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Research Handbook on State Aid in the Banking Sector

Chapter 5. The States' toolkit for rescuing banks in difficulty

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1. Introduction

Even before the first wave of the financial crisis hit the European markets in October 2008, Member States had already used several different types of measures to rescue individual banks in difficulty. Such measures included in particular recapitalizations (for instance in the Crédit Lyonnais[1] or Banco di Napoli[2] cases), which were typically assessed by the Commission under Article 107(3)(c) TFEU and its horizontal guidelines on rescue and restructuring of companies in financial distress. The Commission continued to use this legal and intellectual framework to assess the first "precursor" cases that predated the Lehman Brothers debacle in 2007-2008.[3] The working assumption was then that the bank's difficulties were entirely due to their individual shortcomings.

The systemic nature of the crisis gradually led the Member States to broaden their toolkit and use other measures to rescue banks, including through the provision of funding guarantees, short-term liquidities, and various measures (risk shields, asset guarantees or transfers) aimed at resorting liquidity and confidence, avoiding a bank run, and/or cleaning up bank's balance sheets. At the same time, the Commission introduced from October 2008 a new and (at that time supposedly temporary) State aid Framework (hereafter, "Crisis Framework") comprising several sets of guidelines based on article 107(3)(b) TFEU. This hitherto little-used provision of the Treaty allowed State aid to remedy serious disturbances to a national economy. As summarized by authors, '[t]he Commission's response to the financial crisis has developed ad hoc, through a series of Commission Communications that have reflected the changing nature of State aid issues in the financial sector as the crisis unfolded.'[4] Practically from the beginning of the Crisis Framework, its communications introduced specific requirements tailored for each type of State intervention, thus acknowledging the wide scope of the State's rescue toolkit. Thus, while the first communication of the framework was horizontal (but already distinguished specific rules relating to, in particular guarantees), the second communication was exclusively dedicated to

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1 Commission Decision C 47/1996, Rescue aid by France in favor of the Crédit Lyonnais Group OJ 1998 L221.

2 Commission Decision C(1998) 2495, Conditional approval of the rescue aid by Italy in favor of the Banco di Napoli OJ 1998 L116/36.

3 Commission Decision NN 70/2007, Northern Rock OJ 2008 C 43; Commission Decision NN 25/2008, WestLB OJ 2008 C189; Commission Decision C 9/2008, Sachsen LB C 9/2008 OJ 2009 L104.

4 *Specific Types of Aid, Financial Sector*, in European Union Law of State Aid, para. 17.12, Kelyn Bacon in Oxford Competition Law, 2013.

recapitalizations, and the third dealt with so-called "impaired asset measures", which include various tools aimed at safeguarding the value of specific assets on banks' balance sheets.

Table 1 below describes the Crisis Framework's texts and their main elements.

Table 1: Overview of the Crisis Framework

Text	Description
2008 Banking Communication[5] (25 October 2008)	This text, adopted in the early days of the crisis, highlights the specificity of the crisis but emphasizes the continuity of the general principles of State aid rules. It mainly focuses on recapitalization measures and liquidity assistance with a distinction between "fundamentally sound banks" and others (i.e. unsound or distressed banks).
Recapitalization Communication[6] (15 January 2009)	The Recapitalization Communication develops the analytical framework of the 2008 Banking Communication and places a particular emphasis on appropriate pricing of capital injections. The distinction between fundamentally sound and unsounds banks led to assessment of the recapitalization of the latter under the general principles of the Rescue and Restructuring guidelines for firms in difficulties and the imposition of compensatory measures. This dichotomy has since been abandoned.
Impaired Assets Communication[7] (26 March 2009)	To answer the crisis' specificities, Member States increasingly granted impaired asset measures aimed to address the – at that time relatively new – uncertainty regarding the location and value of toxic and impaired assets, leading to a substantial reduction of credit to the real economy. The Impaired Assets Communication provides guidance as to the conditions for the approval of asset relief and the methodology of valuation of State aid and compensating measures.
Restructuring Communication[8] (19 August 2009)	The Restructuring Communication mainly adapts the Rescue and Restructuring Guidelines for firms in difficulties to the first lessons of the crisis. It imposes a detailed analysis of the bank's problem and, for the first time, describes principles of appropriate burden sharing/own contribution from the aid recipient and compensatory measures to limit distortions of competition. The text had an expiry date of 31 December 2010.

