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State Aid and the Financial
Crisis. A Special View from
Iceland

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Summary

European State Aid Law is rapidly becoming one of the most important area of law within the European Union. Since the beginning of 1970 the Commission and the Court have had to deal with more and more State Aid cases as it grew in correspondence with its growth. There has not been an extensive work done on State Aid until this Millennium with the works of Kelyn Bacon and Mark Heidenhain right up there as one of the most detailed works done on the subject of State Aid. Notwithstanding, the current Financial Crisis has raised State Aid awareness through the roof now when nearly every government within the European Economic Area is applying for an exemption to the State Aid rules located in Article 107(1) TFEU and Article 61(1) of the EEA Agreement. In fact, to see the growing value of State Aid rules one only needs to look at one number: 4506,47. In reality, that number says more than words ever could as it represents the total amount of State Aid granted in the Financial Crisis from the beginning of 2008 to the 30th of September in 2011 by the 27 EU Member States.

The thesis seeks to examine State Aid granted to the banks in the context of the Financial Crisis by the Commission and ESA. In order to sufficiently illustrate the importance of a closer examination of those State Measures one needs to have a basic understanding of the State Aid Rules. Thus, the author, will examine the conditions of State Aid located in Article 107(1) TFEU. In addition, the author will raise current controversial issues in applying the conditions at the Court when appropriate. Moreover, the Commission's role will be further examined and the exemption power based in Article 107(3) that the Treaty expects them to fulfill. Then, gradually the author will move under the scope of ESA within the EFTA part of the European Economic Area and extensively discuss several decisions issued by ESA on the Icelandic Banks. The bad effects of the Financial Crisis really started in Iceland when the Big Icelandic Banks fell in a considerable short amount of time. Those banks held over 80% of the market and all required the Icelandic authorities to step in and rescue them. It had a huge effect on the Icelandic Economy as suddenly a debt free treasury had large amounts of debt with the currency plummeting at an alarming rate. What makes the situation even more remarkable is the unbelievable amounts of debt that followed for the Icelandic authorities estimated at two or three times its GDP. In reality, because of the large amounts of debt that came with the banks Iceland could not go the more traditional way that existed in Europe at the time. Therefore, forcing them to take extra-ordinary measures to rescue and restructure the

banks with the result being three new banks: Íslandsbanki, New Kaupthing and New Landsbankinn.

Samantekt

Evrópsku Ríkisaðstoðarreglurnar eru fljótlega að verða að einum mikilvægasta parti Evrópusambandslaga. Frá byrjun 1970 hefur Framkvæmdaráð Evrópusambandsins og Evrópudómstóllinn þurft að fást við sífellt fleiri ríkisaðstoðarmál þar sem mikilvægi þeirra hefur aukist. Það hefur ekki verið gefið út nákvæmt og ítarlegt rit um ríkisaðstoð þangað til á þessari öld með verkum Kelyn Bacon og Mark Heidenhain sem eru nálægt toppnum yfir það að vera best rituðustu verkin á sviði ríkisaðstoðar. Þar að auki hefur Fjármálakrísan aukið vitund fólks um ríkisaðstoð svo um munar nú þegar næstum hver einasta ríkisstjórn á Evrópska Efnahagssvæðinu sækist eftir undanþágu frá ríkisaðstoðarreglunum sem eru staðsettar í 107(1).gr. Samnings um Stofnun Evrópusambandsins og 61(1) grein EES samningsins. Staðreyndin er sú, að til að átta sig á auknu vægi ríkisaðstoðarreglnanna þarf maður aðeins að líta á eina tölu: 4506,47. Í raun, þá lýsir þessi tala því mun betur en nokkurt orð gæti gert hversu mikla ríkisaðstoð 27 ríki Evrópusambandsins hafa gefið frá byrjun krísunnar 2008 til 30. september 2011.

Þessi ritgerð mun því leitast eftir því að skoða ríkisaðstoð sem hefur verið veitt bönkum í núverandi Fjármálakrísu af Framkvæmdaráði ESB og ESA. Til að sýna fram á það á sem bestan hátt hve mikilvægar reglurnar eru í því samhengi verður byrjað á því að líta yfir almennar ríkisaðstoðarreglur Evrópusambandsins til þess að fá ákveðin grunn í þau mál. Því mun höfundurinn skoða skilyrði ríkisaðstoðar sem eru staðsett í 107(1) gr. TFEU. Þar að auki mun höfundurinn varpa fram umhugsunarverðum og umdeildum álitaefnum, þegar það á við, varðandi það hvernig Evrópudómstóllinn hefur túlkað skilyrðin. Því næst mun staða Framkvæmdaráðs ESB vera skoðuð nánar og þá vald þeirra sem er upprunið frá the Treaty í því að gefa undantekningar við ríkisaðstoðarreglurnar sem er staðsett í 107(3).gr. TFEU. Svo mun höfundur smám saman færa sig inn á svið ESA og þá hvernig það hefur beitt sömu reglum gagnvart EFTA ríkjunum innan EES og þá sér í lagi Íslandi. Það er mikilvægt fyrir þá staðreynd að fyrstu raunverulega slæmu áhrif Fjármálakrísunar byrjuðu á Íslandi þegar stóru bankarnir féllu á ótrúlega stuttum tíma. Bankarnir höfðu haldið 80% af heimamarkaðnum og samt sem áður þurftu þeir allir á því að halda að stjórnvöld gripu inn í reksturinn og björguðu þeim. Sú aðgerð hafði afgerandi áhrif á íslenskan efnahag þar sem að skyndilega hafði áður skuldlaust land tekið á sig gríðarlegar skuldir með hríðlækkandi gjaldmiðli. Það sem gerir stöðuna enn merkilegri eru þær gríðarlegu skuldir sem fylgdu falli bankanna fyrir íslensk

stjórnvöld eða áætlaðar skuldir upp á næstum 3 sinnum verga árs landsframleiðslu . Í raun, vegna gríðarlegra skulda sem fylgdu bönkunum þá gátu íslensk stjórnvöld ekki farið ríkjandi leiðina til að bjarga bönkum á þeim tíma sem var algeng innan Evrópu og þá sér í lagi í Fjármálakrísunni sem átti eftir að dreifa sér um alla álfuna. Þannig að, íslensk stjórnvöld neyddust út í áhættusamar aðgerðir með því að bjarga og endurskipuleggja á annan hátt en tíðkaðist í Evrópu. Úr þeim aðgerðum komu þrjú glænýir bankar úr þeim gömlu: Íslandbanki, Nýi Kaupþing og Nýi Landsbankinn.

Preface

Finally I am at the end of a journey into State Aid Law in the Financial Crisis. When I first started out back in January I only had a basic idea of what I was going to write about but as soon as I received that first letter the path became clearer. In the end the focus turned dramatically to Iceland in the Financial Crisis when I found several interesting issues in ESA's approach to the Crisis.

Needless to say I am extremely grateful for my family, my beautiful fiancée Guðrún Helga and my wonderful girls Írena Rún and Ásta Sýlvía for enduring me all those days I locked myself in my office reading and writing. In addition, I am grateful for the support and guidance Henrik Norinder, my supervisor, gave me throughout the thesis writing process. It really helps when one seems highly interested in reading your thesis. Lastly, I would like to thank Daníel Ingi Þórarinsson and Haukur Viðar Guðjónsson for reviewing my thesis in a splendid manner.

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Abbreviations

Althingi = The Parliament of Iceland

Big Icelandic Banks = The three largest banks of Iceland before the Financial Crisis. Glitnir, Kaupthing and Landsbankinn.

Community Courts = The CJEU and the General Court of the European Union

CSO = Central Statistics Office of Ireland

EFTA = European Free Trade Association

Emergency Act = An act of Althingi no. 125/2008 on the authority to finance from the treasury because of special circumstances on the financial market etc.¹

ESA = European Surveillance Authority of EFTA

EU = European Union

EURIBOR = The rate which Euro interbank term deposits are offered by one prime bank to another prime bank within the Eurozone

Financial Crisis = The Financial Crisis that effectively started with the fall of Lehman Brothers in the USA

FSA = Financial Supervisory Authority of Iceland

GDP = Gross Domestic Product

Icelandic Banks = Applies to every Icelandic Bank that ESA has examined and is discussed in this thesis. For matter of convenience, IHFF is subject to the term as well

IHFF = Icelandic Housing Finance Fund

Íslandsbanki = New Glitnir Bank

Market Value = The value that an impaired assets could have obtained in the market

MEIP = Market Economy Investor Principle

¹ Páll Hreinsson, Tryggvi Gunnarsson and Sigríður Benediktsdóttir "The SIC Report" [2010] Volume 7, p. 105-106

NR = Northern Rock

Real Economic Value = The underlying long-term economic value of the assets on the basis of underlying cash flows and broader time horizons

SGEI = Services of General Economic Interest

SIC = Special Investigation Commission which was established in December 2008, to investigate and analyse the processes leading to the collapse of the three main banks in Iceland. The Members of the Commission were a Supreme Court Judge, Mr. Páll Hreinsson, the Parliamentary Ombudsman of Iceland, Mr. Tryggvi Gunnarsson, and Mrs. Sigríður Benediktsdóttir Ph.D., lecturer and associate chair at Yale University, USA. Summary of the report in English is located at <http://sic.althingi.is> and in Icelandic at <http://www.rannsoknarnefnd.is>

State Measure = A measure that can either be considered to be State Aid in the meaning of Article 107(1) TFEU and Article 61(1) of the EEA Agreement or be considered as a general measure

State Aid = An aid measure that fulfills the conditions laid down in Article 107(1) TFEU and Article 61(1) of the EEA Agreement

TEU = Treaty on European Union

TFEU = Treaty on the Functioning of the European Union

The Commission = The Commission of the European Union

TIAC = Treatment of Impaired Assets

Transfer Value = The value attributed to impaired assets in the context of an asset-relief program

Treaties = TEU and TFEU

Treaty = TFEU

1 Introduction

In 2008 the situation of numerous financial institutions in Europe was delicate with increasing shortage of liquidity on global financial markets was starting to take its toll on the Big Icelandic Banks. In Iceland, the problem was, simply stated, that the Big Icelandic Banks had become too large,² and increasingly dependant on raising funds through international financial markets.³ With the fall of Lehman Brothers on 15. September 2008 most often referred to as one of the most decisive factor in the Icelandic crisis as access to liquidity got more difficult.⁴ Merrill Lynch, AIG and HBOS soon followed and later that month the Central Bank of Iceland received a request for recapitalisation from Glitnir with four loans looming over Glitnir in October amounting to a total 600 million EUR.⁵ The Icelandic Government officially announced that it would recapitalise Glitnir with 600 million EUR and thereby acquiring 75% of the shares in Glitnir,⁶ with that plan later abandoned due to further deterioration in the financial position of the bank.⁷ Subsequently Althingi passed the Emergency Act on the 6th October 2008,⁸ Landsbankinn fell the next day,⁹ and finally Kaupthing on the 9th October 2008 with the FSA taking control of the Big Icelandic Banks through the Emergency Act.¹⁰ Soon, Europe began to struggle with Ireland seemingly the first EU Member State to encounter severe difficulties with their biggest banks which lead to the CSO officially announcing that Ireland was in recession on the 1st Sept. 2008.¹¹ From the beginning of the Financial Crisis in 2008 all up to 30th of September 2011 a staggering amount of 4506,47 billion EUR has been spent by the 27 EU Member States on State Aid to counter the repercussions of the Financial Crisis through bank guarantees, recapitalisation schemes, asset reliefs or other liquidity measures.¹² That makes approximately 36,73% of the

² Ibid. 244; Páll Hreinsson, Tryggvi Gunnarsson and Sigríður Benediksdóttir “The SIC Report“ [2010] Volume 1, p. 208

³ ESA Decision in Case 492/10/COL *Kaupthing banki hf* [2011] OJ C41 7, p. 4-5; The SIC Report Volume 1, p. 208 (cited in fn.2)

⁴ The SIC Report Volume 1, p. 7 (cited in fn. 1)

⁵ Ibid.

⁶ Ibid., p. 36

⁷ ESA Decision in Case 494/10/COL *Glitnir Banki hf* [2011] OJ C41 51, p. 1

⁸ The SIC Report Volume 7, p. 105 (cited in fn. 1)

⁹ Ibid., p. 148

¹⁰ Ibid., p. 159-160

¹¹ See statistics report in 2008 from the Central Statistics Office in Ireland

¹² The European Commission, “II. State aid in the context of the financial and economic crisis“ (Table: State aid approved (2008 – Oct 2011) and state aid used (2008 – 2010) in the context of the financial and economic crisis to the financial sector (2008 – 2010), in billion Euro)

total EU GDP of 2010.¹³ The State Aids granted by the three EEA participating EFTA states have not been significant compared to the total amount spent within the EU as only Iceland and Norway have notified State Aid granted to their banks.¹⁴ In addition, Iceland is the only EFTA state that has only granted State Aids to fundamentally unsound banks with the total amount notified to the Commission somewhere around 49 million EUR in the Financial Crisis.¹⁵ Thus, the Big Icelandic Banks are not located within that figure which questions the ESA's decision to even put a figure forward. Especially, in the light that it is public knowledge that the figure will not even be close to that number as it will at least amount to a staggering 20 billion EUR and will most likely turn out to be considerably higher when the Icelandic Government decides to publish every detail of its rescue operation.¹⁶ Safely stated, State Aid is rapidly becoming one of the most important sectors in the European Union as it is the last line of defence in safeguarding and preventing distortions of competition within the EU by ensuring that rescue and restructuring measures applied by the Member States are reasonable justified and that Member States do not overstep their boundaries. Instead of the current Financial Crisis revolving around Member States protecting their own national champions the Commission has used the State Aid rules to ensure a level playing field within the European Union as expressed in the Treaty.¹⁷

1.1 The Objective

As previously stated the Commission has played a huge role in the Financial Crisis with its numerous decisions on general schemes and individual bank measures provided by the Member States which have amounted to billions of EUR. Subsequently, a lot has been written on the Commission's approach to the Financial Crisis. On the contrary, not much has been written on ESA's approach to the Financial Crisis regarding state measures granted to the Icelandic Banks. Thus, the main objective is to examine whether ESA's approach to the ailing banks in Iceland was acceptable in light of the State Aid rules found in Article 61(1-3) in the EEA Agreement. In addition, the author will try to determine whether ESA has applied a softer approach to the Icelandic Banks than its European counterpart. To that end the author

¹³ See fn. 10

¹⁴ ESA, "State Aid Scoreboard" (Winter 2011), p. 17

¹⁵ ESA, "Press Announcement on State Aid Scoreboard: Different Exposure to Financial Crisis" PR(12)11

¹⁶ The Ministry of Finance, "A-hluti Sjóðstreymi ríkissjóðs. Eiginfjárframlög til bankakerfisins" [2009] Icelandic Budget Act, p. 4. That number will be a lot higher when considering measures such as the government's capitalisation of Íslandsbanki in the form of government bonds. ESA decision on Glitnir bank, p. 9 (referred fn. 7)

¹⁷ For that purpose, notice the 5th paragraph in the Preamble and Article 119 TFEU.

will reveal the change in the Commission's approach from applying Article 107(3)(c) TFEU to applying Article 107(3)(b) TFEU, the reasoning behind it and the impact it has had. Moreover, ESA's approach will be heavily scrutinised in relation to the Financial Crisis in Iceland and the numerous measures taken by the Icelandic authorities. With that, the author will express his opinion on several decisions made by ESA. Thus, ESA will be encouraged to take a harder stance against Iceland and reduce the flexibility it has offered to the Icelandic authorities in the Financial Crisis. Moreover, throughout the latter part of the thesis comparison will be made between ESA's decisions and similar decisions made by the Commission when appropriate.

1.2 Materials

In a sense, the most important provisions for State Aid are located in the TFEU as it is the ultimate basis for actions taken by the Commission and the soft law it has issued. Nonetheless, it would be extremely hard if the Commission only had the TFEU to base their decisions on as Member States would rarely know when their measures constituted State Aid and thus prohibited by Article 107(1) TFEU. Meaning that it would be a strong violation of the principle of equal treatment which spreads through every area in the European Union.¹⁸ Therefore, nearly equally important rules on State Aid are found in the Commission's soft law with plenty new guidelines having been issued in the context of the Financial Crisis. In addition, the Commission has applied its soft law in the Financial Crisis to numerous financial institutions and by that clarified and explained their soft law. To grasp a full understanding of State Aid it must be known how it has been applied. Therefore, the author will look into the decision making practice of the Commission. Moreover, ESA's decisions will not go unnoticed since they form the most important part of this thesis as previously stated. Not to forget, the Court's case-law will be examined when appropriate. Lastly, the thesis will also express the opinion of several scholars and article makers in various sections.

1.3 Previous Works

Recently a lot of extensive work has been issued on State Aid and the Financial Crisis in Europe. Two books deserve a special mention in that regard. Kelyn Bacon's *European Community Law of State Aid* proved extremely helpful, especially regarding the conditions of State Aid. The other one that proved invaluable when getting an overview of the

¹⁸ See e.g. the 3rd paragraph in the Preamble, Articles 2, 3(3), 4(2) and 9 TEU and Articles 8, 153(1)i and 157(1) TFEU.

Commission's Soft Law and approach to State Aid in the Financial Crisis was Martin Heidenhain's European State Aid Law Handbook. Another publication which deserves a special mention is Eoin Pentony's thorough examination of Ireland's approach to State Aid in the Financial Crisis in his dissertation "Is the European Commission's recent interpretation of Article 107(3)(b) a departure from established State aid policy on the financial sector?" It was a big factor in the author's decision not to cover the Ireland's approach as it has already been heavily scrutinised, especially the Commission's decisions on AngloBank.

