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# EDITORIAL COMMENT

## *From rescue to restructuring: The role of State aid control for the financial sector*

After the deepest recession in its history, the EU economy is on its way to recovery. In the second half of 2009, the economic downturn stopped, and a moderate GDP growth is expected for the near future.[1] Though it is too early for sighs of relief, it can be said at least that the worst scenarios have not come true. In particular, a systemic meltdown of the financial sector – which many feared after the Lehman Brothers collapse in September 2008 – has been averted by swift government interventions on a global scale. In order to stabilize financial markets, various instruments have been applied by the Member States, in particular guarantees to cover liabilities of financial institutions in difficulty, capital injections, and measures to assist financial institutions in cleaning their balance sheets of so-called "toxic assets". While the EU has had no active part in providing these helps, under Article 107 TFEU (ex 87 EC) it has an important role in safeguarding the competition on financial markets against potentially distorting effects the Member States' measures may have. Applying the State aid rules in such an unprecedented situation has indeed been a daunting task for the Commission, and it will remain such a task for some time to come.

### *Some facts and figures*

Looking at the sheer numbers, the singular scale of State support for the financial sector becomes evident.[2] The total maximum volume of crisis measures approved by the Commission as of December 2009 amounted to more than € 3.6 trillion, corresponding to around 29 percent of EU GDP. Of these measures, guarantee schemes had the biggest share with a maximum amount of approximately € 2.7 trillion. Recapitalization schemes added up to € 231 billion, while general liquidity measures and asset relief interventions accounted for € 76 billion. In addition to these schemes, the Commission authorized *ad hoc* interventions in individual cases totalling around € 587 billion. Of

1. Cf. European Commission, Directorate-General for Economic and Financial Affairs, European Economic Forecast – Autumn 2009, European Economy 10/2009.
2. All figures referred to in this section are taken from the Commission Staff Working Document Accompanying the Report from the Commission, State Aid Scoreboard, Autumn 2009 Update (7 Dec. 2009), SEC(2009) 1638.

course, these figures do not represent the actual State aid granted to financial institutions as the amounts handed over to the beneficiaries are not yet known. There are, however, figures for 2008 that indicate the dimension of the State aid element: in 2008, the take-up rate of Commission approved State measures in support of financial institutions, which then amounted to a maximum volume of € 3.3 trillion, was 29 percent, i.e. measures with a nominal value of € 958 billion were implemented. The Commission rates the value of the aid element of these measures at € 212 billion, which is the equivalent of 1.7 percent of the EU GDP. This is more than three times the amount of State aid granted to all other sectors of the economy in 2008 (€ 67 billion in absolute and 0.54 % of EU GDP in relative terms). Moreover, the figures for 2008 show that these amounts (in absolute and, more importantly, in relative terms) vary widely between the Member States. Interestingly, differences between the Member States as to the relative level of State aid do not correspond to differences between the relative shares of the banking sector of the Member States' economies.[3]

These figures may raise concerns that the review of State aid for its conformity with the internal market was buried under the massive spring-tide of State interventions caused by the credit crisis. Could the Commission effectively oversee measures that both in their magnitude and in their urgency had never been seen before? As yet, the answer seems to be yes. The Commission has so far done a remarkable job, but some of the most difficult issues may still be ahead.

*Surviving the storm ...*

Normally, the preliminary examination period for notified State aid is two months (Art. 4(5) of Regulation 659/1999),[4] followed by a formal investigation period of another 18 months which may be extended by common agreement between the Commission and the Member State concerned (Art. 7(6) of Regulation 659/1999). As speed was of the essence in order to prevent financial markets from collapsing, decisions on State measures in support of financial institutions (i.e. decisions not to raise objections) were taken within weeks, sometimes even a few days, although under normal circumstances, cases with such an impact and such a complexity would probably have been submitted to a formal procedure.

3. E.g. the crisis aid granted by Ireland in 2008 amounted to € 35.58 billion in absolute terms or 19.16% of national GDP while the banking sector had a 10.9% share of the Irish economy. The corresponding figures for the UK are: € 68.75 billion, 3.79% of the national GDP, and a 7.6% share of the banking sector in the total economy; for Germany: € 51.14 billion, 2.05% of the national GDP, and a 3.6% share of the banking sector in the total economy.

