of the Irish government, non-discriminatory. All banks with systemic relevance to the Irish economy, regardless of origin are covered by the guarantee scheme. A fair contribution to the scheme by the beneficiaries was secured through a certain pricing mechanism of the guarantee.

The scheme was implemented with additional safeguards against abuse of the scheme, restrictions on commercial conduct of the banks and restrictions on balance-sheet growth. The competitive behaviour of covered banks was controlled in order to minimize any distortion of the competition. In addition, restructuring measures, addressing the governance of the banks, were added to the scheme. These measures were especially relevant if the guarantees had to be called upon. The objective of these measures was to build long-term viability of all the covered institutions.²⁰⁵

²⁰³ Ibid., para. 59

²⁰⁴ Ibid., para. 65

²⁰⁵ Ibid., para. 72

5 ANALYSIS OF THE CURRENT STATE AID POLICY IN THE LIGHT OF THE FINANCIAL CRISIS

A year after the first state interventions, we have actually seen signs of economic recovery within the European Union. The situation on the financial market has been improving in early 2009, but situation for banks is most likely going to be challenging for a further period of time.²⁰⁶ It is widely thought that measures have been effective in avoiding a meltdown of the financial markets, in restoring confidence in the financial markets as well as in the real economy²⁰⁷

To analyze how efficient national State aid schemes are on stabilizing the financial market, several so called *stress indicators*²⁰⁸ are analyzed. These stress indicators validates that there has been a stabilization of the financial market and that the measures have been and are necessary to obtain a normal market functioning. This stabilization may be due to the State aid measures taken by Member States since late 2008.²⁰⁹ According to the IMF Global Financial Stability report, the policy interventions implemented by Member States have reduced the risk of a systemic crisis and have laid the foundations for an economic recovery.²¹⁰

There is a consensus that the State aid measures have been effective and necessary for obtaining financial stability.²¹¹ The short-term objective of stabilizing the financial markets has been reached. The question still remains whether the long term effect on competition has been sacrificed. It seems as if the short-term stability has been prioritized in favour of possible distortion of competition. Direct negative effects on the competition have been mitigated by adding behavioral safeguards to the decisions. The question is however if these safeguards are counterproductive to the main objective of the measures of creating long term-viability. If banks are constrained by safeguards, could they really be governed effectively in the long run?

²⁰⁶ ECOFIN, 2009, p.12

²⁰⁷ Interim forecast, September 2009,

²⁰⁸ Examples of *stress indicators i.a.*; inter-bank interest rates and spreads and indicators of default expectations.

²⁰⁹ ECOFIN, 2009, p.7

²¹⁰ GFSR, July 2009, p.1

²¹¹ However, all Member States have not taken measures in response to the crisis. There are 10 Member States that have not taken any public interventions to support the financial sector: Cyprus, Malta, Slovakia, Estonia, Czech Republic, Poland, Lithuania, Bulgaria and Romania. It is interesting to note that it is mostly newly acceded Member States.

Nonetheless, the importance of the implemented measures cannot be questioned. State aid in relation to banks is particularly important for the financial sector, as the State can be the lender of last resort in financial troubled times.²¹² State aid to the financial sector is necessary to avoid a systemic crisis or a collapse of the financial system.

The positive effects on the financial markets of State interventions have clearly outweighed the possible negative effects on competition. Member States and the Commission has been forced to intervene, the stability of the financial sector is simply too important. After the Commission changed its approach and started to apply Article 107(3)(b) TFEU as a legal basis for approving measures, the stability of the financial markets has been the primary focus and possible negative effects has been secondary. Negative effects on competition have been mitigated by attaching compensatory measures to the approved decisions. Ultimately, we have seen a transfer of risk from the private sector to the public sector.

Studying the decisions from the Commission it is obvious that until the recent financial crisis, application of Article 107(3)(b) and a “serious disturbance” in relation to banks in difficulties was inexistent. The failure of individual banks was not believed to be able to affect the entire financial sector. But the Commission’s approach changed after the failure of Lehman Brothers. Letting Lehman Brothers fail, a bank that was held to be *Too Big Too Fail*, even if its business model is questionable, was detrimental to the market and affected the remaining banks. This is an evidence of the high degree of integration and interdependence of the financial markets, not only the European financial markets but also in a global context.