1.4 Delimitation

Originally, the author considered to give more weight to the Commission's approach in the thesis but after seeing extensive works in that area decided against it. Strictly speaking, it was not necessary to review a whole bunch of Commission's decision for comparison to be efficiently made. The decisions and the reasoning of the Commission in numerous cases on the Financial Crisis are often hard to distinguish from one another. As of yet only one negative decision has been made by the Commission on the basis of Article 107(3)(b) TFEU in the Financial Crisis with the decision being made against a Hungarian fertiliser producer.¹⁹ Thus, no negative decision has been issued towards the banking sector by the Commission in the context of the Financial Crisis. With that said, there is little difference in the end result of the Commission's decision and therefore, the author has deemed it sufficient to examine the classic Northern Rock case on the application of the R&R Guidelines, the huge Danish Scheme and one asset relief case in full detail. Various reasoning from other Commission's decisions will be introduced when appropriate for comparison. However, little discussion has been introduced on the EFTA front regarding ESA's approach to the Icelandic Banks with little material being produced by Icelandic scholars on the subject. One would therefore assume that many are waiting for ESA's final decision on the Icelandic Banks' restructuring plans. Regardless, one negative decision has actually been issued by ESA which effectively makes that case more interesting to examine than those gone before in the EU. With that being said, a neutral bystander can see the importance of the decision to focus on ESA's approach to Iceland as extensively as possible.

1.4 Structure

First, the conditions of State Aid will be examined in detail to ensure a basic understanding of the State Aid system because for a state measure to be exempted it must first

¹⁹ *Potential aid to Peti Nitrogenmuvek* (Case C-14/2009) [2010] JOCE L/118/2011

have been considered as State Aid in the meaning of Article 107(1) TFEU. It must be considered to entail State Resources, grant an Advantage and be Selective and lastly it must Distort Competition and Affect Trade between Member States to come under the scope of Article 107(1) TFEU. In addition the aid cannot be so insignificant that it amounts only to an Amount de Minimis otherwise it will fall outside the scope of Article 107(1) TFEU. In addition the author will raise an important question regarding the State Aid conditions by looking at new and interesting issues that may have surfaced recently in the Court.

Subsequently, The Commission's role in the State Aid area and in the Financial Crisis will be outlined in the endeavor to see the different role Commission has in the aforementioned area. Furthermore, the exemptions located in Articles 107(3)(b) and 107(3)(c) TFEU will be thoroughly examined in relation to the Financial Crisis and the Commission's soft law. The author will look at the situation before and up to the Financial Crisis where Article 107(3)(c) TFEU was heavily applied in situations relating to failing undertakings with Article 107(3)(b) TFEU rarely applied before the crisis. That framework continued at the start of the Financial Crisis with Northern Rock being assessed under the Rescue and Restructuring Guidelines rooted in Article 107(3)(c) TFEU and with that the author will express reasons for why the R&R Guidelines were applied and why they weren't considered, necessarily, to be the best way to handle the Financial Crisis. The Commission soon saw difficulties in that approach with the main argument involving the definition found in the R&R Guidelines, centering on the fact that firms had to be experiencing difficulties in order to come under the scope of the Guidelines and so the approach shifted to Article 107(3)(b) TFEU and the Commission's soft law based on that provision.

The most famous, and perhaps most interesting decision was The Northern Rock case which will be addressed but that was more of an ad hoc approach with the Member States, soon after, changing their approach by starting to deal with the Financial Crisis through large schemes. Thus, the Danish General Scheme to their banking sector will be examined in that light and for the sake of comparison to Iceland's actions in dealing with the Financial Crisis and ESA's approach to Iceland. As previously stated, ESA's approach to the Icelandic banks will be thoroughly examined with the author comparing the Icelandic way to the European way as there are clearly some notable differences to the approaches. No better way to start than by looking at the Big Icelandic Banks which hold about 90% of the market in Iceland. Therefore, the state measures granted to the Big Icelandic Banks in the Financial Crisis will be approached with the author expressing his views on the measures but what's highly

interesting with the case is the competition aspect of it as the Big Icelandic Banks hold 90% of the national market. Another interesting case in that connection is the ESA decision on BYR, effectively the fourth biggest bank in Iceland, where BYR had started to encounter extreme financial difficulties and was subsequently taken over by the government. Being the fourth biggest bank in Iceland it was basically the only other competitor to the Big Icelandic Banks. Furthermore, ESA needed to take another decision the same year when the Icelandic authorities decided to sell BYR and after a thorough sales process Íslandsbanki received state measures for the acquisition of BYR. Effectively, Íslandsbanki, one of the Big Icelandic Banks, had taken over the fourth biggest bank in Iceland. This case is extremely dumbfounding when considering the contradiction between the two decision with ESA still trying to argue their way around it. Next, the Icelandic Housing Financing Fund will be examined as the author finds it curious in relation to the Commission's approach to state guarantees in the Financial Crisis as the IHFF by nature has a state guarantee by being a state undertaking while the banks seemingly do not. Notwithstanding, the IHFF decisions are closely linked to ESA's decision on the Big Icelandic Banks as will be illustrated. Moreover, the only negative decision concerning recovery within the EEA in the Financial Crisis will be discussed and the author will illustrate why ESA took a different approach than the Commission Finally, the author will analyse the situation in the EEA by expressing his concerns on the Commission's and ESA's decision making practice and point out what could have been done better.

2 The Conditions of State Aid

A popular belief is that State Aids can easily be distinguished from general measures as they simply consist of a direct payment made by the state to a specific undertaking. But what people soon come to realise is that it has never been that simple. Even the Court, in its early days, concluded that the status of the institutions which administered the aid, and therefore distributed it, were not primarily important when considering whether it fell under Article 107(1) TFEU,²⁰ but rather the effect of the aid granted to undertakings or producers.²¹ Then several years later the Court, by confirming the Commission's assessment, ruled that loans and state guarantees made by the French Government to a French undertaking were to be considered as State Aid.²² Those cases originate all the way back to 1977 and 1988 and State Aid has been under constant scrutiny ever since with more and more measures falling within the scope of 107(1) TFEU.²³ While, on the other hand, the first ever EFTA State Aid case did not arrive before the EFTA Court until March 1999,²⁴ when it ruled on whether ESA was right in its assessment on the necessity of the aid granted to the Husbank, a state housing bank primarily intended to finance housing.²⁵ With years passing by, things have changed considerably and now it is accepted that there are broad types of measures that fall within the concept of State Aid in Article 107(1) TFEU. State Aid exists in many different forms; from a direct payment given to an undertaking to a situation where an undertaking can be relieved of paying taxes. But what does it take for a given state measure to be considered as State Aid? That is where the conditions on State Aid come into play. State Resources, Advantage, Selectivity, Distortion of Competition, Affect to Trade between Member States and Amount de Minimis are numerous criteria that need to be considered. For the purposes of this thesis it is important that the reader has a basic understanding of State Aid and its conditions. For a

²⁰ In this thesis, for simplicity, the author will always refer to the newest Treaty Article on State Aid located in Article 107(1) TFEU. Previous Articles as e.g. Former Article 87 of the Treaty establishing the European Community (with the only change being Treaty to Treaties) have materially the same meaning and effect with the exception of the constant evolutionary case-law of the Court changing the scope of the provisions. Thus former Treaty provisions on the conditions of State Aid applied by the Court will be referred to as 107(1) TFEU for simplicity. On the other hand, Article 61(1) in the EFTA agreement will always be addressed when looking into the ESA's approach to Iceland with those two being equivalent in light of the principle of homogeneity in Article 1(1) of the EEA Agreement and the principle of loyalty in Article 3 of the EEA Agreement

²¹ Case 78/76 *Steinike Und Weinlig v Germany* [1977] I-00595, para 21

²² Case 102/87 *French Republic vs Commission* [1988] I-04067, para 14

²³ Kelyn Bacon, *European Community Law Of State Aid* (Oxford University Press 2009) 26-29

²⁴ With that said, it should be in mind that the EFTA Court was not formed until 1994.

²⁵ Case E-4/97 *Norwegian Bankers' Association v ESA* [1999] EFTA Court Report 1.

closer inspection we look to the provisions on the State Aid conditions located in the TFEU and the EEA agreement. Article 107(1) TFEU states:

1. Save as otherwise provided in the Treaties, 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 internal market.

Then Article 61(1) in the EEA agreement:²⁶

“Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States 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 Contracting Parties, be incompatible with the functioning of this Agreement.”

In those provisions, the most important conditions of State Aid to date can be located:²⁷

- 1) *Granted by a Member State or through State resources;*
- 2) *Distorts Competition;*
- 3) *Advantage;*
- 4) *Selectivity;*
- 5) *Affects trade between Member States.*

Then an interesting condition introduced by the Commission

- 6) *Amount de Minimis.*

As previously stated, State Aid has been further developed by the Commission and in the riches of the Court’s case-law with the Amount de Minimis policy an important factor to consider.

2.1 Any aid granted by a Member State or through State resources

At the outset, it should be noted that after the selectivity criterion, this has caused the most widespread debate among scholars, and even within the Court of Justice of the European Union itself. For those believing their understanding of English grammar quite strong it comes as a surprise that there is more than meets the eye. In *Commission v France*, the Court took a more logical approach when considering whether a fixed tariff charged for a source of

²⁶ This will be the first and only time where the author will state identical rules from both agreements. Out of necessity which is outside the topic of this thesis the EEA agreement is worded in a different way but when it comes to the thesis topic and the rules there within the Provisions are identical in substance. In addition, in light of the homogeneous objective and the principle of loyalty, previously referred to in fn. 20, however, the effect of the rules should be the same but that will be further examined.

²⁷ In addition, it is excellently summarised in the *Vademecum Report*. The Commission, “*Vademecum. Community law on State aid*” (2008)

energy at a level lower than that which would normally have been chosen, should fall under the prohibition in Article 107(1) TFEU.²⁸ The court considered that the tariff in question was a result of an action by the Netherlands State as Gasunie did in no way enjoy a full autonomy when it came to fixing of gas tariffs and therefore did fall under the phrase “aid granted by a Member State”.²⁹ With that, the Court does not only imply that the conditions are alternative but in essence holds that they are.³⁰

Thus, the situation before 2001 at the Court was that of an alternative one as the Court repeatedly certified that it was irrelevant whether public or private undertakings granted the aid as long as it came from State Resources.³¹ The purpose of Article 107(1) TFEU is clearly to prevent any distortion of competition,³² and with the intention of the provision stated as to cover all financial means by which the public sector may actually support undertakings, irrespective of whether or not those means are permanent assets of the public sector.³³ However, the Court decided to change their approach which had previously been in line with the purpose and intention of Article 107(1) TFEU. It happened in 2001 with the *PreussenElektra* case, where legislation requiring a private electricity distributor to purchase a specific amount of electricity from renewable energy sources at a State-fixed minimum price was disputed without any discussions or references to the previous case-law. The disputer, *PreussenElektra* which owned conventional and nuclear power stations in Germany, claimed that the difference it had to pay between the market and state-fixed prices of electricity, according to the legislation, was in violation of the Treaty provisions on State Aid.³⁴ Therefore, it sought reimbursement of payments it had been required to make to a regional electricity supplier.³⁵

In that connection, the case-law of the Court of Justice shows that only advantages granted directly or indirectly through State resources are to be considered aid within the meaning of Article 92(1). The distinction made in that provision between ‘aid granted by a Member State’ and aid granted ‘through State resources’ does not signify that all advantages granted by a State, whether financed through State resources or not, constitute aid but is intended merely to

²⁸ Case 290/83 *Commission v France* [1985] ECR 439

²⁹ *Ibid.*, para 14

³⁰ Subsequently confirming that in Case T-358/94 *Air France* [1996] ECR II-2109, para 67; Case C-482/99 *France v Commission (Stardust)* [2002] I-4397, para 37

³¹ See fn. 21

³² See Articles 3(1)(b) and 119 TFEU

³³ *Air France*, para 67 (cited in fn. 30); Case C-83/98 *P France v Ladbroke Racing and Commission* [2000] ECR I-3271, para 50; *Stardust*, para 37 (cited in fn. 30)

³⁴ Case C-379/98 *PreussenElektra* [2001] ECR I-2099, para 23

³⁵ *Ibid.*, para 58; Case C-295/97 *Rinaldo Piaggio* [1999] ECR I-3735, para 42; Case C-279/08 *P, Commission v Netherlands* [2011] ECR I-0000, para 106.

bring within that definition both advantages which are granted directly by the state and those granted by a public or private body, designated or established by the State (see Case 82/77 Van Tiggele [1978] ECR 25, paragraphs 24 and 25; Sloman Neptun, paragraph 19; Case C-189/91 Kirsammer-Hack [1993] ECR I-6185, paragraph 16; Joined Cases C-52/97, C-53/97 and C-54/97 Viscido [1998] ECR I-2629, paragraph 13; Case C-200/97 Ecotrade [1998] ECR I-7907, paragraph 35; Case C-295/97 Piaggio [1999] ECR I-3735, paragraph 35).³⁶

Last September the Court backtracked considerably from its approach taken in PreussenElektra with the Court's ruling in Commission v Netherlands to give way to more uncertainty on the issue.³⁷ In PreussenElektra the Court explicitly ruled that both conditions needed to be fulfilled. The deciding factor there was the lack of direct or indirect transfer of State Resources to undertakings which produced that type of electricity.³⁸ Here, there is a similar situation in the sense that there was a legislation at issue which allowed the tradeability of Nox emission allowances. The Court confirmed the General Court's conclusion by holding that the legislation in question could entail an additional burden for the public authorities as it gave an exemption from the obligation in paying fines and other pecuniary penalties. That is, if an undertaking wanted to avoid a fine, it had the option of buying emission allowances and the state, by allowing the tradeability of Nox emission allowances without selling or putting them up for auction, forwent public resources.³⁹ Strikingly familiar to the facts in PreussenElektra but different conclusions. In PreussenElektra, as the Court submits,⁴⁰ there was an element of diminution of tax receipt for the State but was justified as it was considered that the tax-loss consequence for the State was an inherent feature of such a legislative provision and could not be regarded as constituting a means of granting to producers of electricity renewable energy sources a particular advantage at the expense of the State.⁴¹ With that the Court essentially subdues the meaning of PreussenElektra by making it highly specific for those circumstances. The Court then concluded by stating that it could not be considered as inherent in any instrument designed to regulate emission of atmospheric pollutants by an emission allowance trading scheme. So in the current climate it seems quite

³⁶ Article 92(1) referred to is equivalent to Article 107(1) TFEU.

³⁷ *P, Commission v Netherlands* (cited in fn. 35)

³⁸ *PreussenElektra*, para 59 (cited in fn. 34)

³⁹ *P, Commission v Netherlands*, paras 106-107 (cited in fn. 35)

⁴⁰ *Ibid.*, para 110

⁴¹ The justification aspect of the case is highly interesting but as it is not directly related to the thesis' topic the author will not address it in more detail

unclear what it takes for the State Resources conditions to be fulfilled as the Court seems to back down from the alternative view taken in *PreussenElektra*.⁴²

Moving on, through the extensive case-law of the Court in State Aid all funds and assets of the central government have been considered to be “State Resources“. In addition, funds in the hands of public and private undertakings,⁴³ funds under the control of public authorities receiving parafiscal charges,⁴⁴ or other compulsory contributions and even private deposits at the disposal of the State all fall within the concept.⁴⁵ On the other hand, Community resources not under the control of a Member State will not be considered to be State Resources.⁴⁶ In addition, broad types of measures are considered to be a grant through State Resources such as any direct or indirect grant from State resources,⁴⁷ waivers of charges,⁴⁸ or state guarantees.⁴⁹

2.2 Advantage

Within Article 107(1) TFEU there is a condition of an advantage, that is, you cannot favour any undertakings. The simplest and most classic explanation is that the undertaking obtains an economic advantage which it would not have received under normal market conditions.⁵⁰ Another author puts the importance on favouring an undertaking by granting a positive economic advantage or relief from an economic burden.⁵¹ The common phrasing of the Court these days is that measures which, whatever their form, are likely to favour, either directly or indirectly, certain undertakings,⁵² or are to be regarded as an economic advantage which the recipient undertaking would not have obtained under normal market conditions, and hence are regarded as aid.⁵³ More important tests applied by the Court are the private creditor test and the private investor test, the latter more commonly referred to as the Market

⁴² The disclaimer is that neither was a Grand Chamber case so it remains relatively open what direction the Court is going to take and therefore what effect the most recent judgement will have.

⁴³ *Steinike und Weinlig v Commission*, para 21 (cited in fn. 21)

⁴⁴ Case 173/73 *Italy v Commission* [1974] ECR 709, para 16.

⁴⁵ *Air France v Commission*, paras 65-66 (cited in fn. 33).