4. Council Regulation 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, O.J. 1999, L 83/1.

As to substance, the Commission first proceeded on the basis of Article 87(3)(c) EC and the Commission Guidelines on State aid for rescuing and restructuring firms in difficulty (the "R&R Guidelines").[5] However, as the State measures evolved from assistance for individual institutions to general schemes, the Commission responded by adopting new communications. The first was the Banking Communication of 13 October 2008.[6] In this Communication, the Commission for the first time invoked Article 87(3)(b) EC, according to which State aid may be considered permissible "to remedy a serious disturbance in the economy of a Member State". The Commission stated that the general principles of the R&R Guidelines should be followed, but exceptional measures (such as rescue measures potentially going beyond six months) may be approved. As regards guarantees schemes, the Banking Communication set out several criteria in order to make sure they were well-targeted, proportionate to the challenge faced, and designed in such a way as to minimize negative spill-over effects on competitors, other sectors and other Member States. These criteria include objective and non-discriminatory access to the guarantee schemes, limitations of the material and the temporal scope of these schemes, a significant contribution from the beneficiaries and/or the sector to the cost of the guarantee, behavioural constraints ensuring that beneficiaries do not use their protection as a means to expand aggressively to the detriment of unprotected competitors (together with enforcement mechanisms provided by the Member State) and follow-up measures providing for adjustments of the financial sector as a whole and/or the restructuring or liquidation of individual beneficiaries.

This guidance was followed by the Recapitalization Communication of 5 December 2008 giving more detailed criteria for the assessment of recapitalization schemes.[7] In this Communication, the Commission stressed the need to distinguish between banks that are fundamentally sound and merely need temporary support and banks with a failed business model that has brought about a risk of insolvency. According to the Communication, fundamentally sound banks may receive State capital injections for adequate renumeration if there are appropriate incentives for the redemption of the capital and safeguards against undue distortions of competition. As the market levels were nowhere near normal conditions during the credit crisis it goes without saying that

5. Community Guidelines on State aid for rescuing and restructuring firms in difficulty, O.J. 2004, C 244/2.

6. Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, O.J. 2008, C 270/08.

7. Communication from the Commission – The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, O.J. 2009, C 10/2.

determining the price of recapitalizations was a tricky issue. Taking up Recommendations of the Governing Council of the European Central Bank,[8] the Commission tackled this problem by linking the price to the base rates set by central banks, supplemented by a risk premium reflecting the risk profile of the beneficiary; the type of capital used; and the nature of the safeguards against abuses. On the other hand, banks which are at risk of insolvency are required to pay more for State support and subject to stricter safeguards. Perhaps more importantly, recapitalizations of these banks must be followed by extensive restructuring to restore long-term viability.

As it was evident in early 2009 that confidence in the financial sector would not return as long as many banks had toxic or impaired assets in their balance sheets, the Commission adopted a third communication, the Impaired Assets Communication of 25 February 2009, providing a framework of evaluation for asset relief measures (such as bad-bank solutions) initiated by the Member States.[9] Again, the Commission aimed to lay down rules (in particular on transparency, disclosure, valuation, pricing and burden-sharing) that ensure compliance with the general principles of necessity, proportionality and minimization of the competitive distortions potentially caused by these measures. However, the Commission also made it clear that the treatment of impaired assets along these lines has to be supported by follow-up measures if the goal of long-term viability without State interventions is to be achieved.

Despite the speed of the procedures and the lack of formal decisions, these Communications brought consistency and transparency into the Commission's evaluation of the Member States' interventions during the credit crisis and managed to avert the most immediate threats to the European level playing field for the banking industry, in particular as far as potential distortions of competition between banks from different Member States and between substantially sound banks and banks with a flawed business model are concerned. The Commission also made sure that the expertise of the European Central Bank and the Eurosystem was taken on board. Finally, those who state with a critical *soupçon* that "the European response to the crisis was State-centred"[10] and deplore that the EU has not taken a more active role should not overlook that the division of work between the Member States (granting the subsidies) and the EU (supervising them) makes sure that the taxpayers' money is spent transparently and to the purpose.

8. Cf. paras 16-8 of the Recapitalization Communication.

9. Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, O.J. 2009, C 72/1.