5 Communication from the Commission: The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis[2008] OJ C270/8 (Banking Communication), 8-14.

6 Communication from the Commission, The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2 (Recapitalization Communication), 2-10.

7 Communication from the Commission on the Treatment of Impaired Assets in the Community Banking sector [2009] OJ C72/1 (Impaired Assets Communication), 1-22.

8 Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] OJ C195/9 (Restructuring Communication), 9-20.

Text	Description
First Prolongation Communication[9] (7 December 2010)	This text extends the Restructuring Communication to the end of 2011 and largely abandons the distinction between fundamentally sound and unsound banks for the purpose of determining whether the aid recipient is required to submit a restructuring plan.
Second Prolongation Communication[10] (6 December 2011)	Acknowledging the long-term nature of the disturbance to the economy, the Commission decided to extend the four communications described above, this time for an unlimited period. It also amended the texts to reflect the sovereign crisis consequences.
2013 Banking Communication[11] (30 July 2013)	The Communication places new emphasis on the way capital shortfalls are addressed by banks internally in order to prevent State intervention as much as possible. Crucially, the Communication confirms that, as a matter of principle, the Commission would authorize structural aid (i.e. recapitalization or impaired asset measures) only after it agreed on a restructuring plan with the Member State. The Communication therefore requires assurances that banks losses are first absorbed by equity, hybrid capital and subordinated debt holders in order to reduce the capital shortfall to the maximum extent possible.

Between October 2008 and October 2014, the Commission adopted more than 450 decisions authorizing State aid measures to the financial sector. As is evident from the Commission's scoreboard on State aid granted during the financial crisis, the bulk of this aid took the form of guarantees on liabilities with a total of €3,249 billion of State aid approved and €1,188.1 billion used (i.e. guarantees effectively provided on liabilities).

Table 2: Total Amount of State aid approved and used, EU-28 (2008-14)[12]

Aid instrument	Amount of State aid approved (in € billion)	Amount of State aid used (in € billion)
Recapitalization measures	802.1	453.3
Impaired asset measures	603.3	188.5
Guarantees on liabilities	3,249.0	1,188.1

9 Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis [2010] OJ C329/7 (First Prolongation Communication), 7-10.

10 Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356/7 (Second Prolongation Communication), 7-10.

11 Communication from the Commission on the application, from 1 August 2013 of State aid rules to support measures in favour of banks in the context of the financial crisis [2013] OJ C216/1 (2013 Banking Communication), 1-15.

12 European Commission, 'State Aid Scoreboard 2015 – Aid in the Context of the Financial and Economic Crisis' <http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html> accessed 30 August 2016 (State Aid Scoreboard 2015).

Aid instrument	Amount of State aid approved (in € billion)	Amount of State aid used (in € billion)
Liquidity measures, other than guarantees on liabilities	229.7	105.0

The Crisis Framework contemplates four broad and distinct categories of aid measures: recapitalizations, impaired asset relief, funding guarantees and liquidity measures. Although they are often used in combination, each of these measures pursues a specific objective. The Commission considers funding guarantees and liquidity measures to be "non-structural" in nature as they are only designed to improve the recipient's access to funding on a temporary basis (Section 2). On the other hand, recapitalizations and asset relief measures are deemed to be "structural", as they are designed to address deficiencies in the recipient's balance sheet (Section 3). This chapter describes both type of measures.

2. First-aid kit: non-structural aid

Non-structural measures were the first and main aid instruments used by Member States to address the financial crisis. Direct liquidity support (Section a) and guarantees (Section b) account for more than two thirds of the amount of State support to banks since the beginning of the crisis. Although both types of measures aim at temporarily stabilizing the liability side of a bank's balance sheet,[13] they differ in a number of technical aspects.

a) Direct liquidity support

i) Overview

Definition, modalities and statistical overview

Direct liquidity support can be provided in a number of forms such as credit lines, loans or lending or sale of Government Treasury notes, which can then be used as collateral in refinancing transactions, or repurchasing operations ("repos"). Direct liquidity measures are designed to secure banks' access to funding during a credit crunch but differ from guarantees considering that the State (usually through its central bank) directly provides the funding instead of guaranteeing private funding. Direct liquidity support is typically granted by governments or by central banks.