⁴⁶ *PreussenElektra*, para 121 (cited in fn. 34); Cases 213-215/81 *Norddeutsches Vieh- und Fleischkontor* [1982] ECR 3583, para 22

⁴⁷ Case 82/77 *Openbaar Ministerie of the Kingdom of the Netherlands v van Tiggele* [1978] ECR 25, para 25

⁴⁸ Cases C-182 and 217/03 *Belgium and Forum 187 v Commission* [2006] ECR I-5479, para 129

⁴⁹ Case C-404/97 *Commission v Portugal* [2000] ECR I-4897, para 44

⁵⁰ Case C-39/94 *La Poste* [1996] ECR I-3547, para 60

⁵¹ Martin Heidenhain, *European State Aid Law. Handbook* (Beck and Hart Publishing 2010) 23. The Author of this thesis will mainly refer to the word advantage without the economic prerequisite on the grounds that it seems more logical as a non-economic advantage would in any case not distort competition

⁵² This wording originating all the way back to *Costa* in 1964. Case 6/64 *Costa v Enel* [1964] ECR 585, p. 595

⁵³ *P, Commission v Netherlands*, para 87 (cited in fn. 35); Case C-280/00 *Altmark Trans* [2003] ECR I-7747, para 84; *La Poste*, para 60 (cited in fn. 50); Case C-342/96 *Spain v Commission* [1999] ECR I-2459, para 41

Economic Investor Principle.⁵⁴ The MEIP is a substantial test made by the Court when evaluating whether there is an advantage. In essence, it is an expression of the basic rule since there is an advantage if a Member State grants an aid to an undertaking that a private investor would not have made under the same market conditions.⁵⁵ A good example would be an aid where a capital investment was made by the State in an undertaking whereas no private undertaking would have invested. Advocate General Slynn has stated most profoundly:⁵⁶

*It is of the essence of a State aid that it is non-commercial in the sense that the State steps in where the market would not. The State may have its reasons for doing so but they are not commercial in the ordinary sense of the word. Thus the State may subscribe for shares in a company or lend money, but when it does so to an extent or on terms which would not be acceptable to the commercial investor, it is granting aid which falls within Article 92 if the tests of that provision are satisfied.*⁵⁷

The Court and the Commission have made this test the basis for their examination of numerous state measures, in particular equity investments, loans, the granting of security and guarantees, the privatisation of State-owned enterprises, the sale of State owned real estate and the undertaking of infrastructure measures. Subsequently, rules on those state measures have been published by the Commission.⁵⁸ In addition, there are several other issues where you apply separate tests.⁵⁹ The criteria of a direct advantage has not been a huge issue for the Commission or the Court and rarely has a measure failed to be considered as State Aid on the ground that there was no direct advantage given.⁶⁰ An issue quite transparent in the Court are tax measures with the Court emphasising the importance of the reference framework in the evaluation on whether an advantage has been given:⁶¹

Consequently, a measure by which the public authorities grant certain undertakings a tax exemption which, although not involving the transfer of State resources, places the recipients

⁵⁴ Hereinafter referred to as MEIP. The private creditor test will not be examined more closely in relation to this thesis as it is closely related to the private investor test and simply covers all the negative measures the State can apply to undertakings, that is relief of debts and etc., while the former test focuses more on positive measures by the state such as investment in an undertaking. More information on the private creditor test can be found e.g. in *European Community Law Of State Aid* 48 (cited in fn. 23)

⁵⁵ Case 234/84 *Belgium v Commission* [1986] ECR 2263, paras 9-18; Case C-301/87 *France v Commission* [1990] ECR I-307, paras 38-9; Case C-305/89 *Italy v Commission* (Alfa Romeo) [1991] ECR I-1603, paras 17-24

⁵⁶ Cases 67,68 and 70/85 *Van der Kooy v Commission* [1988] ECR 219, p. 251

⁵⁷ Article 92 referred to is equivalent to Article 107 TFEU

⁵⁸ *European State Aid Law. Handbook* 24 (cited in fn. 51)

⁵⁹ For more details. See *European Community Law Of State Aid* 26-69 (cited in fn. 23)

⁶⁰ *Nationalisation of Anglo-Irish Bank* (Case N-61/2009) [2009] JOCE C/177/2009, para 36

⁶¹ Case C-222/04 *Cassa di Risparmio di Firenze and Others* [2006] ECR I-289, para 132; Joined Cases C-78-08 to C-80/08 *Paint Graphos and Others* [2011] ECR I-0000, para 46; Joined Cases E-04,06 and 07/10 *The Principality of Liechtenstein, REASSUR Aktiengesellschaft and Swisscom RE Aktiengesellschaft v ESA* [2011] EFTA Court Report 2011, para 70; Case C-387/92 *Banco Exterior de España* [1994] ECR I-877, para 14; Case C-88/03 *Portugal v Commission (Azores)* [2006] ECR I-7115, para 56

*in a more favourable financial position than other taxpayers amounts to State aid within the meaning of Article 87(1) EC. Likewise, a measure allowing certain undertakings a tax reduction or to postpone payment of tax normally due can amount to State aid.*⁶²

The Commission has essentially taken the same approach when looking into systems of charges:⁶³

In the light of the above, the Commission considers that the (ab)normal character of a charge is determined by reference to the general scheme of the system of charges in question. As a consequence, the determination of the reference framework is of particular importance because the very existence of an economic advantage can only be established in comparison to one system of financial charges known as "normal" in the geographical area of reference.

Lastly, state guarantees, another hot topic currently being dealt with by the Commission, is worth of a mention. State guarantees have been quite common after the Financial Crisis, especially when considering measures governments have taken to secure their banks. When considering, state guarantees per se cannot be compared to what a normal market actor would do as he would never have the power nor the reason to issue an effective state guarantee. It is inherent in the word itself that only governments give state guarantees and thus no market actor could give a state guarantee but still the Commission found a way. In Northern Rock the Commission simply stated that the state guarantee given to a firm in difficulty must be held as an advantage since the reason for it was precisely the absence of access to the financial market at commercially viable rates. Therefore the behavior of the State was clearly not similar to a normal market actor.⁶⁴ As the Court puts it, the question is whether an undertaking could get access to liquidity on the capital market without the security of a state guarantee.⁶⁵

2.3 Selectivity

Selectivity's aim is to distinguish between a situation where a state measure is of a general nature and a situation where it is specific whereas a measure that affects all undertakings equally will naturally not distort competition.⁶⁶ To clarify, a state measure must not only favour undertakings but it must favour certain undertakings,⁶⁷ or it must favour

⁶² Article 87(1) EC is equivalent to Article 107(1) TFEU

⁶³ *Greek Pension Reform* (Case N-597/2006) [2007] JOCE C/208/2007, para 67

⁶⁴ *Restructuring Aid to Northern Rock* (Case NN-70/2007) [2007] JOCE C/43/2008, para 87

⁶⁵ Case C-288/96 *Germany v Commission* [2000] ECR I-8237, paras 30-31

⁶⁶ See also AG Fennelly comments on selectivity in *Ecotrade*. Opinion of Advocate General Fennelly in Case C-200/97 *Ecotrade* [1998] ECR I-7907, para 25

⁶⁷ Often referred to as exclusivity

certain sectors of activity as has been repeatedly held by the Court.⁶⁸ On the other hand, a state measure which applies to all undertakings within a Member State will be considered a general measure,⁶⁹ of which a good example is taxation. Thus, comparing two tax systems together is a clear way to see the difference between the two measures. Whereas you could lower corporate tax which is uniformly applied on all companies, the consequent reduction in tax would be considered a general measure by the state. But the line between the two is thin, as, e.g., an introduction of a new tax system with tax brackets where only big foreign companies fall within the highest tax bracket could be considered selective, especially if it goes against the normal tax system in the Member State. But like AG Stix-Hackl noted it can be hard to distinguish between selective and general measures as sometimes you can have a selective aid even where it affects an entire or only several sectors of the economy.⁷⁰ The Court's expression on the selective condition has grown from its early days as it has found the need to clarify it as much as possible though some would argue it only became more confusing.⁷¹

According to settled case-law, Article 87(1) EC prohibits State aid 'favouring certain undertakings or the production of certain goods', that is to say, selective aid (see Case C-66/02 Italy v Commission [2005] ECR I-10901, paragraph 94, and Case C-88/03 Portugal v Commission [2006] ECR I-7115, paragraph 52). As regards appraisal of the condition of selectivity, Article 87(1) EC requires assessment of whether, under a particular legal regime, a national measure is such as to favour 'certain undertakings or the production of certain goods' in comparison with others which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation (see, to that effect, Case C-143/99 Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke [2001] ECR I-8365, paragraph 41; Case C-308/01 GIL Insurance and Others [2004] ECR I-4777, paragraph 68; and Case C-172/03 Heiser [2005] ECR I-1627, paragraph 40). In order to determine whether a measure is selective, it is therefore appropriate to examine whether, within the context of a particular legal system, that measure constitutes an advantage for certain undertakings in comparison with others which are in a comparable factual and legal situation (Portugal v Commission, paragraph 56).⁷²

⁶⁸ Case C-172/03 Heiser [2005] ECR I-1627, para 40; Case C-200/97 Ecotrade [1998] ECR I-7907, para 40; Rinaldo Piaggio (cited in fn. 35); Case C-148/04 Unicredito Italiano [2005] ECR I-11137, para 44; Belgium and Forum 187 v Commission, para 119 (cited in fn. 48); Opinion of Advocate General Léger in Case C-208/05 ITC GmbH v Bundesagentur für Arbeit [2006] I-181, para 35

⁶⁹ Case C-143/99 Adria- Wien Pipeline [2001] ECR I-8365, para 35; Opinion of Advocate General Alber in Case C-409/00 Spain v Commission [2003] ECR I-1487, paras 60 and 65; Opinion of Advocate General Stix-Hackl in Case C-66/02 Italy v Commission [2005] ECR I-10910, para 68

⁷⁰ Opinion of Advocate General Stix-Hackl in Italy v Commission, para 69 (cited above); Opinion of Advocate General La Pergola in Case C-75/97 Belgium v Commission – Maribel [1999] ECR I-3671, paras 32-33

⁷¹ Case C-403/10 P, Mediaset SpA [2011] ECR I-0000, para 36.

⁷² When expressing the condition of selectivity the necessity for the third sentence in light of the second sentence is quite unclear as it does not seem to add anything that was not stated in the second sentence.

The test of selectivity is widely believed to be the hardest of the State Aid conditions as when an advantage is given it does not necessarily mean that it is a selective advantage.⁷³ Subsequently, two situations have been identified as possible problems when applying the selective criterion. First there might be a so-called incidental advantage to certain undertakings but may still be classified as a general measure.⁷⁴ Secondly, the different treatment between undertakings can be justified by the nature and scheme of the system in context to the overall relevant system as will be discussed more thoroughly in 2.3.1. Finally, state measures consisting of direct and indirect benefits to particular sectors, selection by size and resources, geographic selection, preferential treatment to public undertakings or undertakings providing public services are prime examples of selective measures from the case-law.⁷⁵

2.3.1 Justified by the National Scheme

Even though a state measure in principle is selective it can in effect fall outside the prohibition in Article 107(1) TFEU as a non-selective measure if it is justified by the national scheme in question. The Court ruled for the first time on this issue in *Italy v Commission*:⁷⁶

It must be concluded that the partial reduction of social charges pertaining to family allowances devolving upon employers in the textile sector is a measure intended partially to exempt undertakings of a particular industrial sector from the financial charges arising from the normal application of the general social security system, without there being any justification for this exemption on the basis of the nature or general scheme of this system.

Since then it has been repeatedly held by the Court and the most common phrasing by it these days states that “[...] the concept of State aid does not refer to State measures which differentiate between undertakings and which are, therefore, prima facie selective where that differentiation arises from the nature or the general scheme of the system of which they form part.”⁷⁷ Incidentally or not, those few state measures that have been justified by the national scheme in question are most often those of tax or social security.⁷⁸ The substantive judgement in *Commission v Portugal* expresses the important factors when assessing whether state measures are justified.⁷⁹ The measure must result directly from the basic principles of its system and there must be a link between the principles of the relevant system and the measure

⁷³ *European Community Law Of State Aid* 80 (cited in fn. 23)

⁷⁴ *Ibid.*

⁷⁵ *European Community Law Of State Aid* 80-85 (cited in fn. 23)

⁷⁶ *Italy v Commission* (cited in fn. 44)

⁷⁷ Case C-106/09 P, *Gibraltar v Commission* [2011] ECR I-0000, para 145;

Adria-Wien Pipeline, para 42 (cited in fn. 69); *Azores*, para 52 (cited in fn. 61); Case C-487/06 P *British Aggregates v Commission* [2008] ECR I-10515, para 83; *Paint Graphos*, para 64 (cited in fn. 61)

⁷⁸ *European State Aid Law. Handbook* 48 (cited in fn. 51)

⁷⁹ *Commission v Portugal* (cited in fn. 61)

at issue.⁸⁰ Thus, it does not relate to the causes or the objectives of a state measure but rather to its effect when deciding whether it can be justified.⁸¹ More importantly, the state measure has to be considered to be appropriate, proportional and necessary for it to be justified by the nature or general scheme of a given system of a Member State.⁸²

2.4 Distortion of Competition and Affect to Trade between Member States

Among the many conditions located in Article 107(1) TFEU there is a requirement that a State measure must distort competition or at least threaten to distort competition to be deemed State Aid. It is often looked at together with affecting trade between Member State but as they are neither alternative nor culmative you are forced to make a distinction. Regardless, it makes sense to look at them together as they are closely linked. On one hand you could have a national distortion of competition and inevitably that leads to repercussions on trade between Member States as there are nearly always, at the very least, potential competitors in other Member States and therefore it will affect trade between them.⁸³ Then on the other hand a measure that affects trade between Member States, e.g. by making it harder for foreign competitors to enter the market would inevitably lead to distortion of competition on the national market. The Community Courts seem to look at the two conditions together and whether any difference is made is sometimes quite unclear as it seems inconceivable by the Court that only one of the conditions is fulfilled.⁸⁴ As Heidenhain points out there seems to be an increasing trend by the Court of First Instance to look at them together, describing them as “extricably linked.”⁸⁵ In the most recent cases the Court examines the conditions together and often refers to the established case-law:⁸⁶

For the purpose of categorising a national measure as State aid, it is necessary, not to establish that the aid in question has a real effect on trade between Member States and that competition is actually being distorted, but only to examine whether the aid is liable to affect such trade and distort competition.

⁸⁰ Ibid., paras 81-83

⁸¹ Paint Graphos, para 68 (cited in fn. 61)

⁸² Ibid., para 75. Conditions further discussed later in the thesis.

⁸³ Hypotetically we could imagine us a situation were a certain activity was only allowed in one Member State and forbidden in others on grounds of public policy

⁸⁴ See fn. 85-87

⁸⁵ *European State Aid Law. Handbook* 50 (cited in fn.51). Now called the General Court

⁸⁶ *Paint Graphos*, para 78 (cited in fn. 61); *Case C-372/97 Italy v Commission* [2004] ECR I-3679, para 44; *Unicredito Italiano*, para 54 (cited in fn. 68); *Cassa di Risparmio di Firenze and others*, para 140 (cited in fn. 61)

Similar line seems to be taken by Advocate Generals:⁸⁷

Against that background, I read paragraph 74 of the Court of First Instance's judgment as, essentially, reinforcing this point. The Court of First Instance held that, even if the Commission did not necessarily have to examine [the relationship of interdependence between the EU market and the Far Eastern market]', (59) the bald statement that Wam was involved in intra-Community trade was inadequate to show a likely effect on such trade or a distortion or threatened distortion of competition. For that reason (the Court of First Instance continued) the Commission had to carry out a detailed examination of the effects of the aids, taking into account – in particular – the fact that they met expenses incurred on the Far Eastern market as well as, to the extent necessary, (60) the interdependence between that market and the EU market.

The burden of proof for the Commission cannot be regarded as being difficult as Advocate General Mengozzi points out:⁸⁸

In particular, where aid granted by a Member State strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by that aid.

Regardless, the Commission still has to put forward reasoning for why a particular State Measure is liable to distort competition and affect trade between Member States:⁸⁹

As regards more particularly a decision concerning State aid, the Court of Justice has held that although, in certain cases, the very circumstances in which the aid has been granted may show that it is liable to affect trade between Member States and to distort or threaten to distort competition, the Commission must at least set out those circumstances in the statement of reasons for its decision (Joined Cases 296/82 and 318/82 Netherlands and Leeuwarder Papierwarenfabriek v Commission [1985] ECR 809, paragraph 24; Joined Cases C-15/98 and C-105/99 Italy and Sardegna Lines v Commission [2000] ECR I-8855, paragraph 66; and Case C-334/99 Germany v Commission [2003] ECR I-1139, paragraph 59).

The importance of the latter condition, that a state measure cannot affect trade between Member State cannot be understated. In a way, it is crucial for the EU to have boundaries between pure national issues and pure EU issues as one could imagine the work load if the Court was responsible for purely internal situations as well.⁹⁰ In the end of 2008 there were actually 767 cases pending before the CJEU with the average waiting time being 16.8

⁸⁷ The Opinion of Advocate General Sharpston in Case C-494/06 *P Commission v Italy and Wam* [2009] ECR I-0000, para 60

⁸⁸ The Opinion of Advocate General Mengozzi in Case C-206/06 *Essent Netwerk Noord and Others* [2008] ECR I-5497, para 89; *Unicredito Italiano*, para 56 (cited in fn. 67); Joined Cases C-393/04 and C-41/05 *Air Liquide Industries Belgium* [2006] ECR I-5293, para 35

⁸⁹ Joined Cases T-81/07 to T-83/07 *KG Holding and Others v Commission* [2009] ECR II-2411, para 63

⁹⁰ The judges rarely sit in a full court these days as the workload is enormous. David Chalmers, Gareth Davies & Giorgio Monti, *European Union Law* (2nd edition, Cambridge University 2010) 145

months.⁹¹ Subsequently, a situation where a state measure distorts competition within a Member State without affecting any foreign competitors, that is, purely internal will not fall within the scope of the competition rules in the Treaty and with that cannot be considered as State Aid by the Community Courts. Effectively the same situation is prevailing in the free movement area within the European Union.⁹² In light of the aforementioned it is interesting to look at a recent Court of the First Instance Judgement where the CFI annulled a negative State Aid decision by the Commission on the grounds that it had not satisfactorily demonstrated that the aid in question had an effect on trade or threatened to distort competition.⁹³ Then the opportunity came for the Court itself to clarify the issue.⁹⁴ The Court held that CFI had not erred in law when requiring the Commission to examine properly whether the aid would actually affect trade between Member States or distort or threaten to distort competition.⁹⁵ With that a twist was introduced in the previous case-law cited in the judgement as if an aid is intended to finance expenditure for a non-member State market penetration programme Article 296 TFEU puts more burden on the Commission than normally to put greater effort in stating its reasons.⁹⁶ If the judgement were to be read with an open mind this could mean that in any circumstances where a Member State states that their state measure is intended to be put into financing activities in non-Member States, the burden gets heavier for the Commission to prove that trade between Member States is affected or competition is or is liable to be distorted.