10. Smits, "From the Board: The Credit Crisis and its aftermath", 36 LIEI (2009), 279–284, at 283.

*... and fixing the boats*

It has always been clear that the supervision of the Member States' rescue operations would only be the first step. The next step is to secure a return to viability without State support, which will not happen without the Commission's active involvement in the restructuring of financial institutions. As former Commissioner Kroes put it in September 2009: "In terms of enforcement, the most crucial thing in my inbox is bank restructurings. This is the second stage of 'rescue and restructuring' aid offered in the past year. In plain English – the price of State support is that you must submit a restructured business to us for approval in order to offset the competition distortions of aid."[11]

The Banking Communication, the Recapitalization Communication and the Impaired Assets Communication all refer to criteria that trigger a Member State's obligation to present a restructuring plan. Regarding banks which are fundamentally sound and have only received a limited amount of State aid, Member States only have to submit a report to the Commission that allows for the assessment of the bank's viability. By contrast, banks with an unsustainable business model that have received large amounts of subsidies have to restructure. The approach taken by the Commission to the evaluation of restructuring aid granted to banks is set out in the Restructuring Communication of 14 August 2009.[12] The Communication requires that where restructuring is needed, banks have to demonstrate strategies to achieve long-term viability under adverse economic conditions. Typical restructuring strategies aim at reorientation of business models or changes in the asset-liabilities management, but in many cases they may have to go further than that and include divestments of parts of the bank or a break-up and sale of its different parts to competitors with a superior performance. While implementing these measures may take some time, decisions as to the path to be followed cannot wait: It would be both too costly and too risky to have so-called "zombie banks" (as they were known in the U.S. savings and loans crisis of the 1980s) as players on the financial markets for much longer.

An example of how the Commission's control develops from the rescue to the restructuring phase is the ING case. After having granted a capital injection of € 10 billion and liquidity guarantees amounting to € 12 billion under the Dutch liquidity guarantee scheme in 2008, which were both approved by the

11. Kroes, "Antitrust and State Aid Control – The lessons learned", 36th Annual Conference on International Antitrust Law and Policy, Fordham University, New York, 24 Sept. 2009, p. 6.

12. Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, O.J. 2009, C 195/5.

Commission,[13] the Dutch Government provided the financial group ING in January 2009 with a so-called illiquid assets back-up facility covering 80 percent of a portfolio of $ 39 billion. For reasons of financial stability, the Commission approved the measure on 31 March 2009 for six months.[14] At the same time, it opened an in-depth investigation regarding the valuation of the portfolio and burden sharing as set out in the Impaired Assets Communication. This investigation took notably longer than the earlier assessments and led to a final conditional decision on 18 November 2009.[15] In this decision, the Commission accepted the illiquid assets back-up facility in return for a commitment of the Netherlands to increase the renumeration to be paid by ING by € 1.3 billion. Moreover, the restructuring of ING was supplemented by a commitment of the Netherlands to temporarily ban ING from acquiring other firms and from exercising price leadership. Additionally, for a certain period of time, ING needs formal Commission approval for calling certain debt capital instruments. Only on these conditions was the Commission satisfied that ING's restoration to long-time viability was ensured without undue distortions of competition.

Considering that the imposition of behavioural constraints, divestments and other conditions by the Commission does not only affect single companies, but directly or indirectly the whole financial sector in Europe if all cases are taken together, it becomes clear that the instrument of State aid control provides the Commission with an enormously powerful means to shape the future of the European financial institutions. While the Commission had to struggle to keep up with the pace of State interventions during the credit crisis, it is now determining the pace of the restructuring phase, after which the landscape of the European financial markets will look very different. Whether the Commission lives up to the proverbial great responsibility that comes with great power, remains to be seen.

Together with the changes in the regulatory framework of the financial sector that are necessary in order to root out the causes of the crisis, the restructuring efforts instigated by the Commission will hopefully lead to stable and productive financial markets. But the fall-out of the crisis in the form of public debt resulting from the State interventions still has to be dealt with. The control of State aid is not designed to cure these consequences. As it seems unlikely that the public deficits piled up during the recession will soon melt away in the sun of economic recovery, more budgetary discipline may be required from the Member States in order to restore fiscal stability.

13. Case N528/2008 – Measure in favour of ING; Case N524/2008 – Dutch credit guarantee scheme.

14. Case N138/2009 – ING Illiquid asset facility.

15. Case C10/2009 – ING Illiquid assets back-up facility and restructuring plan.