Since 2008, the Commission has approved aid measures amounting to €229.7 billion for liquidity measures. Member States effectively used half of this amount only (€105 billion, see Table 2 above). One reason for this discrepancy may be that banks' liquidity requirements are hard to forecast with accuracy and Member States may have tended to tailor their State aid notifications to worst-case scenarios that have not always unfolded in practice. In any

[13] 2013 Banking Communication, para. 56.

event, the figures mentioned above largely understate the amount of short-term liquidity support received by EU banks, since they do not include most of the liquidity assistance provided by central banks, which is generally considered not to constitute State aid. ELA's amounts are not publically available but information regarding specific countries were disclosed by the press. For instance, Greek banks received ELAs amounting to €89 billion during the summer of 2015. As of June 2016, that figure still stood at €61.8 billion.[14] In practice, only some Member States have granted liquidity support directly to the financial sector. Spain and the Netherlands account for more than half of the outstanding aid amounts in the peak year (i.e. 2009).

In the euro area, the provision of liquidity support by central banks is subject to Eurosystem rules regarding the provision of emergency liquidity assistance (ELA). Pursuant to Article 14.4. of the Statute of the European System of Central Banks and of the European Central Bank, the Governing Council of the ECB may restrict the possibility for central banks to provide ELAs if it considers that such ELAs 'might interfere with the objectives and tasks of the Eurosystem'.[15] Since 1999, the ECB has set up and regularly revised specific procedures to implement these principles. The main features of these procedures are summarized in a paper published in October 2013 by the ECB.[16] In particular, ELAs exceeding €500 million should be notified in advance to the Governing Council and ELAs above €2 billion are specifically examined by the Governing Council in order to determine whether there is a risk they might interfere with the Eurosystem objective. At the request of the national central bank concerned, the Governing Council (with a two-thirds majority) may set a maximum threshold for the ELA considered by the NCB. While the Governing Council's decisions are not systematically published, the ECB does from time to time communicate on some specific cases. In particular, following the Greek referendum in June 2015, the Governing Council announced that it had maintained the level of ELAs granted to Greek banks and later adjusted the haircuts applied to the collaterals granted against such ELAs.[17]

In non-euro Member States, similar systems exist for the provision of liquidity by central banks. For instance, in 2008 the UK granted HBOS and Royal Bank of Scotland ELA amounting to £61.5 billion. The ELA granted took the form of collateral swaps, under which the Bank lent the two banks UK Treasury bills against unsecuritized mortgage and loan assets. Similar to the euro-zone Member States, the UK system provides that three criteria need to be met in order to activate an ELA: (i) the potential failure of the bank should pose a threat to systemic stability; (ii) the beneficiary bank should be solvent; and (iii) a viable exit strategy should exist in order to reach further stability and repay the ELA.[18]

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14 Claire Jones and Kerin Hope, 'ECB Votes to Reinstate Measure to Aid Troubled Greek Banks' *Financial Times* (Athens, 22 June 2016) <http://www.ft.com/cms/s/0/10708ef6-387a-11e6-9a05-82a9b15a8ee7.html#axzz4FiI3sq4R> accessed 30 August 2016

15 ELA Procedures, the procedures underlying the Governing Council's role pursuant to Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank with regard to the provision of ELA to individual credit institutions (ELA Procedures), 17 October 2013 <https://www.ecb.europa.eu/mopo/ela/html/index.en.html> accessed 30 August 2016.

16 *Ibid*.

17 See ECB press releases of June 28, 2015 <https://www.ecb.europa.eu/press/pr/date/2015/html/pr150628.en.html> and July 6, 2015 <https://www.ecb.europa.eu/press/pr/date/2015/html/pr150706.en.html>, both accessed 30 August 2016.

18 Ian Plenderleith, 'Review of the Bank of England's Provision of Emergency Liquidity Assistance in 2008-09', Presented to the Court of the Bank of England, October 2012 <http://www.bankofengland.co.uk/publications/Documents/news/2012/cr1plenderleith.pdf> accessed 30 August 2016, para. 21

Set out below is the total amount of direct liquidity support measures granted per Member State during the 2008-14 period (excluding non-aid ELAs).