2.5 Amount de Minimis

The Amount de Minimis policy stems from the special power attributed to the Commission in State Aid issues as the Commission is the authority that will decide whether a certain State measure is State Aid. The rule was first stipulated with the SME Guidelines in 1992 where a state measure would not be considered as State Aid under those guidelines if the total amount was below a certain threshold. The Commission needed to introduce this rule to reduce the administrative burden on both Member States and the Commission by preferring to use their resources on genuinely important cases.⁹⁷ Thus the rule, entails that if a state

⁹¹ *European Union Law* 178 (cited above)

⁹² See e.g. the situation in free movement of persons. Catherine Barnard, *The Substantive Law Of The EU. The Four Freedoms* (3rd edition, Oxford University Press 2010) 226-235

⁹³ Joined Cases T-304 and 316/04 *Italy and Wam SpA v Commission* [2006] ECR II-64, paras 73-74

⁹⁴ *Italy and Wam SpA* (cited in fn. 87)

⁹⁵ *Ibid.*, para 57

⁹⁶ *Ibid.*, para 62

⁹⁷ Opinion of Advocate General Jääskinen in *Paint Graphos*, para 124 (cited in fn. 61)

measure amounts to a figure lower than an established threshold it does not affect trade between Member States.⁹⁸ That is, the amount is not high enough to be considered as having a perceptible effect on trade between Member States. More Community work has then followed from 1992 with the Commission issuing a notice and regulations reaffirming the policy.⁹⁹ The main document to date is Regulation 1998/2006 on the de minimis policy.¹⁰⁰ In general, to qualify as de minimis aid requires that the aid granted to any undertaking does not exceed a ceiling of 2000,00 EUR over a period of three fiscal years. These ceilings apply irrespective of the form of the de minimis aid or the objective pursued and regardless of whether the aid granted by the Member State is financed entirely or partly by resources of Community origin. When it comes to State Guarantees it is interesting to know that the regulation does not apply in certain circumstances:

[...]This specific ceiling should therefore not apply to ad hoc individual aid granted outside the scope of a guarantee scheme, to aid granted to undertakings in difficulty, or to guarantees on underlying transactions not constituting a loan, such as guarantees on equity transactions.[...]

Furthermore, the consequences of the de minimis conditions being fulfilled have been debated. To clarify, it was unclear whether the Commission could narrow the scope of Article 107(1) TFEU. The Commission seemingly wasn't able to convince the Court with their Commission notice on the de minimis policy as the Court repeatedly held that the amount of aid was not relevant when considering whether a state measure fell within Article 107(1) TFEU.¹⁰¹ It was finally settled with the de minimis Regulation which entails that certain types of State Aid fall within that regulation and those who do not subsequently fall outside the scope of the regulation and will be decided under Article 107(1) TFEU.¹⁰² On the other hand, some scholars see this as problematic and wonder what will happen if a State Measure qualifies for the Amount de Minimis regulation and fulfills the criteria of Article 107(1) TFEU.¹⁰³

⁹⁸ *European State Aid Law. Handbook* 61-62 (cited in fn. 51)

⁹⁹ *Ibid.*

¹⁰⁰ Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid [2006] OJ L 214 (Amount de Minimis Regulation). See also summary in the Commission's Vademecum Report, p. 57-58 (cited in fn. 27)

¹⁰¹ Case C-57/86 *Greece v Commission* [1988] ECR 2855, paras 17-18; Case C-142/87 *Belgium v Commission* [1990] ECR I-959, para 43; Case C-310/99 *Italy v Commission* [2002] ECR I-2289, para 86; *Heiser*, para 34 (cited in fn. 68)

¹⁰² For more information. *European Community Law Of State Aid* 101-102 (cited in fn. 23)

¹⁰³ *European State Aid Law Handbook* 71 and fn. 72 (cited in fn. 51)

3 Supervision by the Caretaker of the European Union

3.1 The Beginning of a Financial Crisis

The starting point was in and around 2006 when the real estate bubble in the United States burst.¹⁰⁴ The cause has most often been directed at the hugely popular sub-prime lending which had been increasing rapidly the years before. In short, subprime lending is when an institution such as a bank decides to loan big amounts of money to people who might have difficulties in fulfilling their repayment plan. Thus, because of high risk the interest rates are high. So in essence a lot of people that would normally not have access to the credit market could access big amounts of money with the subprime lending arrival. In the end, this led to a housing bubble which ended up having big repercussions in Europe. With the occurrences in the USA the snowball started to roll and effectively spread out to Europe. Often referred to as the “snowball effect.”¹⁰⁵ The European Commission stated:

*The heavy exposure of a number of EU countries to the US subprime problem was clearly revealed in the summer of 2007 when BNP Paribas froze redemptions for three investment funds, citing its inability to value structured products. (1) As a result, counterparty risk between banks increased dramatically, as reflected in soaring rates charged by banks to each other for short-term loans (as indicated by the spreads -- see Graph I.1.3). (2) At (1) See Brunnermeier (2009). (2) Credit default swaps, the insurance premium on banks' portfolios, soared in concert. The bulk of this rise can be that point most observers were not yet alerted that systemic crisis would be a threat, but this began to change in the spring of 2008 with the failures of Bear Stearns in the United States and the European banks Northern Rock and Landesbank Sachsen. About half a year later, the list of (almost) failed banks had grown long enough to ring the alarm bells that systemic meltdown was around the corner: Lehman Brothers, Fannie May and Freddie Mac, AIG, Washington Mutual, Wachovia, Fortis, the banks of Iceland, Bradford & Bingley, Dexia, ABN-AMRO and Hypo Real Estate. The damage would have been devastating had it not been for the numerous rescue operations of governments.*¹⁰⁶

Others have pointed to other causes such as an abundance of cheap money in certain developed countries which was made available by the unprecedented growth in current

¹⁰⁴ The Commission, *Economic Crisis in Europe: Causes, Consequences and Responses* (European Economy No 7, 2009), p. 10

¹⁰⁵ The snowballing effect is when a chain of events occurs. That is, when one event triggers another which subsequently triggers the third and etc. For a more detailed explanation for the spill over from USA to Europe an excellent economic summary is to be found in the *Economic Crisis in Europe: Causes, Consequences and Responses*, p. 10 and onwards (cited above)

¹⁰⁶ *Ibid.*, p. 9

account surpluses in countries such as China and Japan.¹⁰⁷ More issues mentioned were the large inflow of cheap money leading to riskier lending practices such as sub-prime mortgages and banks in rather stable countries getting involved in the crisis through their participation in asset backed securities.¹⁰⁸ Subsequently, the big problem in Europe was that if borrowers from Member State A had difficulties in financing a repayment of a huge debt to a bank in Member State B it would put the banking system in Member State B under significant risk as Europe soon began to realise.

3.2 The European Commission

Article 17(1) TEU states:

The Commission shall promote the general interest of the Union and take appropriate initiatives to that end. It shall ensure the application of the Treaties, and of measures adopted by the institutions pursuant to them. It shall oversee the application of Union law under the control of the Court of Justice of the European Union. It shall execute the budget and manage programmes. It shall exercise coordinating, executive and management functions, as laid down in the Treaties. With the exception of the common foreign and security policy, and other cases provided for in the Treaties, it shall ensure the Union's external representation. It shall initiate the Union's annual and multiannual programming with a view to achieving interinstitutional agreements.

Therefore, it is safe to say that it plays a big role and carries a heavy burden when promoting the general interest of the Union. Although the Commission's main objective is to ensure correct application of Union law the situation gets a bit more complicated in the area of State Aid. The most important line in that context is that the Commission "[...]shall exercise coordinating, executive and management functions, as laid down in the Treaties." This has been their major purpose in State Aid from its early days as Plaumann clearly illustrates where the Federal Republic of Germany requested the Commission to authorise it to suspend the collection of the customs duty of 13%.¹⁰⁹ Thus, what makes State Aid Law special is the fact that when in doubt about whether a State Measure constitutes State Aid you should seek permission from the Commission with that view rooted in the Treaty. Article 108(1-3) TFEU states:

The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the internal market.

¹⁰⁷ Christian Ahlborn and Daniel Piccinin, "The Application of the Principles of Restructuring Aid to Banks during the Financial Crisis" [2010] 9(1) EStAL 48

¹⁰⁸ Ibid.

¹⁰⁹ Case 25/62 *Plaumann v Commission* [1963] ECR 95, p. 97

If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through State resources is not compatible with the internal market having regard to Article 107, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission.

[...]

The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the internal market having regard to Article 107, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.

Similarly to the competition rules found in Article 105 TFEU where the Commission shall inspect possible infringements of the competition rules on its own initiative and in cooperation with national authorities there is a similar obligation of them within the State Aid area.¹¹⁰ The only difference is that the Commission's role in State Aid is bigger as there is an obligation of notification of possible grants of State Aid and thereby forcing governments to notify every state measure that can possibly be construed as a State Aid. In addition, the Commission is the decisive institution within the EU that has an exclusive authority when it comes to assessing whether a certain State Aid is compatible with the common market or not. Thus the Community Courts do not but rather they have the authority to rule on whether the Commission made the right decision. As if that was not enough, the Commission has considerable discretionary authority when assessing whether a State Measure is to be regarded as State Aid in the meaning of Article 107 TFEU as can be seen from the extensive case-law on the matter:¹¹¹

However, it must be held, in accordance with settled case-law, that review by the Community judicature of complex economic assessments made by the Commission, such as those in this case, must necessarily be confined to verifying whether the rules on procedure and on the statement of reasons have been complied with, whether the facts have been accurately stated and whether there has been any manifest error of assessment or misuse of powers.

Not to forget the Commission's low burden of proof when it comes to proving that a State Measure distorts competition and affects trade between Member States. That is well

¹¹⁰ The main difference between Competition Rules and State Aid, though very similar areas of law, is the public element that is the red silver lining through all State Measures

¹¹¹ Case C-399/08 P *Commission v Deutsche Post AG* [2010] ECR I-0000, para 97; Case C-333/07, *Société Régie Networks* [2008] ECR I-10807, para 78; Case C-56/93 *Belgium v Commission* [1996] ECR I-723, para 11; Joined Cases C-328/99 and C-399/00 *Italy and SIM 2 Multimedia v Commission* [2003] ECR I-4035, para 39; Joined Cases C-501,513,515 and 519/06 P *GlaxoSmithKline Services and Others v Commission and Others* [2009] ECR I-0000, para 85; Joined Cases C-75/05 P and C-80/05 P *Germany and Others v Kronofrance* [2008] ECR I-0000, para 59

illustrated in the Cassa judgement where it was simply sufficient that an economic sector had been liberalised.¹¹² Likewise, you only need to establish the existence of a tax benefit and then you have distortion of competition and affect of trade between Member States,¹¹³ with it being sufficient that there were potential competitors in other Member States.¹¹⁴

¹¹² *Cassa di Risparmio di Firenze and Others*, para 142 (cited fn.61)

¹¹³ *Paint Graphos*, paras 79-80 (cited fn. 61)

¹¹⁴ *Ibid.*, para 80

4. The Commission's response to the Financial Crisis

4.1 Introduction

The Commission's soft law has a huge effect on the judiciary system in the European Union as in many cases it is the only way that a case will come before the European Court of Justice.¹¹⁵ The importance is even greater in Competition and State Aid Law where considerable weight is put on the Commission to prove that certain actions are against Community Law. When it comes to State Aid the importance of Commission's soft law has become even greater after the Financial Crisis as will now be illustrated. In general there are two kinds of exemptions with different effects. On one hand we have the exemptions found in Article 107(2) TFEU which will automatically be approved by the Commission. The provision expresses three types of aid that should be rendered compatible with the internal market. Aid having a social character(a), aid that make good damage caused by natural disasters or exceptional occurrences(b) and aid granted in connection to the division of Germany(c). Subsequently, on the other hand, we have exemptions in Article 107(3) TFEU which might be approved by the Commission. Therefore, it will mainly be Article 107(3) TFEU that will be looked at in the context of this thesis as Article 107(2) TFEU is basically not involved when it comes to State Aids in the Financial Crisis regarding the banking sector. The most important ones which can render a State Aid compatible with the Treaty are those found in Articles 107(3)(b) and 107(3)(c) TFEU:

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;

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;

Gradually, the Commission has relied more heavily on the former Article in issues relating to the Financial Crisis with considerable soft law constructed on the basis of the aforementioned Article in that relation. The Commission's soft law and its huge impact

¹¹⁵ A classic example of that is when an individual or an undertaking has no court dispute with the alleged infringer of European Law. That would be the case in Competition Law when a competitor suspects a cartel in its sector. There is no real dispute that could go before the Court but rather something the Commission has to investigate and decide whether to act upon.

cannot be understated as the soft law expands the scope of the exemption found in Article 107(3)(b) TFEU with that statement easily identified in ESA's application of the equivalent provision found in Article 61(1) of the EEA Agreement which later will be examined.

4.2 The Situation before the Financial Crisis

Since the beginning of the 1980s and to the start of the Financial Crisis in Europe the Commission had only applied 107(3)(b) TFEU once. Doing so in its decision on the economic situation in Greece where there were serious balance of payments difficulties in the autumn of 1985.¹¹⁶ In that case, it had become apparent that the difficulties were sufficiently serious to be considered as liable to cause a serious disturbance in the economy of Greece as they granted aid to the privatisation of 208 businesses.¹¹⁷ The Rescue and Restructuring Guidelines, on the other hand, had been applied on numerous occasions by the Commission.¹¹⁸ Furthermore, the Court itself had applied the R&R Guidelines several times.¹¹⁹ In Alfa Romeo the Italian Government, through its public holding companies IRI and Finmeccanica, had granted Alfa Romeo, an undertaking in the motor vehicle sector, substantial capital contributions. The Commission ruled that the aid was incompatible with the Treaty. What is interesting regarding this judgement and the one that came before is the high emphasis the Court puts on the undertaking to submit a viable restructuring programme for it to be granted an exemption according to the R&R Guidelines.¹²⁰

4.3 At the start of the Financial Crisis

In the beginning of the crisis the Commission had only one set of Guidelines based on Article 107 (3)(c) TFEU to apply named Community Guidelines on State Aid for rescuing and restructuring a firm in difficulty. Interestingly, the Guidelines do not cover aid measures intended “to make good the damage caused by natural disasters or exceptional occurrences“ which are located in Article 107(2)(b).¹²¹ It is worth to note that the line between those two articles of TFEU is very thin as certain market failures can be seen as exceptional

¹¹⁶ *Aid to Greek Industry* - Commission Decision 88/167/EEC [1988] L/76/18

¹¹⁷ *European State Aid Law. Handbook* 203 (cited in fn. 51)

¹¹⁸ Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 244, 1.10.2004, p.2 (the R&R Guidelines). *Quimigal* (Case C-25/89) [1990] OJ C/188/3; *Leuna-Werke* - Commission Decision 96/545/EC [1996] OJ L239/1; *Kali und Salz* (Case-74/97) [1998] OJ C/197/7

¹¹⁹ Case 323/82 *Intermills* [1984] ECR 3809; Case 318/82 *Leeuwarder Papierwarenfabrik* [1985] ECR 809; *France v Commission* (cited in fn. 55); *Belgium v Commission* (cited in fn. 101); *Alfa Romeo* (cited in fn. 55)

¹²⁰ *Alfa Romeo*, para 35 (cited in fn. 55)

¹²¹ The R&R Guidelines, para 19 (cited above)

occurrences.¹²² In addition, the Commission considered Article 107(3)(b) not to be applicable in the case that only one operator or one sector needed State assistance.¹²³ Subsequently, it was not applied in Northern Rock as the UK authorities did not provide enough information for the Commission to believe there was a risk of a systemic crisis. Rather, it focuses on Article 107(3)(c) TFEU where the Commission can authorise an aid that does not adversely affect trading conditions to an extent contrary to the common interest. Therefore, it could be argued that the Commission was quite unprepared for the Financial Crisis spreading into Europe as can be read from the fact that the Commission first applied the R&R Guidelines for ailing banks in Europe but later introduced considerable soft law to take its place in the Financial Crisis.¹²⁴ Regardless, the R&R Guidelines have provisions aimed at correcting problems of financial institutions.¹²⁵ In the end, the R&R Guidelines were too problematic in relation to the Financial Crisis as they only applied to a “firm in difficulty“. A firm is considered to be in difficulty if “it is unable, whether through its own resources or with the funds it is able to obtain from its owner/shareholders or creditors, to stem losses which, without outside intervention by the public authorities, will almost certainly condemn it to going out of business in the short or medium term.“¹²⁶ The biggest problem with that was that Member States needed to take action before it came to firms encountering difficulties.¹²⁷ Another issue was that structural measures, which did not require immediate action, such as, the irremediable and automatic participation of the State in the own funds of the firm, could not be financed through rescue aid.¹²⁸ That was a substantial problem as the Financial Crisis had become systematic.¹²⁹ Lastly, The Commission had to take a u-turn on its previous approach to the R&R Guidelines whereas the Commission had applied them extremely restrictively and describing them as highly distortive.¹³⁰

¹²² The same applies to Article 107(3)(b) TFEU as exceptional occurrences can qualify for a serious disturbance in the economy of a Member State

¹²³ *Restructuring Aid to Northern Rock*, para 38 (cited in fn. 64); *Crédit Lyonnais* (Case C-47/1996) Commission Decision 98/490/EC [1998] OJ L/221/28, page 28. The Commission then changed their approach from the Northern Rock case when they deemed it not relevant whether Article 107(3)(b) was applicable as the Commission had already decided it fell under 107(3)(c) through the R&R Guidelines. *Bradford & Bingley* (Case NN-41/2008) [2008] JOCE C/290/2008, para 52

¹²⁴ Addressed later in the thesis

¹²⁵ To that end, the banking sector is specifically mentioned. The R&R Guidelines, Article 25(a) and fn. 15

¹²⁶ See R&R Guidelines, para 9

¹²⁷ *European State Aid Law. Handbook* 204 (cited in fn. 51). The Commission “State Aid Scoreboard“ (Scoreboard 164, Spring 2009), p. 8

¹²⁸ R&R Guidelines, Articles 15-16. Spring Scoreboard 2009, p. 8 (cited above)

¹²⁹ Spring Scoreboard 2009, p. 8 (cited above). For more details on a systemic banking crisis see e.g. David Beim, “What Triggers a Systemic Banking Crisis?“ (2009) CBSCWJ

¹³⁰ Rose M. D’Sa ““Instant“ State Aid Law in a Financial Crisis – A U-Turn?“ [2009] 2 EstAL 140.

4.4 Northern Rock

A prime example of how the R&R Guidelines and Article 107(3)(c) TFEU were applied is the Northern Rock case.¹³¹ It concerned a huge mortgage bank located in the North East of UK in Newcastle upon Tyne, called Northern Rock. NR had accumulated a lot of small shareholders which amounted to a total of circa 176,000 shareholders. With the continuing turbulence in financial markets around the globe the mortgage securitisation market, greatly important for NR, eventually closed leaving NR in deep trouble as over 90% of its activity concerned residential mortgage lending. Thus, suddenly, there was no access to finance for NR in financial markets. After seeking many alternatives NR looked set to go bankrupt if the Bank of England had not stepped in which it eventually did. On 14th of September the Bank of England granted emergency liquidity assistance to NR. Subsequently, to prevent a bank run, the Bank of England announced state guarantees for all existing accounts in NR on 17th of September.