Inter bank lending is very common, banks are one other’s creditors, a failure of one affects the other’s as creditors. A failure is also bound to affect the pricing and the confidence in various financial instruments. For the above stated reasons, the need for a swift intervention to avoid a systemic crisis is needed. This has been fulfilled by the Commission. Notified rescue measures have been swiftly given a decision.

State aid measures that previously took several months to be analyzed and approved by the Commission were decided in days. Decisions on emergency rescue measures have been taken in very short time periods, according to the “Banking Communication” the Commission promised to be able to deliver a decision within 24 hours or over a weekend. Rescue measures might however take longer time, since the analyses are more complex in order to determine whether or not the proposed aid measure is capable of restoring the long term viability of the company.

²¹² Casu et al., 2009, p. 123.

That the Commission has had such a key role in the coordination of Member states' action is unique. The objective has been to keep the level playing field, preserving the internal market and stop Member States to engage in protectionist subsidy races. The safeguarding of the internal market is another aspect of the Commission's State aid policy. National interventions, in many different approaches, have been coordinated through decision-making by the Commission. The high level of coordination has probably been crucial for the return to viability and has effectively prevented Member States to engage in subsidy races.

The Commission is well aware of that rescue and restructuring aid must be accompanied by restructuring plans on how to change banks unsustainable business models. Sometimes liquidation is the only option to ensure a financial stability.²¹³

The legal shortcomings in the area are evident. Questions of the admissibility of State aid is more than anything else a political question. Economic analysis and legal aspects have to give in for political considerations. And even if the SAAP introduced a more economic approach to analyze State aid decisions, decisions are taken more on a political consideration than a legal or economic basis. It is believed to be easier to get to the core of the market failure with a stronger economic approach towards state aid analysis. Conducting a proper analysis and defining the very reason for the market failure, be it externalities, imperfect information or coordination problems, is crucial. A decision made by identifying these parameters, is far better than a decision made without the economic analysis.

It is too soon to conclude if the Commission has found the right balance between the different competition concerns and the aim of financial stability. On the other hand, what could be concluded is that the Commission effectively has controlled the amount and on what terms state aid has been granted. Hopefully, this has ensured a level playing field and a way back to long-term viability.

It is undisputable that the current financial crisis has had an impact on the European economies. Accordingly, the Commission adopted a temporary framework which would allow temporary aid measures. Member States could be tempted to start a subsidy race and support only their own companies without any considerations for the common market. Individual action, which is connected to subsidy races, has proven in the past to be detrimental to the internal market. In respect to the current financial situation the Commission once again underlined that there is a great need

²¹³ State Aid Scoreboard, 2009 Spring, p. 28.

for a level playing field for European companies and a coordinated framework for national aid measures on a community level.²¹⁴

A disturbing truth is the problem of moral hazard. What are the consequences of supporting banks and thereby protecting owners and creditors previous excessive risk taking? Rescued companies are given an unfair competition advantage, the burden of structural adjustment, social and economic costs are shifted to competitors functioning without aid and to other economies of the common market.²¹⁵

When discussing aid to fundamentally sound banks, which have been affected by exogenous reasons only, the justification for aid is less controversial. But when aid is granted to banks that have been affected by endogenous reasons, the justification is harder. Such banks should not benefit from aid measures without comprehensive restructuring plans. The need for extensive restructuring plans and far-reaching compensatory measures for fundamentally sound banks may be of less importance. In fact, too comprehensive compensatory measures, can serve the opposite purpose of limiting distortion of competition. Compensatory measures may lead to that the ability to functioning most efficiently on the market is constrained. *Coppi et al.* defines three reasons why compensatory measures under Article 107(3)(b) TFEU are not justified.