Table 3. Total amount of direct liquidity support measures granted per Member State during the 2008-14 period (excluding non-aid ELAs)

Member States	2008	2009	2010	2011	2012	2013	2014	Maximum, 2008-14
Belgium	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Denmark	0.6	2.0	0.7	0.0	0.0	0.0	0.2	2.0
Germany	3.6	0.0	4.7	0.0	0.0	0.0	0.0	4.7
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ireland	0.0	0.0	0.0	0.1	0.7	0.9	0.0	0.9
Greece	0.5	4.3	6.9	6.6	2.8	2.3	2.2	6.9
Spain	2.3	19.3	19.0	13.5	3.5	0.2	0.0	19.3
France	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Italy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cyprus	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Latvia	1.0	1.0	0.9	0.8	0.6	0.6	0.6	1.0
Lithuania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Luxembourg	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Hungary	0.0	2.5	0.0	0.0	0.0	0.0	0.0	2.5
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	13.2	30.4	7.9	3.8	3.8	3.8	4.7	30.4
Austria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Poland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portugal	1.1	3.7	3.8	2.5	0.2	0.0	0.0	3.8
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sweden	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

United Kingdom	0.0	6.9	18.5	33.3	32.7	26.8	24.0	33.3
Total	22.2	70.1	62.6	60.6	44.3	34.6	31.6	105.0
						% 2014 EU GDP		**0.8%**

Source: European Commission

Main objectives

Liquidity measures essentially aim to allow banks to continue to access funding when facing a lack of liquidities. While such measures typically aim to address the negative consequences of a systemic event such as the drying up of the money market, which took place after October 2008, they may also be used to remedy specific shortcomings of individual banks, such as an excessive reliance on short-term funding coupled with a brutal loss of confidence on the markets.

By granting liquidities to their banks, authorities also aim to avoid a bank failure and, thus, a systemic risk. Additional liquidities for banks help stabilize both the banking market and the liability side of the bank's balance sheet.

The financial crisis revived interest in the role of central banks as providers of emergency liquidity support (or "lenders of last resort") in times of crisis. The concept is not new and was, for instance, advocated in 1873 by Walter Bagehot in his famous *Lombard Street*.[19] At that time, the then Governor of the Bank of England explained that in times of crisis national central banks should lend freely and at a penalty rate to solvent institutions against good collateral (as considered during normal times) in order to stabilize the banking system.

ii) State aid control of direct liquidity support

Main legal texts

The 2008 Banking Communication already set out the main conditions for approval of liquidity support measures.[20] In its 2013 Banking Communication, the Commission reiterated most of these rules, building on its decisional practice since the beginning of the crisis; the Communication deals with liquidity and guarantee measures together within the same section.[21]

In contrast with structural measures such as recapitalizations, the 2013 Banking Communication confirms that direct liquidity support and guarantees do not require the prior

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[19] Walter Bagehot, *Lombard Street: A Description of the Money Market* (reprinted by Seven Treasures Publications 2009).

[20] The 2008 Banking Communication both laid down the conditions for a liquidity measure to escape the qualification of State aid and the conditions for compatibility of such measures should they be considered as State aid. Liquidity measures constituting aid could be deemed compatible and approved for a period ranging from six months to two years.

[21] 2013 Banking Communication, sections 4 and 5.

approval of a restructuring plan unless the recipient bank faces a capital shortfall. In such cases, the Commission will apply the procedures set out in points 32 and 34 of the 2013 Banking Communication, including the requirement for a restructuring or wind-down plan, unless the aid is repaid within two months.[22]

Points 59 and 60 of the 2013 Banking Communication lay down the main conditions for clearance of liquidity and guarantee measures. While most of these rules are only relevant for guarantees, some basic principles also apply to liquidity measures:

- the recipients of guarantees and liquidity support must refrain from advertising referring to State support and from employing any aggressive commercial strategies which would not take place without the support of the Member State;
- liquidity support schemes must be restricted to banks without a capital shortfall as certified by the competent supervisory authority;
- Member States must report to the Commission on a three-month basis on the operation of the scheme; and
- the Communication does not lay out specific rules relating to the remuneration of temporary liquidity support. The Commission assessed the remuneration of temporary liquidity support by referring to the general principles laid down in the texts of the Crisis Framework. For instance, the Commission accepted remuneration at a premium of 100 basis points over the ECB's marginal credit facility by referring to the Recapitalization Communication framework.[23] The Commission also referred to the First Prolongation Communication and specified that to

> […] assess the compliance of the remuneration agreed between FIB and the Bulgarian authorities […] the Commission has used as a base the cost of funding of the Bulgarian State, by taking into consideration the average weighted yield on government securities issued in BGN, with comparable maturity. To that base line, the Commission has added a top-up resulting from the calculation of the fee applicable to the pricing of State guarantees, defined in the Annex to the 2011 Prolongation Communication.[24]

Implementation in leading cases

As a matter of principle, liquidity support usually falls within the scope of national schemes (i) but the Commission also analysed *ad hoc* individual liquidity measures (ii).