The Commission first set out to examine the basic conditions for State aid put forward in Article 107(1) TFEU. The liquidity measures on 14th of September were not considered to be State Aid. The Commission highlighted several points for that conclusion. First, it was only temporary liquidity support to NR as their normal sources of funds were closed with NR still being solvent. Secondly, the facility was secured against high quality collateral assessed on a daily basis. Thirdly, it was given against a penal interest rate above the one applied to its standing facility. Lastly, the measures were taken on the initiative of the Bank of England, independent of other measures taken later on. The points set out in the aforementioned conclusion by the Commission are interesting as NR is one of the first cases of its kind and concluded before the Financial Crisis had truly spread to Europe. In the ruling, we see how important the market economy investor principle will be in the context of the Financial Crisis as that seems to have been central to the Commission's decision. Especially, when the Commission concluded that the latter measures taken from the 17th of September and onwards were considered to fall within the orbit of the ever expanding Article 107(1) TFEU since no market economy investor would have granted any such measures.¹³² Regardless, the Commission, seems to believe that a market economy investor would have granted the liquidity assistance under normal circumstances on the 14th of September which is quite hard to believe.

¹³¹ *Restructuring Aid to Northern Rock* (cited in fn. 64)

¹³² *Restructuring Aid to Northern Rock*, para 35 (cited in fn. 64)

The Commission considered that the state guarantees made from 17th of September and onwards could not be exempted under Article 107(3)(b) TFEU. First it cited its earlier case-law from *Crédit Lyonnais* by stating that the aid in that case was not “designed to remedy serious economic disruption, since its purpose is to resolve the problems of a single recipient, *Crédit Lyonnais*, as opposed to the actual problems facing all operators in the industry.” Thus, in *Crédit Lyonnais* it hung on the fact that it was a specific measure aimed at one operator in one sector. In the end, in the present case, the Commission found there were lack of facts to conclude that Northern Rock fell to a systemic crisis that might have arisen. Subsequently the State Guarantees could not be exempted under Article 107(3)(b) TFEU.

The Commission then moved on to Article 107(3)(c) TFEU and the R&R Guidelines by ruling that they were applicable in this context. First, by agreeing with the UK authorities, the Commission confirmed that NR was a firm in difficulty according to the R&R Guidelines. Secondly, the Commission considered the rescue aid compatible to the five conditions stipulated in point 25 of the R&R Guidelines. The conditions in point 25(a) and (c) were fulfilled.¹³³ The 6 month time limit to reimbursement or guarantee end has an exception when it comes to the banking sector. In addition the State Measures at hand were not considered to be structural measures. Furthermore, the time limits are fulfilled as the UK authorities must notify restructuring measures after 6 months from the beginning of the rescue measures. Finally, the interest rates were considered to be satisfactory in this case as the cost of financing of NR was at least comparable to interest rates on loans to healthy firms. Secondly, Point 25(b) was fulfilled since without the assistance from the UK authorities NR would most likely have gone into bankruptcy so the conditions of serious social difficulties is upheld as is the condition of no undue adverse spill-over effects on other Member States as NR could not possibly act aggressively on the market.¹³⁴ Thirdly, the condition found in point 25(d) is fulfilled since the amount was kept to the absolute minimum.¹³⁵ NR only gets funding for each week ahead and gets supervised by the Bank of England on how they use the liquidity. Finally, NR has not benefitted from any rescue measures in the last 10 years and therefore the State Measures are compatible with the R&R Guidelines and hence the Commission granted an exemption to NR.¹³⁶

¹³³ *Ibid.*, paras 48 and 50

¹³⁴ *Ibid.*, para 49

¹³⁵ *Ibid.*, para 51

¹³⁶ *Ibid.*, para 52

What is perhaps the most interesting application of the R&R Guidelines in the NR case is how the Commission examined the criteria of no unduly adverse spill-over effects on other Member States.¹³⁷ There, the Commission considered it only necessary to conclude that NR could not be aggressive on those markets as they only got funding for one week ahead. Not even considering the possible hindrance to other banks in entering the UK market as a big mortgage lending bank was kept alive in the UK with government funding. At the very least, the Commission should have taken up the issue in its decision.

4.5 A change in the approach

On 13 October 2008 the Commission changed their approach to Article 107(3)(b) with the issuing of the Communication on the “application of State aid rules to measures taken in relation to financial institutions in the context of the current global Financial Crisis.”¹³⁸ In many ways, the Banking Communication was better suited to deal with the Financial Crisis as it could deal with a serious disturbance in the economy of a Member State without a specific firm being in difficulty as demanded by the R&R Guidelines. That is, it could deal with the systematic Financial Crisis that had spread throughout the EU. On the other hand, the Commission had to change their longstanding approach to Article 107(3)(b) TFEU which involved not applying it to state measures benefitting only one operator or one sector as it stressed in Northern Rock. An example where it was actually applied is the restructuring aid to companies in the Greek public sector in 1980s where the crisis was considered to go beyond any sector of the economy.¹³⁹ Not everyone agrees with the necessity on the change in approach with some pointing out the lack of explanation by the Commission.¹⁴⁰ Another issue stressed in the Banking Communication is that a restrictive interpretation of Article 107(3)(b) is necessary when considering what constitutes a serious disturbance in the economy of a Member State.¹⁴¹ Therefore, in principle, you can not apply Article 107(3)(b) to other crisis

¹³⁷ Ibid., para 49

¹³⁸ Communication from the Commission – The application of State aid rules to measures taken in the current financial institutions in the context of the current global Financial Crisis, OJ C 270, 25.10.2008, pages. 8-14 (The Banking Communication)

¹³⁹ ““Instant“ State Aid Law in a Financial Crisis – A U-Turn?” 142 (cited in fn. 130)

¹⁴⁰ Ibid.

¹⁴¹ Banking Communication, Article 8 (cited above). Joined Cases T-132 and 143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para 167; *Crédit Lyonnais* (Case C-47/1996) Commission Decision 98/490/EC [1998] OJ L/221/28, para 10, *Bankgesellschaft Berlin* (Case C-28/2002) [2005] OJ L/116, page 1, para 153 and onwards; *BAWAG* (Case C-50/2006) [2007] JOCE L/83/2008, para 166; *Restructuring Aid to Northern Rock* (Case NN-70/2007) [2007] JOCE C/43/2008, p. 1; *Rescue aid to WestLB* (Case NN 25/2008) [2008] C/189, p. 3; *SachsenLB* (Case C-9/2008) [2008] JOCE L/104/2009

situations in other sectors when it does not impose considerable and immediate risk, comparable to that in the banking sector, to the whole economy of a Member State.¹⁴² Suffice to say, this contradicts, to an extent, the restrictive approach put forward in the Banking Communications as it is quite vague what the Commission means by stating “as a matter of principle.”¹⁴³ Moreover, the shift to the Banking Communications from the R&R Guidelines gives the Commission more leniency when assessing an aid as in the Banking Communication there is a general test of necessity, appropriateness and proportionality with several relatively open conditions compared to the complicated and restrictive five point test found in the R&R Guidelines.

Possible State Measures allowed under the Banking Communication are mainly liabilities of financial institutions. In addition, it focuses on recapitalisation measures, controlled winding up of financial institutions and various other forms of liquidity assistance. Finally, the measures have to fulfill the general conditions found in the Banking Communication:¹⁴⁴

- a) *Non-discriminatory access in order to protect the functioning of the Single Market by making sure that eligibility for a support scheme is not based on nationality;*
- b) *State commitments to be limited in time in such a way as to ensure that support can be provided as long as it is necessary to cope with the current turmoil in financial markets but will be reviewed and adjusted or terminated as soon as improved market conditions so permit;*
- c) *State support to be clearly defined and limited in scope to what is necessary to address the acute crisis in financial markets while excluding unjustified benefits for shareholders of financial institutions at the taxpayer's expense;*
- d) *An appropriate contribution of the private sector by means of adequate remuneration and the coverage by the private sector of at least a significant part of the cost of assistance granted;*
- e) *Sufficient behavioural rules for beneficiaries which prevent an abuse of State support, like for example expansion and aggressive market strategies on the back of a state guarantee;*
- f) *An appropriate follow-up by structural adjustment measures for the financial sector as a whole and/or by restructuring individual financial institutions that had to rely on State intervention other than guarantees.*

Furthermore, Member States throughout Europe found it increasingly important to recapitalise their financial institutions, the so-called precautionary recapitalisation of banks to

¹⁴² Spring Scoreboard 2009, p. 10 (cited in fn. 127). Banking Communication, Article 11 (cited in fn. 138)

¹⁴³ Banking Communication, Article 11 (cited in fn. 138)

¹⁴⁴ Summed up nicely in the Spring Scoreboard 2009, p. 11 (cited in fn. 127)

ensure lending to the real economy.¹⁴⁵ In fact, that was one of the State Aid forms allowed in the Banking Communication but as new schemes introduced by Member State varied from one Member State to another the pressure increased on the Commission to give more guidance on the issue. That led to the Communication on the “Recapitalisation of financial institutions in the current Financial Crisis: limitation of aid to the minimum necessary and safeguard against undue distortions of competition.”¹⁴⁶ As recapitalisation is within the scope of the Banking Communication it is quite similar but with specific emphasis on two principles.¹⁴⁷ First, remuneration should be close to market prices to limit any distortion of competition and second, the recapitalisation should be temporary in nature, with incentives for State capital redemption favouring an early return to normal functioning of the market.¹⁴⁸

Subsequently, after continued decrease in the market value of portfolio investments, Member States sought to provide State Measures that would relieve banks of their impaired assets.¹⁴⁹ That is, Member States wanted to rid banks of toxic assets by purchasing them with a newly set-up “bad bank” or provide insurances, guarantees or swaps against those assets meaning that the asset’s unclear market value was not a factor anymore and therefore leading to an increase in the onward lending of those banks.¹⁵⁰ The Commission responded with the Communication “on the Treatment of Impaired Assets in the Community Banking sector.”¹⁵¹ In short, when you relieve a bank of an impaired asset he benefits from State Aid as long as the transfer value is higher than the market value with the transfer value being based on the long term as opposed to a market value based on the present.¹⁵² An interesting case in that regard is the German case of HSH Nordbank which is the fifth biggest German Landesbank.¹⁵³ HSH Nordbank is a public bank focusing on the area of private- and merchant banking and thereby

¹⁴⁵ Ibid.

¹⁴⁶ Communication from the Commission – The recapitalisation of financial institutions in the current Financial Crisis: limitation of the aid to the minimum necessary and safeguard against undue distortions of competition, OJ C 10, 15 January 2009, p.2-10, adopted 5 December (the Recapitalisation Communication).

¹⁴⁷ For more info on the Recapitalisation Communication see Spring Scoreboard 2009, p. 11-12 (cited in fn. 127)

¹⁴⁸ Ibid., p. 12

¹⁴⁹ Ibid., p. 12

¹⁵⁰ Elaine Gibson-Bolton and Michael Reiss, “Bank bailouts, state aid and the financial crisis” [2009] 4 CRI 162, 165

¹⁵¹ Communication from the Commission on the treatment of Impaired Assets in the Community banking sector, OJ C 72, 26 March 2009, p.1., adopted 25 February 2009 (The impaired Assets Communication). More information in the Spring Scoreboard 2009, p.12 and onwards (cited in fn. 127)

¹⁵² For more information on Impaired Assets see Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector – Frequently Asked Questions – MEMO/09/85.

¹⁵³ *Germany HSH Nordbank* (Case C-29/2009) [2009] Unpublished, para 4

having an unlimited state guarantee until 18 July 2005.¹⁵⁴ Subsequently in the Financial Crisis of 2007, HSH Nordbank's impairments were estimated around 1-2 billion EUR and therefore seriously affected their loan capabilities at the time.¹⁵⁵ The effects of that forced the German authorities to react with two State Measures. HSH Nordbank was granted a capital injection of 3 billion EUR and a second-loss risk shield of 10 billion EUR on a large part of the balance sheet with the latter being the main focus of the author. The latter measure therefore revolved around a risk shield which entailed that the Länder could shelter HSH Nordbank from losses stemming from total assets of about 150-200 billion EUR.¹⁵⁶ The first loss tranche of 2-4 billion EUR is covered by the HSH, the second one of up to 10 billion EUR is covered by the Länder and then losses beyond 12-14 billion EUR are covered by the HSH.¹⁵⁷ The probability that the second one will be utilised at all is estimated by Germany below 20-60%.¹⁵⁸ Subsequently, the risk shield was held to have elements of State Aid and as to the compatibility of the risk shield the Commission considered several aspects; primarily the i) Valuation, ii) Burden-sharing and iii) Remuneration:

i) First, the Commission considered that it was not sufficient that valuation reports, produced by independent experts, only covered a residual fraction of the shielded portfolio.¹⁵⁹ It had to cover the whole portfolio in question and therefore the Commission questioned the compatibility of the measure. Second, the Commission criticised the management of assets as the IAG required that there was a clear functional and organisational separation between the beneficiary bank and its shielded assets.¹⁶⁰ Third, the Commission expressed their doubts on the compatibility as to the lack of sufficient information for the assessment of the real economic value of the whole portfolio.¹⁶¹

ii) Regarding the burden sharing, the Commission, did not reconcile with the fact that only 1-5% of the shielded portfolio fell on the bank and it only reinforced its doubts on the compatibility of the measure.¹⁶²

¹⁵⁴ *Ibid.*, para 7-8

¹⁵⁵ *Ibid.*, para 11

¹⁵⁶ *Ibid.*, para 19

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*

¹⁵⁹ *Ibid.*, para 43

¹⁶⁰ *Ibid.*, para 44

¹⁶¹ *Ibid.*, para 47

¹⁶² *Ibid.*, para 50

iii) In short, the Commission further expressed their doubts over the complicated remuneration proposal provided by Germany. E.g., one part of the proposal provided for the remuneration of the 5 year old guarantee in question with a 30 year German Government Bond.¹⁶³ In the end, despite deeply thought remuneration proposals, the Commission expressed its doubts on whether the remuneration would be high enough.¹⁶⁴

With all things considered the Commission prolonged the preliminary authorisation of the impaired asset measure provided for six months until it has reached a final decision on the measure.¹⁶⁵ Notably, the Commission subsequently requested specific information and data on the valuation of the shielded portfolio by external experts and a detailed timetable for the implementation of the different measure.¹⁶⁶ There are several conditions of the IAC where the Commission raised doubts over whether the risk shield fulfilled them as seen above. Therefore, the formation of the risk shield in question was at the very least badly executed by the German authorities with the Commission taking their usual laid-back approach of “You have six months to fix it.” Regardless, that is the approach the Commission has taken to the Financial Crisis and crucially, it is homogeneous within the EU. Moreover, The Commission puts big emphasis on Member States providing all information and data that might be relevant and if there might be the slightest delay in the restructuring plan it should be notified. In the end, it has to be criticised that the Commission simply did not consider the risk shield incompatible with the Treaty as the number of faults entailed in the risk shield are plenty, as previously illustrated. Thus, it is still an open question how bad a state measure has got to be in order for the State authorities not to receive a prolongation to rectify their mistakes.

4.6 General Schemes and Ad Hoc Interventions.

There have been substantial amounts of general schemes introduced by Member States in the light of the recent Financial Crisis.¹⁶⁷ Most of them are strikingly familiar with the Commission, using the same approach on the application of 107(3)(b) and its soft law. In that regard, it is perhaps most suitable to start with the “most valuable“ Commission decision on the schemes introduced by Denmark in light of the Financial Crisis. The Denmark’s state

¹⁶³ *Ibid.*, para 53

¹⁶⁴ *Ibid.*, para 56

¹⁶⁵ *Ibid.*, p. 15

¹⁶⁶ *Ibid.*

¹⁶⁷ Spring Scoreboard 2009, p. 17 and onwards (cited in fn.127)

guarantees alone amounted to a total 580.00 billion EUR after the latest modification of the guarantee scheme.¹⁶⁸

In short, Denmark introduced three general schemes on 23 January 2009 in the form of a recapitalisation scheme for credit institutions in Denmark and amendments to a guarantee scheme for banks located there.¹⁶⁹ The recapitalisation scheme was introduced on the ground that the Danish economy had been severely hit by the current crisis.¹⁷⁰ Current growth in Denmark was slowing down at an increasing rate with export markets affected by the crisis. On top of that, private consumption had been dampened for several reasons expressed in the decision with the most notable one relating to the bad outlook on the Housing Market. Amendments made to the State Guarantee schemes were also considered necessary to include newly issued loans to ensure that credit institutions continued to have access to medium term liquidity and thus avoiding banks' cutting off loans and credits.