First, if the aid is compatible there is simply no justification and most importantly the Commission lack power to demand such measures. Second, compensatory measures are only reasonable when aid measures are disproportionate and since aid approved measures pursuant to Article 107(3)(b) are proportionate no further alterations needs to be made. Last, it is questionable if compensatory measures are consistent with the goal of Article 107(3)(b), the long-term viability and the stabilizing of the financial market, this argument is however less persuasive.²¹⁶

Still, it has to be underlined that the response to the financial crisis have been that of national initiatives, but directed by the Commission with a European framework as a base. However, Member States actions have been taken in the coordinated manner that has been the objective of the Commission.²¹⁷ Furthermore, the inadequate financial regulations, has increased the importance of the European State Aid policy.

Rescue measures and other schemes under Article 107(3)(b) will probably strengthen that insurances will come easier in the future if needed, thereby creating renewed incentives for excessive risk taking. Therefore, it is extra important that any rescue and restructuring measures is designed to not

²¹⁴ Temporary Framework, p. 2.

²¹⁵ MEMO/08/363, p. 1.

²¹⁶ Coppi et al, 2009, p. 95.

²¹⁷ Editorial Comments, 2009, p. 9.

create, designed to mitigate problems of moral hazard.²¹⁸ If banks that have not used excessive risk taking as a business model notice that their competitors are bailed out, incentives for running their business based on appropriate risk taking will be lost.

As we have seen, aid schemes must be open to all banks on the market and be non-discriminative. The justification for this criterion is not hard to embrace. But, beneficiaries of aid may get unfair advantages compared to banks that in fact are presenting good figures. If fundamentally *unsound* banks are not distinguished from fundamentally *sound* banks in the granting procedure, this will lead to a distortion of competition, creating fewer incentives to be risk averse and ultimately weaken the long-term competitiveness of the European financial system.²¹⁹

It is not acceptable that banks that decide to get investments and funding from other sources than the State may be punished by getting into a less competitive position. It is therefore of vital importance that the remuneration of guarantees and all other state aid instruments are as close to the corresponding market prices.

Saving all institutions on the legal basis of Article 107(3)(b) might have been a point to save the financial system during the undergoing crisis, but not after the crisis is over. Non-viable banks definitely need restructuring, something that *Neelie Kroes* time after time has underlined. And other measures aimed at limiting distortion of competition

Support to the financial sector must not only help the banks, but it must also benefit the economy at large. Governmental intervention must be made at a national level, but to be sure that Member States does not engage in subsidy races a tight coordinated framework based on the Community rules must be established.

It is however a fact that we have an abundance of financial regulation already implemented on the European market and within the European Union. Obviously, the implemented financial regulations “Banking Directives” are not strict enough to prevent financial players from e.g. engage in excessive risk taking.

The logical way to solve the problem would not be using the competition framework and State aid policy as a solution. The most reasonable way to address the problem in the financial sector in the long term would be to revise the financial regulations and adapt the provisions to the prevailing circumstances. This would be a way to address the root of the problem and a much more satisfying result than the indirect financial sector regulation with

²¹⁸ Maes, p. 4.

²¹⁹ Foecking at al, 2009, p. 2.

e.g. behavioral constraints and compensatory measures that are included in every state aid decision.

At a first glance the Banking Communication and the temporary framework may seem to introduce new aspects of State aid control. It is true that use of the exemption in Article 107(3)(b) TFEU was made available as a legal basis to grant measures. Instead of individual rescue and restructuring aid under the R&R guidelines, the Member States were given an option to address problems affecting the entire Member States economy. Another difference is the acceptable duration of aid measures. The strict six month rule under the R&R Guidelines was extended under the Banking Communication for as long as the aid measures were necessary. But, at the end of the day, the reality is more of an illusion of a temporary framework.

To sum up, with exception for the above stated rules, the communicated policies from the Commission is in line with their previous State aid policy. It is an illusion that the new temporary frameworks bring any big changes to the Commission's manifested State Aid Policy. Instead, the recent development has been more of a clarification and codification of the Commission's previous work within the legal field. What is true is however that the Commission has increased legal certainty by drafting their Communications and that increased coordination of State aid on a European level have given satisfactory results on the financial market. The short term goal has been the stabilizing the financial markets and hopefully the long term goal of healthy competition have not been undermined. After all, the legal shortcomings may perhaps be the solution to financial crisis, giving more room for economical and political considerations.

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