- Schemes

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22 *Ibid*., para. 58.

23 Commission Decision SA.33917, Recapitalization and Liquidity Support for Banco de Valencia OJ [2012] C63/1, paras. 50-1.

24 Commission Decision SA.39854, Restructuring plan of First Investment Bank, 25 November 2014.

The Table below provides an overview of the main schemes adopted by Member States and their main provisions.

Table 4: Overview of main liquidity schemes by country[25]

Country	Main provisions
Bulgaria **29 June 2014**[26]	In response to speculative attacks targeting two banks and urging customers to withdraw their deposits, Bulgaria provided banks experiencing liquidity issues with a €3.3 billion credit line that was approved by the Commission within a day.
Cyprus **22 October 2009**[27]	Cyprus issued €3 billion-worth of special government bonds to credit institutions, to be used as collateral to obtain liquidity from the ECB on interbank markets. The liquidity should be used for housing loans and loans to small- and medium-sized enterprises on competitive terms. The special bonds did not pay coupons, had a maturity of a maximum of three years, and lent to eligible credit institutions against collateral and the payment of a fee.
Denmark **30 September 2010**[28]	As part of the Danish winding-up scheme, the Commission approved a liquidity measure in the form of loans by the Financial Stability Company bearing interest on "market oriented terms". These loans were only available to the so-called "New Bank" that acquired the assets of the distressed bank before being wound up.
Greece **19 November 2008**[29]	The Commission approved a Greek scheme that combined a recapitalization guarantee and liquidity scheme. The liquidity scheme took the form of a State bond loan in return for remuneration and appropriate collateral in order for the banks to obtain liquidity from the ECB and interbank markets.
Poland **25 September 2009**[30]	Similar to the Greek scheme, the Commission approved a Polish support scheme that also included the lending of Treasury bonds against a fee.
Spain **22 December 2008**[31]	The Spanish scheme provided for a fund to buy high-quality assets from credit institutions through a reverse auction mechanism aimed at injecting liquidity into the banking system. The fund was endowed with €30 billion, expandable to €50 billion. The fund could use either outright purchases of assets or repurchasing operations (repos) for a maximum two-year period. The fund

25 State aid: Overview of decisions and on-going in-depth investigations of Financial Institutions in Difficulty, Memo/12/2018.

26 Commission Decision SA.38994, Liquidity scheme in favor of Bulgarian banks OJ 2014 C301/1.

27 Commission Decision N511/2009, Special government bond scheme OJ 2010 C1.

28 Commission Decision N407/2010, Danish winding-up fund for banks OJ 2010 C312/7.

29 Commission Decision N560/08, Support Measures for the Credit Institutions in Greece OJ 2009 C125/6.

30 Commission Decision N208/09, Support scheme for banks' funding in Poland OJ 2009 C250/1.

31 Commission Decision NN54/08, Fund for the Acquisition of Financial Assets OJ 2009 C123/5.

Country	Main provisions
	received remuneration at least higher than the government bond yield.
Slovenia **20 March 2009**[32]	While the Slovenian authorities believed that Slovenian banks should be able to obtain liquidity under the Guarantee scheme, they deemed it necessary to implement an additional liquidity scheme that was approved by the Commission in 2009. The measure took the form of loans. The guarantee and liquidity scheme's overall limit amounted to €12 billion. The fees were calculated to ensure that borrowing directly from the State was not cheaper than borrowing on the market with the State guarantee.
Hungary **21 April 2009**[33]	Hungary enacted a liquidity scheme aimed at providing loans to Hungarian financial institutions to enable them to maintain lending to the real economy in spite of the severe liquidity shortage. The liquidity support took the form of non-subordinated, non-structured loans, with a maximum maturity and an entry window which was opened until 30 June 2010.
United Kingdom **13 October 2008**[34]	The United Kingdom implemented a liquidity scheme as part of its aid scheme (in the form of collateral for swaps of Treasury bills).