The Danish authorities and the Commission were in agreement that the state measures fulfilled the conditions laid down in Article 107(1) TFEU and in that light the Commission examined whether it fulfilled conditions laid down in Article 107(3)(b) TFEU for the state measures to be granted an exemption. The Commission expressed the importance of there being a measure that has the effect "to remedy a serious disturbance in the economy of a Member State".¹⁷¹ Subsequently, the Commission recalls a long line of judgements by the CFI and the Commission where it is stressed that Article 107(3)(b) TFEU is to be applied restrictively and that it must tackle a disturbance in the entire economy of a Member State.¹⁷² With that in mind, the Commission agreed with the Danish authorities that if the problems would not be addressed it would have a systemic effect on the Danish economy as a whole and therefore the scheme was considered to be apt to remedy a serious disturbance in the Danish economy.¹⁷³

¹⁶⁸ Table in Spring Scoreboard 2009, p.17 (cited in fn. 127)

¹⁶⁹ In addition, cash payment facility for the winding-up company were introduced as well

¹⁷⁰ *Danish Bank Recapitalisation Scheme and Guarantee Scheme on New Debt* (Case N31a/2009) [2009] JOCE C/50/2009, para 10

¹⁷¹ *The Danish New Debt Scheme*, para 57 (cited above)

¹⁷² *Ibid.*, para 57; Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para 167; Confirmed in *Crédit Lyonnais* (Case C-47/1996) Commission Decision 98/490/EC [1998] OJ L/221/28, para 10; *Bankgesellschaft Berlin* (Case C-28/2002) [2005] OJ L/116, page 1, para 153 and onwards; *BAWAG* (Case C-50/2006) [2007] JOCE L/83/2008, para 166; *Restructuring Aid to Northern Rock* (Case NN-70/2007) [2007] JOCE C/43/2008, p. 1 *Rescue aid to WestLB* (Case NN 25/2008) [2008] C/189, p. 3; *SachsenLB* (Case C-9/2008) [2008] JOCE L/104/2009

¹⁷³ *The Danish New Debt Scheme*, para 58 (cited in fn. 170)

The Commission, when assessing whether an aid scheme is compatible with Article 107(3)(b) stated that it must, in the light of the objectives of the Treaty and in particular old Articles 3(1)(g) and 4(2) EC, comply with the following conditions:¹⁷⁴

- a) *Appropriateness: The aid has to be well targeted in order to be able to effectively achieve the objective of remedying a serious disturbance in the economy.*
- b) *Necessity: The aid measure must, in its amount and form be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in less distortive form were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary.*¹⁷⁵
- c) *Proportionality: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives.[...]*

To start with, the Commission examined the recapitalisation scheme and considered it compatible with the above mentioned conditions and thus Article 107(3)(b) for various reasons put forward in its decision.¹⁷⁶ Furthermore the Commission looked into the new guarantee scheme. First the Commission considered the scheme to be the appropriate means as it has on numerous accounts established that guarantee schemes should help to overcome liquidity difficulties by allowing a revival of interbank lending.¹⁷⁷ When it comes to the necessity, the Commission notes that the guarantee is needed because the supply of medium term liquidity had become a challenge and that those institutions already members of the existing guarantee schemes will have to pay a fee to be part of the new guarantee.¹⁷⁸ Regarding the time limit, the duration of the guarantee will not be any longer than 3 years with the application window lasting to 31 December 2010 if the Financial Crisis will be ongoing. Thus, the necessity condition was fulfilled. Lastly, the Commission, noted that the measures were proportional as distortion of competition is minimised with various safeguards. With the most important one being a market-oriented premium which guarantees that financial institutions will pay on average an adequate premium. In addition, safeguards from the previous existing guarantee scheme will be applied for the new one. Behavioural

¹⁷⁴ Ibid., para 59. Those conditions are often referred together as the Rule of Proportionality.

¹⁷⁵ Confirmed in the Court's case-law: Case 730/79 *Philip Morris* [1980] ECR 2671; Case C-390/06 *Nuova Agricast v Ministero delle Attività Produttive* [2008] ECR I-2577, where the Court held that, "As is clear from Case 730/79 [...], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market [...]."

¹⁷⁶ *The Danish New Debt Scheme*, paras 60-75 (cited in fn. 170)

¹⁷⁷ Ibid., para 76

¹⁷⁸ Ibid., paras 77-78

safeguards such as no mass marketing, regular reporting on the operation of the scheme and limitation of aggregate balance sheet growth and limitation in relation to management's salaries to name a few.¹⁷⁹

Finally, Ad Hoc interventions are made in favour of specific financial institutions. Thus, they do not constitute a general scheme made for host of financial institutions in Member States. The R&R Guidelines and Article 107(3)(c) are interesting in this context as they apply to undertakings in financial difficulties, similarly to the situation regarding Ad Hoc interventions. Regardless, the Commission has addressed the ad hoc intervention in the Financial Crisis under Article 107(3)(b). One cannot underestimate the importance of these measures for competition authorities as they are highly likely to distort the market if not used restrictively as they they amounted to nearly 400 billion Euros before 31 March 2009. To put it into context, it corresponds to approximately 0,32% of the EU GDP.

4.7 Remarks

First of all, strangely and somewhat remarkably there had been no negative decision adopted in 2009 and quite few formal investigations initiated. What is surprising about that is the abnormality of the situation. Every single one of those State Aids would have struggled to be exempted before the Financial Crisis. It is only in this context that various state measures have been deemed compatible with the Treaty.¹⁸⁰ Secondly, it remains to be seen where the threshold stands. That is, what threshold does an undertaking have to exceed for it to be deemed to have returned to profitability.¹⁸¹ Thirdly, one question always remains the same, is it proportional or even necessary for Member States to issue full state guarantees for banks in crisis? That discussion does not even seem to have taken place.¹⁸² The most prosperous and idealistic way would be a pan European aim in dealing with the Financial Crisis with state guarantees. In a way, the framework exists within Directive 2009/14/EC which originally guaranteed a minimum 50000 EUR per deposit with that being doubled on 31 December

¹⁷⁹ Ibid., paras 35 and 81-82

¹⁸⁰ Andreas Bartosch, "Editorial On competition or its leftovers" [2009] 8(2) EStAL 111, 111

¹⁸¹ Ibid.

¹⁸² With that said, note the little distortionary impact the state guarantees had on non participating banks as examined by London Economics in their study on behalf of EC DG Economic and Financial Affairs. Regardless, the authors themselves belittle their own conclusion by stating that "[...], one should be very prudent in drawing any policy conclusions concerning scheme design and effectiveness with regards to bank outcomes." Patrice Muller, Shaan Devnani and Rasmus Flytkjaer, "The impact of state guarantees on bank's debt issuing costs, lending and funding policy" (2012) 447 Economic Papers 10, 112-113. Another factor is that bonds issued by state guaranteed banks in Ireland and non-state guaranteed banks in French is not really comparable as Ireland are encountering serious difficulties with huge amount of debts while French's problems are nowhere near that of Ireland.

2010. Thus, in a sense, the Financial Crisis has rendered the Directive nearly meaningless. The only realistic circumstances where the Directive will be used is when a small bank is liable to go bankrupt. Furthermore, as we will see from ESA's decision on BYR, if a small bank is in trouble within the context of a Financial Crisis the exemption found in Article 107(3)(b) TFEU still applies. So in such scenarios, in addition to dealing with big banks, Member States will be tempted to use the exemption found in Article 107(3)(b) TFEU. The idea is formidable but it is too limited in scope as the Directive only applies to deposits and the guarantee is not set high enough. Retailers and big money owners will not only have a higher incentive to move their deposits to banks with full state guarantees but put huge pressure on governments to act in times of trouble¹⁸³. Still, without a doubt, the new minimum deposit guarantee represents more fairness than an unlimited state guarantee as European citizens do not need to bail out banks to such a vast extent. Surely, if this Financial Crisis has taught us nothing else it is that there is an underlying state guarantee for every bank waiting to breathe air. Lastly, recent elections in Greece clearly illustrate the importance of banks being able to fail without the tax payer having to save them.

¹⁸³ Not everyone agrees with that assessment. See e.g. a statement in an excellent thesis on the history of Article 107(3)(b) TFEU: "By implementing a pan European Guarantee Scheme covering up to 100,000 EUR it will reduce the need of the member states to introduce domestic guarantee schemes" Eoin Pentony "Is the European Commission's recent interpretation of Article 107(3)(b) TFEU a departure from established State aid policy on the financial sector?" (MA thesis Dublin Institute of Technology 2010), p. 56

5 ESA and Iceland

5.1 Glitnir Bank hf

ESA has adopted three similar measures regarding the Financial Crisis with two of them nearly identical. The measures taken to rescue Glitnir Bank and Kaupthing Bank and the restructuring process that followed was pretty much the same in both cases.¹⁸⁴ Subsequently, it seems natural to start by examining the decision made on Glitnir Bank since it actually set the tone for future decisions in the Icelandic Financial Crisis as described in the Introduction. Later on, we will look at the decision on Landsbanki hf with the aim of examining whether there was any difference in the reasoning as ESA came to the same conclusion regarding all Big Icelandic Banks.¹⁸⁵

In the Glitnir case the State Measures revolved around the Emergency Act introduced by the government shortly after the State had announced their intention to buy shares in Glitnir Bank and thereby, recapitalising Glitnir with 600 billion EUR. A plan which was later abandoned due to a large amount of debt to be repaid in the coming months. Instead the FSA took over the operation of the Glitnir bank given authority by the recently passed legislation referred to as the Emergency Act and with that, the power to decide on the disposal of Glitnir's assets and liabilities. What is interesting in the Icelandic situation compared to what was happening in Europe is that the Icelandic government, essentially, divided the bank into two. Certainly, that was the European way at the time but here the means were different. The Icelandic government appointed a Resolution Committee for Glitnir who acted with the power of the board of directors and formed a New Glitnir bank,¹⁸⁶ fully owned by the state. Subsequently, the FSA transferred all domestic liabilities to Íslandsbanki and in addition, several assets with large part of them being domestic. Instead, Glitnir bank was to be compensated a sum made up of the difference between the value of the assets transferred to Íslandsbanki and the amount of liabilities transferred meaning that its creditor would not go empty handed. As might be expected the process was far from simple when putting down a valuation of those assets. In short, the Icelandic authorities separated the foreign operations of the old banks from the domestic deposits and loans located in the newly established banks and subsequently let the

¹⁸⁴ The difference was only in the facts of the case and did not matter in the outcome.

¹⁸⁵ See ESA Decision in Case 492/10/COL *Kaupthing banki hf* [2011] OJ C41 7; ESA Decision in Case 493/10/COL *Landsbanki Íslands hf* [2011] OJ C41 31; ESA Decision in Case 494/10/COL *Glitnir Banki hf* [2011] OJ C41 51

¹⁸⁶ Later renamed Íslandsbanki hf and the bank will be referred to as Íslandsbanki henceforth

old bank enter bankruptcy proceedings.¹⁸⁷ This approach is central to the Emergency Act and essentially protected the internal payment system.¹⁸⁸

5.1.1 The State Aids

To start with, the state recapitalised the new bank by providing around 5 million ISK in cash as initial capital and in addition issued a commitment to contribute up to 110 billion ISK to the new bank in exchange for all of its equity.¹⁸⁹ The figure was estimated as a 10% of an initial assessment of the likely size of the bank's risk weighted asset balance with the intention to provide an adequate guarantee of the operability of the banks until all other issues could be resolved.¹⁹⁰ Moreover, the state, provided a measure guaranteeing all deposits in Íslandsbanki with the government referring to it on a regular basis.¹⁹¹ Contrary to the ESA's approach, the method in Europe was to split them into a bad bank and a good bank. Thus, a good bank would hold the good assets of the banks with all domestic and foreign deposits guaranteed with the bad bank getting the so-called toxic assets.¹⁹² Some even think that was a viable option for Iceland in the summer of 2008.¹⁹³

5.1.2 The creditors' agreement

The first option for creditors for compensation was to gain control of 95% of the share capital in Íslandsbanki as part of compensation package from the state with the government also contributing to the capital of Íslandsbanki with a subordinated loan amounting to 25 billion ISK with a Tier II ratio of around 4%.¹⁹⁴ Secondly, the creditors, in the event they did not desire to acquire control of Íslandsbanki, would be compensated through three bond instruments which would in the end amount to 132 billion ISK. Within that package, the creditors could still exercise a right to acquire control of 90% of the government's shares in Íslandsbanki but only exercisable between 2011 and 2015.

On 15 October 2009 Glitnir's Resolution Committee acting on behalf of its creditors decided to take option 1 and acquire 95% of the share capital in Íslandsbanki with the government

¹⁸⁷ Gylfi Zoega and Jón Daníelsson, "The Collapse of a Country" [2009] W09:03 IOES, p. 14-15

¹⁸⁸ Ibid.

¹⁸⁹ ESA Decision on Glitnir Bank, p. 8 (cited in fn. 185)

¹⁹⁰ Ibid.

¹⁹¹ Ibid.; The Icelandic Government's Press Announcement on the 3rd February 2009 and the 9th December 2009; The Ministry of Finance, "Ríkisábyrgðir og áhættuskuldbindingar" [2011] Icelandic Budget Act

¹⁹² The Collapse of a Country, p.10-11 (cited in fn. 187)

¹⁹³ Ibid.

¹⁹⁴ ESA Decision on Glitnir Bank, p. 9 (cited in fn. 185)

holding the other 5% by providing a sum of 5,5 billion ISK in capital.¹⁹⁵ In addition the Government provided Íslandsbanki with a subordinated loan to strengthen the equity and liquidity position of Íslandsbanki and by that complying with the requirements of the FSA. The subordinated loan amounted to around 128 billion EUR and was repayable within ten years of 30 December 2009 with interest rate per annum 400 basis points above EURIBOR which subsequently gets considerably higher in the latter 5 years.¹⁹⁶ Lastly a Special Liquidity agreement had been agreed if the creditors took control of Íslandsbanki consisting of max loan amount of 25 billion ISK with various interest rates.¹⁹⁷ Therefore, the three conditions that needed to be satisfied for the restructuring of the three main Icelandic banks to begin had been fulfilled. International stakeholder claim had been settled through the Resolution Committee of Glitnir bank, recapitalisation had been provided and lastly the future ownership structure had been clearly established.¹⁹⁸ Another issue worth mentioning is the Straumur securities lending agreement which effectively resulted in Íslandsbanki taking over Straumur's liabilities for deposits which Íslandsbanki in return got a bond from Straumur for assuming deposit obligations.¹⁹⁹ More importantly, the agreement gave Íslandsbanki even more access to liquidity from the Government through the Central Bank of Iceland.²⁰⁰

5.1.3 State Aid Issues

Disturbingly and rather stubbornly, the Icelandic government had denied, on at least two occasions, that the “rescue measures“ undertaken for the Icelandic banks should be considered as having elements of State Aid according to Article 61(1) of the EEA Agreement.²⁰¹ Finally, the Icelandic Government, in its notification, changed their view by stating that the aforementioned measures constitute State Aid.²⁰² Naturally, The EFTA Surveillance Authority agreed with that statement by stating that the recapitalisation and the state guarantee of deposits should be considered as State Aid.²⁰³ Both measures involved a transfer or a possible transfer of State Resources to Íslandsbanki.²⁰⁴ Additionally, ESA concluded that the recapitalisation measures conferred an advantage on Íslandsbanki and were

¹⁹⁵ Ibid., p. 10 (Tier I capital contribution)

¹⁹⁶ Ibid., p. 10 (Tier II capital contribution)

¹⁹⁷ Ibid., p. 10 (Special Liquidity Facility)

¹⁹⁸ Ibid., p. 11

¹⁹⁹ Ibid., p. 12

²⁰⁰ Ibid.

²⁰¹ Article 107(1) TFEU.

²⁰² ESA Decision on Glitnir Bank, p. 15 (cited in fn. 185)

²⁰³ Due to several reasons the author will only examine the recapitalisation and state guarantees from the Decision as they are most interesting towards the aim of the thesis.

²⁰⁴ ESA Decision on Glitnir Bank, p. 20-21 (cited in fn. 185)

selective as the measures were not granted to all operators on the market.²⁰⁵ The state guarantee had the same effect, i.e. it conferred an advantage on Íslandsbanki and actually the whole banking sector but that did not prevent the measure from fulfilling the selective criterion and therefore constitute State Aid.²⁰⁶ Subsequently, the measures were considered to distort competition and constitute State Aid according to Article 61(1) of the EEA Agreement.²⁰⁷ Then ESA examined whether conditions under Article 61(3)b of the EEA Agreement were fulfilled and applied the three pong test of necessity, appropriateness and proportionality. First of all, the necessity of the measures was rather straight forward with ESA concluding that it was self evident that the state had to intervene in order to restore the Big Icelandic Banks and avoid a systemic failure of the Icelandic financial system.²⁰⁸ Secondly, ESA examined whether the measures were appropriate, that is, would the means taken achieve the objective of safeguarding an Icelandic banking sector and the wider economy. Subsequently ESA concluded that the approach taken by the Icelandic Government was likely the only credible and effective way to achieve that objective,²⁰⁹ dismissing other possible measures used in the Financial Crisis within the EEA.²¹⁰ On the proportionality, ESA started by stating that the impact on competition and trade across the EEA was limited as the three main banks in Iceland controlled 80% of the domestic market.²¹¹ In addition the state intervention is prima facie proportionate as it ensures that the creditors of the old bank become majority shareholders of the new bank and by that ensuring quick private sector involvement in the bank and reducing substantially the amount of aid paid by the State.²¹² Moreover, the amount of the capital provided is the absolute minimum necessary to comply with the minimum capital adequacy ratio set by the FSA. Then interestingly ESA states:

²⁰⁵ Ibid., p. 21

²⁰⁶ Ibid.

²⁰⁷ Ibid., p. 22

²⁰⁸ Ibid., p. 24

²⁰⁹ Ibid.

²¹⁰ Ibid. State Aids such as plain recapitalisation, restructuring and relief for impaired assets.

²¹¹ Ibid. Interesting to compare the market share expressed in this decision and then the market share expressed in the BYR decision but the author will address that issue later in the thesis

²¹² The problem with that argument on pages 24-25 in the Decision is that the aid paid by the State was not in a sense reduced, it was rather changed into a loan to a private company instead of them actually putting money into a State owned undertaking. The difference is hard to see as even though the Government gets fair interests rates on the subordinate loan it does not mean that the Government wouldn't have benefitted a lot more from taking the bank over. Popular views in competition law such as Consumer Welfare's is not taken into the context as the most important thing is that the State gets as much money back as possible which in the end would mean that the consumer's in Iceland would have more money to pay off their debts to the banking system. Private Sector involvement in the bank should not be a positive indication when investors in reality do not bring any money to the table, rather let of their previous demands

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an "entry level" price for capitalising fundamentally sound banks.