- Individual liquidity measures

The Commission has also adopted a few decisions regarding individual liquidity measures, which were typically granted together with other State support measures. Key individual decisions include:

- *Northern Rock (UK)*. Before the collapse of Lehman Brothers, Northern Rock (NR), which was facing serious difficulties, was nationalized by the UK government. As part of the restructuring package, the Commission approved, amongst others, liquidity measures of up to £27 billion.[35] NR was then split into a "good bank" and a "bad bank" and the latter was run down.
- *Banco de Valencia (Spain).* In addition to a recapitalization, Spain granted Banco de Valencia a liquidity facility amounting to a maximum of €2 billion.[36] Spain required the bank to submit a restructuring plan and charged an

32 Commission Decision N637/2008, Liquidity scheme for the Slovenian financial sector OJ 2009 C143/1.

33 Commission Decision N664/2008, Support measure for the banking industry in Hungary OJ 2009 C147/1.

34 Commission Decision N507/2008, Financial Support Measures to the Banking Industry in the UK OJ 2008 C290/1.

35 Commission Decision C14/2008 implemented by the United Kingdom for Northern Rock OJ 2010 L112/38.

36 Approved by the Commission Decision SA.33917 Recapitalization and Liquidity support for Banco de Valencia, S.A. OJ 2012 C63/1.

interest equivalent to 100 basis points on top of the marginal credit facility of the ECB.

- *Dexia (Belgium, France)*. As part of the emergency aid received, the Commission approved a liquidity measure[37] provided by the Belgian and French national central banks.

Important liquidity measures were also individually approved for German banks (such as Sachsen LB)[38] or Greek banks (Eurobank,[39] Alpha bank,[40] Piraeus Bank,[41] and National Bank of Greece[42]).

Key legal and practical issues

- Existence of aid – from the Bagehot times to twenty-first century competition policy

A key legal issue regarding the provision of liquidity by central banks is whether such measures involve State aid or must be seen as part of the central bank's mandate regarding monetary policy. As recalled by the 2013 Banking Communication, from the beginning of the crisis the Commission has considered that '[t]he ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of State aid rules'.[43] The underlying logic is that measures adopted by independent central banks acting under a specific mandate related to monetary policy cannot be considered as being imputable to the State and/or involving State funds.

However, the Commission has also applied exceptions to this principle when the central bank's decision appeared in practice imputable to the State and/or involving (even indirectly) State funding. Two examples stand out in this respect:

- In *Northern Rock*, the Commission considered that the provision by the Bank of England (BoE) of emergency liquidity assistance composed of (i) loan facilities against a charge over mortgage loans and (ii) a repurchase facilities on certain securities did not constitute State aid. The Commission justified this finding by the fact that the following conditions were met: (i) the bank was temporarily illiquid but solvent at the moment of the liquidity provision; (ii) the facility was secured against high-quality collateral to which appropriate haircuts were applied; (iii) the central bank was charging a penal rate, which was above that of the bank's standing facility; and (iv) the measure was provided at the central bank's own initiative and was not backed by any counter-guarantee of the State. By contrast, the Commission found that additional liquidity measures later granted to Northern Rock by

37 Commission Decision C9/2009, Emergency aid to Dexia in the form of a guarantee for bonds and liquidity assistance OJ 2009 C181/82.

38 Commission Decision C 9/2009 implemented by Germany for Sachsen LB OJ 2009 L104/34.

39 Commission Decision SA.34825 implemented by Greece for the Eurobank group OJ 2014 L357/112.

40 Commission Decision SA.34826 implemented by Greece for Piraeus Bank group OJ 2015 L80/49.

41 Commission Decision SA.34823 implemented by Greece for Alpha Bank group OJ 2015 L80/49.

42 Commission Decision SA.34824 implemented by Greece for National Bank of Greece OJ 2015 L183/29.

43 2013 Banking Communication, para. 62.

the BoE constituted State aid because they were granted at the request of the Treasury and were subject to a counter-guarantee by the State, which had committed to indemnify the BoE from any liability resulting from these measures.[44] Interestingly, the criteria laid out in the NR decision are very close to those developed one century before by Bagehot in *Lombard Street* (see above).

- In *Fortis* and *Dexia*, the Commission also considered that an ELA granted by the Belgian central bank (the BNB) constituted State aid on the grounds that the facilities granted by the BNB were covered by a guarantee from the Belgian State – although the guarantee was not dedicated to the operation itself but resulted from a national law establishing the Statute of the BNB.[45] Indeed, in light of the private status of BNB such guarantee was in practice indispensable to ensure the effectiveness of the ELA. The Commission later considered that even an ELA granted by the Banque de France (which does not benefit from a State guarantee such as that of the BNB) to Dexia partly constituted State aid, on the grounds that the BNB and the BdF had signed an agreement whereby they would share half the revenues (and risks) of their respective ELA to Dexia.[46]

As of today, the Commission still uses the criteria it initially laid down in Northern Rock to assess whether an ELA involves State aid.[47] For instance, in the case of Greek banks the Commission found that the ELAs granted by the Bank of Greece (BoG) to Greek banks constituted State aid since it was backed by a State guarantee established by 2011 legislation.[48] As in the case of the BNB, this guarantee was the corollary of the private nature of the BoG, which is a *société anonyme* listed on the Athens stock exchange. In the context of the Eurosystem, where ELAs are subject to detailed rules implemented by the ECB, one might wonder whether this differentiation between privately-owned banks (which typically require an explicit guarantee for their ELAs, and therefore are presumed to grant State aid) and publicly-owned banks (which do not require an explicit guarantee) still makes sense from a policy (and even a legal) perspective. Indeed, one could argue that the only reason why publicly-owned banks do not require an explicit guarantee is that they benefit from an implicit State guarantee due to their status. A more consistent position would be to consider that – at least in the euro area – to the extent that central banks act on their own initiative and subject to the Eurosystem rules of governance, their interventions relate to the conduct of monetary policy, cannot be imputable to the State and therefore do not constitute State aid. As of today, neither this proposition nor the Commission's theory regarding the potential State aid nature of certain ELAs have been tested before the European Courts.

- Coordination between Eurosystem ELA mechanisms and State aid control

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44 Commission Decision NN70/2007, Rescue aid to Northern Rock OJ 2008 C43/1, paras. 20 and 30-5.

45 Commission Decision N 574/2008, Garantie Fortis – BE OJ 2009 C 38; Commission Decision C9/2009, Emergency aid to Dexia in the form of a guarantee for bonds and liquidity assistance OJ 2009 C 181/82, paras. 134-6. See also chapter 12 on Belgium by Jean-Sébastien Duprey (Duprey).

46 See Duprey.

47 See 2013 Banking Communication, para. 62.

48 See e.g. Commission Decision SA.34825 implemented by Greece for the Eurobank group OJ 2014 L357/112, paras. 273-5.

As explained above, the provision of ELAs in the euro area is subject to specific rules and/or clearance by the ECB's Governing Council. In practice, the parallel existence of such clearance and State aid control leads to two issues. First, since ELA procedures are inherently confidential and central banks do not communicate fully on the extent of such measures, one could wonder how to prevent distortion of competition when potential aid can be granted without a review by the Commission, leaving no possibility in practice for competitors to lodge a complaint against the measures. In addition, the coexistence of ELA and State procedures may also question the credibility of the standstill obligation in times of crisis: indeed, for the few ELAs that were considered as State aid, the emergency nature of the assistance and the main role played by the NCB and the Eurosystem meant that the ELA was granted before being notified and/or cleared by the Commission.

b) Indirect liquidity support – guarantees

i) Overview

Definition, modalities and statistical overview

A guarantee is a legally enforceable commitment by which one party (the guarantor) agrees to fulfil the obligations of another party (the principal obligor) should the latter fail to pay or perform certain of its obligations towards a third party. Funding guarantees provide banks in difficulty with indirect liquidity support by enhancing their creditworthiness, thereby allowing them to raise additional funding at a lower cost, benefitting from the more favourable credit profile of the guarantor, or avoiding bank runs by protecting retail deposits. The Commission distinguishes such funding guarantees (which cover liabilities on the banks' balance sheet) from asset guarantees, which cover the bank's exposure to certain assets and are considered as structural "impaired asset measures" and will be described in more detail in Section III.B below.[49]

Independent guarantees must be distinguished from "suretyships". Independent guarantees are (i) autonomous (ii) payable on first demand and (iii) independent from the principal contract between the principal obligor and the beneficiary of the guarantee. Suretyships, however, are accessory to the principal obligation. Therefore, the guarantor under a suretyship can raise any objections or defences based on the primary obligations provided by such suretyship (e.g. nullity, *exceptio non adimpleti contractus*) to avoid payment.

Credit rating institutions have developed criteria for guaranteed debt achieving credit substitution, i.e. for issuers benefitting from the credit rating and related lower cost of funding of the guarantee.