Capitalisations of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. Although the remuneration payable in the case of Islandsbanki does not most likely comply with these requirements it is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.²¹³

Thus, ESA seems to have introduced an exception to the remuneration of capital rules found in The Recapitalisation Communication not found in the Communication itself. On the timescale side of the measures the ESA took an understanding view in the light of various issues affecting the rescue and restructuring intention of the Icelandic authorities. The most delaying aspects of those was the asset estimation as the Icelandic Authorities had appointed Deloitte to put value on the Glitnir's banks assets and the substantial amount of loans that are non-performing which consist of 39% of all loans. Therefore, the circumstances are exceptional and the rescue measures should be able to remain in place for a longer period than normally allowed. An open possibility was left in the Authority's guidelines on recapitalisation that in some cases longer periods of time was needed for restructuring.²¹⁴

5.1.4 Remarks

What's important to highlight in the approach taken by the Icelandic government in this case and essentially the same approach in Kaupthing is the seemingly contradicting aspect of the government's measures. First, when rescuing and restructuring the banks the Icelandic government highlights the importance of saving the banks for the real economy and that the measures taken would accomplish that goal. What is contradicting, is the fact that the measures taken by the government do not envisage a lot of private money involvement as the money used to "buy" the two banks are subordinated loans from the Icelandic Government through the CBI. This point is highlighted in the Competition Authority of Iceland's report on the rescue measures used in the Financial Crisis in Iceland. Another point of note is the distortion of competition effect. ESA contends that as the Big Icelandic Banks hold 80% of the market the distortion is not enormous not even taking into the fact that it will aid in the prevention of other foreign banks establishing subsidiaries in Iceland.²¹⁵ That point was actually taken up by the Commission in October 2011 where it stated that State Aid to banks

²¹³ ESA Decision on Glitnir Bank, p. 25 (cited in fn. 185)

²¹⁴ Ibid., p. 25-26

²¹⁵ Ibid., p. 24

could have a bad effect on the level playing field in the internal market as it could prevent potential entry by foreign banks into the domestic market.²¹⁶ In that context, it is good to remember the words of Joaquín Almunia, the Vice President of the European Commission, when expressing his opinion on the proposed merger between NYSE/Euronext and Deutsche Börse and the subsequent impact on the derivatives market in Europe.²¹⁷

“In this particular case, we are concerned that a very large player may monopolise the derivatives markets in Europe. Therefore, any outcome that would eliminate the possibility of new entry and user flexibility would be unacceptable to us.”

Furthermore, in light of the misleading numbers expressed by ESA, the author expresses serious concerns over the professionalism in assessing the aid provided to the Big Icelandic Banks. ESA, when assessing the aid stated that the Big Icelandic Banks in Iceland made up over 80% of the domestic market.²¹⁸ However, in its assessment of BYR things have seemingly changed with ESA stating that the Big Icelandic Banks held a market share of up to 90% in most segments of the Icelandic financial market. Though, strictly speaking, the former number is true the latter gives a whole new picture of the situation in the Icelandic market with the Big Icelandic Banks collectively super dominant.²¹⁹ This does not quell whispers on the rubber stamp approach taken by the Commission and ESA in the Financial Crisis. Moreover, the 90% market share is more in line with note no. 1/2011 of the Competition Authority of Iceland where the Big Icelandic Banks collectively hold around 87,5% of the market share for loans to homes and 92,5% for loans to companies.²²⁰ At the very least, this goes to show that competition effects are not taken as seriously as one might expect.

5.2 Byr and how the global Financial Crisis threatens to destroy everything

The Old Byr was a savings bank that had been created by mergers of four saving banks in Iceland between 2006 and 2008.²²¹ The New Byr on the other hand was founded on 22 April 2010 with the now customary transfer of all assets and certain liabilities from Old

²¹⁶ The Commission Staff Working Paper, “The effects of temporary State aid rules adopted in the context of the financial and economic crisis” (SEC(2011) 1126 final), p. 87

²¹⁷ Joaquín Almunia Vice President of the European Commission, “State aid control as a resolution tool in the EU” (2011) SPEECH/11/57

²¹⁸ E.g. ESA Decision on Glitnir Bank, p. 24 (cited in fn. 185)

²¹⁹

²²⁰ The average of all estimations was used in the calculation. The Icelandic Competition Authority, *On Competition in the Banking Sector in Iceland* (Note No 1, 2011), p. 59; The Icelandic Competition Authority Press Announcement on 13th September 2011

²²¹ ESA Decision in Case 126/11/COL on state aid for the establishment and capitalisation of BYR hf [2011] OJ C 182 12

Byr. ESA does not go into detail on the market share of BYR but it was relatively small compared to the Big Icelandic Banks on around 5-10%.²²² The main measures in question are initial share capital contribution of ISK 900 million by the state by acquiring 100% in the bank, commitment from the Icelandic authorities to enter into a subordinated loan facility agreement and a settlement agreement on transfer of assets and liabilities of Old Byr to New Byr. That would result in new shares being issued to Old Byr in case the assets outweighed the liabilities.²²³ Therefore, the total equity of New Byr would amount to ISK 17.2 billion.²²⁴ In addition, there was an option to purchase the government's stake applying for one year on a price equal to what the Icelandic Government paid to acquire the shares in New Byr with interest rates.²²⁵ Subsequently, ESA, found the state measures to be State Aid under Article 61(1) of the EEA Agreement and then examined whether an exemption should be granted. ESA concluded that the measures fell within the scope of Article 61(3)(b) of the EEA Agreement as the collapse of several big financial institutions in Iceland resulted in a serious disturbance in the economy. Further on, it considered that the measures were necessary and appropriate as the collapse of New Byr, Iceland's fourth biggest bank, would lead to a severe blow for the financial system and in particular to confidence of deposit holders in Iceland.²²⁶ In the end, the measures were considered proportional after a thorough economic assessment of the measures and the repayment plan.²²⁷

5.2.1 Remarks

First, the discussion on banks being too big to fail always comes up regarding the big banks in the Financial Crisis as ESA did in the case of the Big Icelandic Banks by stating the importance of saving them as at the time they held over 80% of the market.²²⁸ But then, when it comes to small savings banks like Byr, even though it is the fourth biggest, ESA takes the other view pole by stating that BYR is really the only alternative to the Big Icelandic Banks by holding a market share of 8.8% in retail market and 10% in the corporate market.²²⁹ Thus, by letting BYR go to bankruptcy would effectively lessen competition on the national market. That immediately begs the question why ESA didn't try to impact the size of the Icelandic banks and even consider to split them up to increase competition. Second, competition

²²² See fn. 220

²²³ ESA Decision on BYR, p. 4 (cited in fn. 221)

²²⁴ *Ibid.*, p. 5

²²⁵ *Ibid.*

²²⁶ *Ibid.*, p. 13

²²⁷ *Ibid.*, p. 13-16

²²⁸ ESA Decision on Glitnir Bank, p. 24 (cited in fn. 185)

²²⁹ ESA Decision on BYR, p. 16 (cited in fn. 221)

arguments in the banking sector do not really hold ground these days when it comes to deposits as e.g. increasing competition between banks automatically leads to higher interest rates for deposits. That in turn leads to the banks being able to access more liquidity and loan more money and thus the risks get higher as banks holding only deposits for ISK 500 could in reality loan out for around ISK 10000.²³⁰ And as happened in the Icelandic Financial Crisis the banks had outgrown Iceland and when ultimately they couldn't pay their debts as access to liquidity dried up it all fell on the Icelandic government.²³¹ So for all the competition between the banks in getting deposits nation- and world wide it only resulted in a Financial Crisis which few stand to benefit from. Third, ESA maintains their view that the Icelandic economy is in turmoil by stating that "[...], the Icelandic financial system is still in a state of turmoil inter alia due to the ruling of the Supreme Court in June 2010 declaring certain types of foreign currency denominated loans to be unlawful."²³² One one hand you could argue on the fact that the judgement is clearly not part of the reason that the Icelandic Financial System might be in turmoil as the banks themselves have even looked at the judgement in question quite restrictively.²³³ On the other hand it is risky to suggest that if a controversial judgement is given it could translate to a turmoil situation in the Icelandic financial system. More appropriate would have been to state that the Icelandic Financial System was in a state of turmoil because of large amount of government debt. In addition, ESA seems to regard a simple turmoil situation equivalent to a serious disturbance in a Member State which subsequently goes to show the lack of arguments ESA had to apply Article 61(3)(b) of the EEA Agreement. Fourth, there's a real doubt in the author's view whether this case should come under the scope of Article 61(3)(b) of the EEA Agreement, but not under the R&R Guidelines based on Article 61(3)(c) of the EEA Agreement. The Argumentation applied by ESA doesn't hold up in that regard. For a State Aid to be granted an exemption on Article 61(3)(b) it needs to be able "[...]to remedy a serious disturbance in the economy[...]" while

²³⁰ On the other hand, one can see the importance when it comes to lending practices as more competition in that area would lead to lower interest rates on consumer's loans.

²³¹ Jared Bibler, an examiner at verðbréfasviði the FSA has an interesting way of describing the fall of the Big Icelandic Banks. They held assets for a total of USD 182 billion in June 2008 and he subsequently described their collective size as more than 80% of Northern Rock. If it was an USA bank it would have made the third biggest bankruptcy in its history. On the impact it had on a small country like Iceland he drew comparison with the UK having to handle serious financial disturbances in more than 140 Northern Rock banks. Jared Bibler, "Hversu stórt var fall íslensku bankanna á heimsmælikvarða" [2010]

²³² ESA Decision on BYR, p. 12 (cited in fn. 221). The seriousness of the judgement is clearly overstated. E.g. it took the savings bank SPRON only 1 month to calculate which customers the judgement was applicable to and work began to rectify the foreign currency denominated loans. See Spron Press Announcement on 16th February 2012 and the 16th March 2012

²³³ See press announcements referred to above.

ESA simply states that the “collapse of Iceland’s main financial institutions has resulted in a serious disturbance in Iceland’s economy.” Thus, ESA puts weight on BYR partly falling due to the meltdown of Iceland’s financial institutions and of the global Financial Crisis to conclude that Article 61(3)(b) of the EEA Agreement should be applied. Instead, ESA should have come to the conclusion that if BYR would fall it would not result in a serious disturbance in the economy of Iceland and therefore Article 61(3)(b) EEA Agreement could not be applied. In addition, the defeatist attitude is quite prevailing from the competition authorities with ESA in their assessment of the proportionality of BYR stating that there was no other way. Same with the competition authorities in Iceland regarding SPRON where it admitted that there was no other option than to allow the merger between Kaupthing and SPRON as the latter would have ceased to exist regardless.²³⁴ Some would ask themselves whether a scenario where the government would step in and take over the bank and compete with the Big Icelandic Banks, until a viable buyer is found, isn’t a better option than increasing the market share of those holding around 90% of the market.

5.3 State measures to Íslandsbanki for the acquisition of BYR

The saga took a somewhat surprising twist when Íslandsbanki was granted permission to acquire BYR and subsequently it came to ESA to decide whether to grant an exemption under Article 61(3) of the EEA Agreement to Íslandsbanki.²³⁵ What makes the decision really special is the fact that Íslandsbanki is one of the Big Icelandic Banks and ESA had earlier reminded us of the need to have a fourth bank for the sake of competition.

The measures involved were the extension of the subordinated loan facility granted to BYR hf as well the acquisition of Byr by Íslandsbanki. BYR had struggled to meet the Capital Adequacy ratio requirements set by the FME and subsequently the sale process started which was concluded on 12 July 2011 more than 3 months before the exemption from CAD ran out.²³⁶ In short, there were only two serious buyers that wanted to acquire BYR. Íslandsbanki and an unnamed bank referred to as XY Bank. First of all, ESA examined the funding for the transaction. According to the Icelandic authorities Íslandsbanki had a clear funding confirmed by the Chairman of the Board of Directors of Íslandsbanki and the bank’s auditors. On the other hand the funding from XY Bank was obscure as it was conditional upon the successful

²³⁴ The Icelandic Competition Authority Press Announcement on 26th September 2008

²³⁵ ESA Decision in Case 325/11/COL *on the acquisition of Byr hf by Íslandsbanki and the prolongation of the temporary approval of the subordinated loan facility granted to Byr hf* [2011] OJ C16 10

²³⁶ *Ibid.*, p. 2-3

subscription for new shares in XY Bank of ISK and quite unclear whether the necessary funding could be obtained. Secondly, Íslandsbanki provided two options to purchase old shares both of them connected to an issuing of a bond with both options being rather straightforward.²³⁷ By contrast, the XY Bank had a more complex offer relating to an offer to the shareholders of BYR having their BYR shares transferred to a newly issued and separate class of shares of XY Bank with several conditions.²³⁸ One of them seemingly more important in the final conclusion was the fact if BYR's equity, after revaluation of assets, would be less than zero and/or would adversely affect XY Bank's equity ratio a guarantee would hold the XY Bank harmless.²³⁹ Other differences in offers related to the subscription of new shares, unilateral right of termination and offer of further negotiation.²⁴⁰

On the State Aid granted to Íslandsbanki for the acquisition of BYR ESA considered it to involve elements of State Aid according to Article 61(1) of the EEA agreement and subsequently assessed whether it was liable to be granted an exemption on Article 61(3)b of the EEA agreement and whether it was in conformity with the Restructuring Guidelines.²⁴¹ The important paragraphs in the guidelines are 39-41 but the first two state that State aid must not be used to the detriment of competitors which do not enjoy similar public support such as when a bank uses state aid for the acquisition of competing businesses. The exception to that is subsequently found in para 41 of the guidelines:

“In exceptional circumstances and upon notification, acquisitions may be authorised by the Authority where they are part of a consolidation process necessary to restore financial stability or to ensure effective competition. The acquisition process should respect the principles of equal opportunity for all potential acquirers and the outcome should ensure conditions of effective competition in the relevant markets.”

Multiple criteria can be drawn from the paragraph:

- i) *Exceptional Circumstances*
- ii) *A Consolidation Process*
- iii) *Restore Financial Stability or*
- iv) *Ensure Effective Competition*

²³⁷ Ibid., p. 4

²³⁸ Ibid.

²³⁹ Ibid.

²⁴⁰ Ibid., p. 4-5

²⁴¹ Communication from the Commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules, OJ C 195, 19 October 2009, p.9 (The Restructuring Guidelines)

- v) *Principle of Equal Opportunity*
- vi) *Conditions of Effective Competition*

Firstly, ESA considered that it was justified to invoke exceptional circumstances in light of the continued delicate situation in the Icelandic financial market.²⁴² Secondly the envisaged merger was considered to be part of a consolidation process as certain efficiency gains would be gained by the acquisition with the resulting reduction of branches, staff and backoffice cost,²⁴³ the acquisition should still ensure effective competition in the markets concerned,²⁴⁴ and the Icelandic financial system remains too large to be sustainable in the long run.²⁴⁵ Then as for the sale procedure itself, the Authority reckons there is no reason to doubt that the principle of equal opportunity was not respected.²⁴⁶ Regardless, ESA expressed doubts over whether the acquisition was necessary to restore financial stability and whether it would result in effective competition in the market concerned.²⁴⁷

When examining the conditions of necessity, appropriateness and proportionality ESA concluded that the insolvency of BYR could have resulted in a serious threat to financial stability as the non-access to deposits would have destabilised the whole financial sector in Iceland and thus the acquisition was both necessary and appropriate.²⁴⁸ The proportionality assessment proved to be more interesting with ESA admitting that it would have been, undoubtedly, more advantageous for competition in the Icelandic financial markets had Byr been taken over by a smaller player such as XY Bank.²⁴⁹ Before hand the Big Icelandic Banks jointly held up to 90% of the market with ESA expressing its concerns on how the transaction will impact competition in the Icelandic financial markets.²⁵⁰ Subsequently, ESA ruled out the possibility of the XY Bank acquiring control over BYR giving weight to the argumentation of the Icelandic authorities that it was unclear whether necessary funding for the transaction would have been obtained by the XY bank.²⁵¹ In addition, ESA did not find it relevant whether the guarantee XY Bank requested would constitute State Aid in the meaning of Article 61(1) of the EEA Agreement(85).²⁵² Further on, the Icelandic authorities contended

²⁴² Ibid., para 79

²⁴³ Ibid., para 80

²⁴⁴ Ibid.

²⁴⁵ Ibid.

²⁴⁶ Ibid., para 81.

²⁴⁷ Ibid., para 82.

²⁴⁸ Ibid., para 83. Interesting how ESA looks at the necessity and appropriateness together.

²⁴⁹ Ibid., para 84.

²⁵⁰ Ibid.

²⁵¹ Ibid., para 86

²⁵² Ibid., para 85

that there were only two options left to choose from to safeguard financial stability. Either, agreeing to the acquisition in question or let BYR be taken over by the FME which subsequently would have lead to one of the Big Icelandic Banks taking over most of the market share held by BYR.²⁵³ Thus, a forced takeover by the FME would have been unsuitable as it would have created uncertainty about the state of financial stability in Iceland and therefore deemed the transaction proportional.²⁵⁴

5.3.1 Effective Competition

As the most attentive readers would notice, effective competition is mentioned twice in paragraph 41 of the Restructuring Guidelines. First as an alternative with financial stability and then as an effect of the state measure. The difference between the need to “ensure effective competition” and the aim that the outcome should “ensure conditions of effective competition” is quite vague. The former seems to broader and thus if a consolidation process would be considered necessary to ensure effective competition it would automatically ensure conditions of effective competition. On the other hand, the acquisition in question is part of a consolidation process which is considered to be necessary to restore financial stability but not necessarily to ensure effective competition. Regardless, the outcome should “ensure that conditions of effective competition in the relevant markets.”²⁵⁵ ESA when considering the bad impact on competition the acquisition would lead to it stated that their concerns had exacerbated as the Big Icelandic Banks’ market share would increase even more and Teris and the savings banks that depended on it would be badly affected by the fall of BYR.²⁵⁶ Lastly, instead of stating the obvious that the outcome would not lead to conditions of effective competition ESA referred to the case practice of the European Commission and invited the Icelandic Authorities to involve measures to limit distortions of competition to address the characteristics of the financial market in the restructuring plan that was to be submitted.²⁵⁷

5.3.2 Remarks

At the outset, it must be stated that the most important factor in the decision revolved around the possibility of XY bank acquiring BYR. First, in light of the distortive effect the merger will have on competition it is hard to comprehend why the Icelandic authorities didn’t

²⁵³ *Ibid.*, para 87

²⁵⁴ *Ibid.*, paras 88-89

²⁵⁵ *Ibid.*, para 76

²⁵⁶ *Ibid.*, para 90

²⁵⁷ *Ibid.*, para 92

require extra information from XY bank to explain the measures and possibly request better funding. The Icelandic authorities could even have assisted the XY bank in financing the takeover. Furthermore, the Icelandic authorities, through FME, could have taken over the bank and maintained its market position until it found a suitable buyer similar to the current situation with Landsbanki.²⁵⁸ There's a lot of uncertainty in Iceland and the author fails to grasp the reasoning that it would create more uncertainty if BYR was taken over by the FME. Finally, the soft approach taken by ESA to the limited competition in the Icelandic financial market is unacceptable. To start with, ESA should have forced the Icelandic authorities to submit a restructuring plan for the Big Icelandic Banks involving measures to rectify the bad competition aspects of the Icelandic financial markets such as decreasing the size of the Big Icelandic Banks by any means possible. Notwithstanding, ESA took another soft approach when allowing the acquisition of BYR by Íslandsbanki and finally inviting the Icelandic authorities to involve measures to limit distortions of competition in the restructuring plan. With BYR effectively disappearing from the market it means in reality that the Big Icelandic Banks share around 95% of the Icelandic financial market between them. ESA got the opportunity to take a harder stance to the Icelandic authorities and the Icelandic banks and failed to grasp that opportunity by authorising the acquisition.

5.4 The Icelandic Housing Financing Fund Saga

Another interesting decision made by ESA is in the case of the Icelandic Housing Financing Fund.²⁵⁹ Earlier, the EFTA Court had expressed doubts whether the IHFF operated in the services of general economic interest by providing general loans, supplementary loans and loans for rental housing.²⁶⁰ However in the ESA case we had the added twist of the Icelandic authorities trying to save the fund by injecting capital into the IHFF.²⁶¹ IHFF's main activity is to provide mortgages to individuals for the construction, purchase or renovation of residential housing. Problems began to surface with the Financial Crisis in the autumn of 2008 where a number of households in Iceland experienced debts problems for various reason. In fact right before the crisis the loan-to-value ratios had increased rapidly and with a decrease of around 20% after the crisis many mortgages exceeded the property value itself.²⁶² However, the big issue was the possibility of legal entities benefitting from the capital injection beyond

²⁵⁸ See ESA Decision on *Landsbanki Íslands* (cited in fn. 185)

²⁵⁹ ESA Decision of 23 March 2011 in case 69/11/COL on rescue aid to the IHFF OJ C 182, p.11

²⁶⁰ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland vs ESA* [2006] EFTA Court Report 2006, paras 66 and 69-79

²⁶¹ ESA Decision on IHFF, p. 1 (cited in fn. 259)

²⁶² *Ibid.*, p. 5

what a normal private creditor would have provided as the IHFF could also provide loans to municipalities, associations and companies for construction and purchase of residential housing for the purpose of letting.²⁶³ Interestingly, and what ultimately proved sufficient, the Icelandic authorities expressed their commitment to only agree to write downs for a legal entity where a company would otherwise be forced into liquidation.²⁶⁴ That is, the Icelandic authorities promised to uphold the private creditor principle in case of write downs of the debt's of legal entities so there was no State Aid element involved.

Further on, ESA looked at the general compatibility of the debt restructuring, capital injection and the state guarantee for the IHFF with Article 61(3)(b) of the EEA Agreement and thus whether the state measures complied with the conditions of necessity, appropriateness and proportionality. The debt restructuring and capital injection were considered strongly related as the 110% mortgage alignment measures without the capital injection would leave IHFF with major negative equity at the end of the year 2010 and considerable legal risk.²⁶⁵ In the end the measures were deemed necessary as without the mortgage alignment the IHFF would have suffered impairments to their mortgage assets,²⁶⁶ and subsequently the capital injection is inextricably linked with the mortgage alignment and to support the solvency of IHFF.

In assessing the appropriateness of the measures ESA took into account that numerous other measures had been offered by the Icelandic authorities instead of the 110% mortgage alignment but the Icelandic population chose not to participate in those measures.²⁶⁷ Thus, the measures were considered to be appropriate means to maintain some stability on the financial and real estate markets in Iceland and assist the Icelandic householders in their payment difficulties.

The proportionality seemed more difficult for ESA to assess. ESA concluded, at that stage, that it was not necessary for IHFF to provide remuneration for the capital injection by the Icelandic Authorities as it might qualify as a SGEI. The connection to SGEI comes strongly in the proportionality assessment as ESA leaves it open for the future provided restructuring plan for IHFF. That is, the unremunerated capital injection will be deemed proportional in a future restructuring plan if the SGEI is clearly defined.

²⁶³ *Ibid.*, p. 6

²⁶⁴ *Ibid.*, p. 10

²⁶⁵ *Ibid.*, p. 12

²⁶⁶ *Ibid.*, p. 9 and 12

²⁶⁷ *Ibid.*, p. 13

5.4.1 Remarks

A big question mark has to be put on ESA accepting only a commitment from the Icelandic authorities and not requiring actual actions from the state to prevent the funds being used to write off companies' debts. Another debatable point is the mortgage alignment as it is hard to envisage that it is necessary just because of the fact that it will suffer impairments anyway. The lack of economic assessment is evident when considering the mortgage alignment and why it was set at 110%. Lastly, the patience showed from ESA never ceases to amaze as the Icelandic Authorities and IHFF have now had little more than 6 years to provide a clearly defined scope for the SGEI involvement of the IHFF. You could call it flexibility but a better word would be carelessness as ESA seems to be in no rush to conclude whether there is a valid SGEI element involved in IHFF. As certainly, if ESA would deem IHFF not to be providing SGEI the state measures in question, without remuneration, would be highly distortive. In addition, the SGEI discussion at this point in time, during a Financial Crisis, must be awful timing for the state in light of the IHFF being the main motivator behind the 100% bank loans for purchasing real estate. It started in 2004 with the IHFF introducing loans for up to 90% and thereby initiating strict competition with the banks ending with all parties lending for 100%. The RNA described it as one of the bigger mistakes in economic control that lead to the fall of the Icelandic Banks. When considering the SGEI discussion in that light it seems obvious that IHFF is not an institution providing Services in the General Economic Interest.

5.5 The Mortgage Loan Scheme

On the 27th May 2009 ESA received a notification from the Icelandic authorities regarding the Mortgage Loan Scheme that was being introduced in Iceland.²⁶⁸ The Scheme authorises the IHFF to take over mortgage loans from certain financial institutions in Iceland in exchange for IHFF bonds, a form of permanent asset swap.²⁶⁹ Thus, a financial institution can use the IHFF bonds as collateral for them being able to take cash loans from the Central Bank of Iceland.²⁷⁰ Subsequently, the objective, was to provide liquid funds to eligible financial institutions and to ensure availability of loans for the residential housing market.²⁷¹

²⁶⁸ ESA Decision in Case 206/11/COL *on the Mortgage Loan Scheme in Iceland* [2011] Unpublished

²⁶⁹ *Ibid.*, p.2

²⁷⁰ *Ibid.*, p.3

²⁷¹ *Ibid.*

An important factor to consider is that the scheme was intended for small savings banks and in addition, to be permanent, opposed to the former scheme that had been introduced earlier in 2009.²⁷² As might be expected, several banks submitted applications for an asset swap under the Scheme: Keflavik Savings Bank, BYR Savings Bank, Bolungarvik Savings Bank, Ólafsfjarðar Saving Bank, Mýrasýsla Saving Bank, Höfðhverfinga Saving Bank and SPRON.²⁷³ The first three, Keflavik Savings Bank, BYR Savings Bank and Bolungarvik Savings Bank were accepted while the other four were rejected.²⁷⁴ Furthermore, after having concluded that the Scheme fell under Article 61(1) of the EEA Agreement ESA looked into the compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the Impaired Assets Communication.²⁷⁵ ESA had earlier considered the Icelandic authorities argument that the Scheme should fall under the Restructuring Guidelines but dismissed it as the Scheme could be applied to any financial institution regardless of whether the financial institutions were being restructured.²⁷⁶ That is an interesting comment by ESA as The Commission didn't even address it when when assessing the risk shield in the Nordbank case.²⁷⁷ Next, ESA started assessing whether an exemption under the IAC could be granted by looking into five main conditions: a) Eligibility of assets,²⁷⁸ b) Valuation,²⁷⁹ c) Burden Sharing,²⁸⁰ d) Remuneration,²⁸¹ and e) Scope and Duration²⁸²

a) The Icelandic authorities contended that the assets in questions were not impaired and as such ESA could not apply the IAC to them.²⁸³ ESA rejected that argument by referring to the definition of impaired assets found in the IAC with the important part of the definition in this context being “[...]or subject to severe downward value

²⁷² Ibid.

²⁷³ Ibid., p. 4

²⁷⁴ Ibid.

²⁷⁵ Ibid., p. 12-14

²⁷⁶ Ibid., p. 14. That is a quite interesting statement made by ESA as it seems that only banks in need of restructuring are the ones applying for the aid and hard to see any banks not under restructuring applying for an asset swap in Iceland (nearly every bank being restructured). In any case, ESA could have suggested to the Icelandic authorities of limiting only for financial institutions undergoing restructuring for it to fall within the Restructuring Guidelines.

²⁷⁷ *Germany HSH Nordbank*, para 35-37 (cited in fn. 153)

²⁷⁸ *Mortgage Loan Scheme in Iceland*, p. 14 (cited in fn. 268)

²⁷⁹ Ibid., p. 15-16

²⁸⁰ Ibid., p. 16

²⁸¹ Ibid., p. 17

²⁸² Ibid., p. 17-18

²⁸³ Ibid., p. 14

adjustments[...]”²⁸⁴ Subsequently drawing from that definition the mortgage loans that cannot be sold on the market should be considered impaired.

b) First of all, it was not deemed sufficient by ESA that only one part, the credit risk method, of the valuation assessment had been prepared by an independent expert. Regardless, it would not be sufficient that an independent expert had provided the method for assessing the credit risk as it is the IHFF that applies that method and thus performs the valuation. In addition, it was acceptable that only part of the mortgage loans had been put under valuation by an independent expert. Secondly, the Icelandic Government failed to show that the transfer value was based on the Real Economic Value.

c) Strongly related to the faulty valuation made by the IHFF as it could not be confirmed that the eligible financial institutions bore a share of the burden.

d) The bad valuation of the assets in question certainly triggered a chain reaction as ESA deemed the Scheme not to provide adequate compensation for the risk taken on by the State. Furthermore, it was stated that such remuneration could simply be provided by setting the Transfer Value of assets sufficiently below the Real Economic Value. Moreover, the fee that the financial institutions are charged is equal to the premium fee that the IHFF normally charges its customers to cover operating costs.

f) In short, ESA criticised the Icelandic authorities for not having specified any time-limit for the Scheme or specified any time-limit within which the financial institutions could apply to enter the Scheme.

In the end ESA concluded that the Mortgage Loan Scheme was illegal State Aid.²⁸⁵ That is, it would not be granted an exemption under Article 61(3)(b) of the EEA Agreement.

5.5.1 Remarks

ESA didn't request any evidence for severe downward value adjustments and did not even address it in its Decision but instead stated that the mortgage loans that could not be sold on the market should be considered impaired. In reality, you would not really have to put forward any evidence for the severe downward value adjustments as it is public knowledge

²⁸⁴ IAC., para 32

²⁸⁵ *Mortgage Loan Scheme in Iceland*, p. 18 (cited in fn. 268)

and an inherent feature in the Financial Crisis.²⁸⁶ The conditions expressed in a)-d) and the subsequent criticism by ESA could have been addressed and rectified by the Icelandic authorities. Those conditions were a big factor in the final conclusion and given the fact that some part of the assets had been assessed by an independent expert ESA seem quite harsh in their assessment since a prolongation until those issues could be fixed would have been sufficient to the aim of avoiding distortions of competition. Another fact that is not even considered is the reality of the situation, i.e. the Scheme is only being applied to three banks.²⁸⁷ Actually four banks were rejected with all seven which had applied relatively small banks with the exception of perhaps BYR.²⁸⁸ This gives the impression that banks that decide to apply for the Scheme have to fulfill strong conditions though that is not illustrated sufficiently in the Decision. Moreover, the specifics of how the Scheme had been applied was not considered fully especially in the light that all three of the accepted banks are undergoing restructuring.²⁸⁹ That in itself should be a huge factor in ESA's assessment as it would have been more appropriate to examine the Mortgage Loan Scheme in relation to each bank. The author strongly believes that if there would have been three separate schemes being applied to the banks in their restructuring plan ESA would have expressed doubts but accepted the Scheme until the final restructuring plan would be issued as that seems to be the situation in the HSH Nordbank Decision previously reviewed.²⁹⁰ It is a slightly different case but an interesting one in this context as it revolves around an asset relief measure as part of a large restructuring process of HSH Nordbank. The most crucial difference between the two measures is that the former was part of a general scheme provided for all banks in Iceland, regardless of whether they were under a restructuring process or not. Notably, nearly every single bank in Iceland went under some kind of restructuring process in the Financial Crisis even small banks across the country which at least Icelandic banks holding together around 99% of the market were committed to.²⁹¹ On the other hand, the latter measure was targeted

²⁸⁶ Note that a big Mortgage Loan Bank was actually one of the first banks to fall in the Financial Crisis. It had serious difficulties and the British Government had been forced to step in. Discussed in Section 4.4

²⁸⁷ It is an open Scheme so theoretically more banks could follow but if that happens ESA could deal with it then

²⁸⁸ Now part of Íslandsbanki

²⁸⁹ See Section 5.2 above regarding BYR's restructuring and subsequent acquisition by Íslandsbanki in Section 5.3; Keflavik Savings Bank was not even considered viable for plain restructuring and therefore was taken over by Landsbankinn: The Ministry of Finance Press Announcement on 23rd April 2012; The Savings Banks Union Press Announcement on 4th October 2010

²⁹⁰ See Section 4.5

²⁹¹ ESA, "Press Announcement: The Authority gives green light to a rescue scheme for small savings banks in Iceland" PR(10)35

against one specific bank with a future restructuring plan in mind which seems to have been the most important factor in the different approaches between the Commission and ESA.

6 Final Conclusions

In light of the main objective of examining ESA's approach to the Icelandic Banks the author considers: First, ESA introduced an exception to the remuneration of capital rules found in the Recapitalisation Communication on the basis that the bank had experienced far-reaching restructuring including a change in management and corporate governance.²⁹² That conclusion has to be considered unacceptable since if it would be accepted, a large number of banks would be considered to fall within that exception. It is difficult to envisage a lot of banks in the Financial Crisis that have not or are not going to experience far-reaching restructuring. Second, the lack of private money involvement in the case of two of the Big Icelandic Banks is worrying especially when ESA puts it down as one of the pluses in the restructuring of Glitnir and Kaupthing. Why ESA does not put up a harder stance on private money involvement coming into the bank without the help of the Icelandic Government has to be criticised. Third, ESA surprisingly stated in its proportionality assessment on the state measures that the impact on competition and trade across the EEA would be limited as practically the same measures were being adopted in the other two big banks with them sharing over 80% of the domestic market.²⁹³ In essence, ESA turned the market share factor upside down by stating that the impact on competition would be limited as all the big players essentially got the same treatment. Notwithstanding the moral hazard issue involved in that argumentation but also it effectively rules out other banks growing bigger, new banks being formed in light of big gaps in the banking sector in Iceland if the banks would have fallen or shrunk or foreign involvement in the form of subsidiaries or branches. By side stepping this issue as ESA did is inexcusable and impossible to imagine the same approach being taken by the Commission. Fourth, when it comes to small banks ESA's conclusions makes one wonder how small the banks have to be in the Financial Crisis for governments not being allowed to step in and rescue them. As in BYR, ESA managed to manipulate the phrase "serious disturbance in the economy of a Member State" by stating that there was already a serious disturbance Article 61(3)(b) of the EEA Agreement was applicable. Additionally, to support the former conclusion it mentions a possible bank run on Icelandic banks. However, the author contends there is more weight in the argument that it should fall outside Article 61(3)(b) of the EEA Agreement on possibly be assessed under the R&R Guidelines.

²⁹² See eg., ESA Decision on *Glitnir Bank*, para 25 (cited in fn. 185)

²⁹³ *Ibid.*, p. 24

Moreover, the lack of examination is apparent when considering how ESA specifically mentioned a controversial judgement in Iceland being one of the factors in the turmoil in the Icelandic Financial System and subsequently making turmoil equivalent to a serious disturbance. Finally, in its proportionality assessment, ESA suddenly finds competition arguments to be of great importance when assessing the impact of BYR being allowed to fall as the only viable alternative to the Big Icelandic Banks. Fifth, ESA's dealings with the Icelandic Authorities and Íslandsbanki on its acquisition of BYR is remarkable in light of the gravity of the situation in question. That is, that ESA did not fully commit themselves in getting a deal with XY Bank by all possible means is beyond acceptable. At the very least, ESA could have let the acquisition fail on a proportionality test as in any way you look at the acquisition it would always be a better solution to let the Icelandic Government seize ownership of the bank for the unforeseeable future. In addition, it is extremely disappointing that after this acquisition the Big Icelandic Banks hold around 95% of the market and ESA has not ordered them to decrease their size by any means possible. Sixth, when considering the fact that the mortgage alignment was set at 110% without any economic assessment being made by ESA on why that exact percentage was chosen, one worries about how lightly ESA deals with the state measure in question. The Economic Assessment made by ESA is easily explained in the words of ESA itself when stating that if it had not been introduced, IHFF would have suffered impairments anyways. Subsequently, in light of all that has been drawn forward by the author, it must be held that ESA's approach to the ailing Icelandic Banks is not only bad application of State Aid Law but unacceptable.

In the end, when regarding the Commission's approach to banks in Europe, it must be concluded that ESA's approach to the Icelandic Banks, overall, is a lot softer than that of its friend in Brussel. That is especially true when it comes to time limit as the Icelandic Banks seem able to stall with their notifications a lot longer without any major repercussions. The only issue that the author found where the situation was reversed is in the case of the Mortgage Loan Scheme introduced by the Icelandic authorities and in the case of the Risk Shield in the Germany HSH Nordbank Decision where the Commission seems far more lenient than ESA. Instead of expressing only their doubts and request that the Icelandic authorities fix the Mortgage Loan Scheme, ESA held that the Scheme was illegal State Aid and ordered full recovery of the aid. In the end, when addressing the latter question posed, there is no doubt that ESA's approach to the Icelandic Banks has been softer than that of the Commission.

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