- First, the guarantee must be irrevocable and unconditional. The latter requires that the guarantee be enforceable 'immediately […] without a

[49] In complex cases, the distinction between funding/liability guarantees and asset guarantees may not be so clear-cut. For instance, in *Dexia* the Belgian and French States provided a specific guarantee that allowed the bank to sell its US subsidiary FSA to Assured Guaranty. This guarantee covered a put option that allowed one of the subsidiaries of FSA, under certain circumstances, to sell certain assets to Dexia at their residual nominal value. While the guarantee technically covered a contingent liability for Dexia, the Commission analyzed it as an asset guarantee and therefore a structural measure. See Dexia, Commission Decision of 13 March 2009 OJ 2009 C181/42, paras. 22-42 and 57-62.

requirement that the creditor first exhausts his remedies against the debtor'[50]. This does not mean however that the guarantor cannot contractually limit the scope of its obligations under the guarantee. However, for the obligations that fall within the scope of the guarantee, the guarantor must 'pay first [and] argue later'[51].

- Second, the guarantor must explicitly waive all defences 'available to the principal obligor under the guaranteed debt contract".[52] The guarantor undertakes a 'primary obligation',[53] independent from the principal contract. It cannot rely on a defence provided for in the principal contract to avoid payment and will be liable 'even if the principal debt is invalid',[54] subject to a limited set of exceptions such as violation of international public order).

- Third, the guarantee must ensure 'full and timely payment'[55]. The guarantor must 'pay no later than when the guaranteed obligation is contractually due'[56].

Guarantees can be granted under a scheme or on an individual basis. A "guarantee scheme" means any tool on the basis of which, without further implementing measures, guarantees can be provided to companies if they fulfil certain conditions of duration, amount, underlying transaction, type or size of undertakings (such as for instance SMEs). Alternatively, guarantees can be provided on an individual basis, outside of any scheme.

Between 2008 and 2014, the Commission authorized a total amount of aid of €3,249 billion for guarantees on liabilities, mostly in the form of aid schemes. Those guarantees were actually implemented by all Member States, except for Bulgaria, Czech Republic, Estonia, Croatia, Lithuania, Hungary, Malta, Poland, Romania and Slovakia.[57] While this represents the total maximum amount of guarantees that could be issued under the Commission authorization decisions, the total amount of guarantees effectively issued was much lower and reached €1,188.1 billion over the same period.

Set forth below is the total amount of guarantees measures granted per Member State during the 2008-14 period.

Table 5. Total amount of guarantees measures granted per Member State during the 2008-14 period

Member State	2008	2009	2010	2011	2012	2013	2014	Maximum, 2008-14
Belgium	9.0	46.8	32.8	26.4	45.6	36.9	37.6	46.8

50 Philip R. Wood, *Comparative Law of Security and Guarantees* (Sweet & Maxwell 1995) (Wood 1995), 331.

51 Ross Cranston, *Principles of Banking Law* (OUP 2002) (Cranston 2002), 391.

52 Moody's Investor Service, 'Moody's identifies Core Principles of Guarantees for Credit Substitution', 2010 (Moody's 2010).

53 Cranston 2002, 391.

54 Wood 1995, 332.

55 Moody's 2010.

56 *Ibid*.

57 State Aid Scoreboard 2015.

Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Denmark	145.0	6.4	22.3	23.0	1.2	0.7	0.0	145.0
Germany	18.7	135.0	132.0	34.7	10.0	3.0	2.0	135.0
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ireland	180.3	284.3	196.3	110.5	83.5	37.2	10.6	284.3
Greece	0.0	1.5	26.7	56.3	62.3	47.8	60.0	62.3
Spain	0.0	36.1	55.8	61.7	72.0	53.6	11.1	72.0
France	8.7	92.7	91.5	71.8	53.4	46.9	36.1	92.7
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Italy	0.0	0.0	0.0	10.9	85.7	81.7	22.0	85.7
Cyprus	0.0	0.6	2.8	2.8	2.3	1.0	1.0	2.8
Latvia	0.0	0.5	0.2	0.1	0.0	0.0	0.0	0.5
Lithuania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Luxembourg	0.4	1.6	1.4	1.2	1.9	3.8	0.6	3.8
Hungary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	0.9	36.0	40.9	33.2	19.4	12.4	0.0	40.9
Austria	2.4	15.5	19.3	17.1	11.8	2.4	4.0	19.3
Poland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portugal	1.2	5.2	5.0	8.5	16.6	14.4	3.5	16.6
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	0.0	1.0	2.2	1.6	0.2	0.1	1.8	2.2
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.1
Sweden	0.3	14.3	19.9	14.0	4.4	1.3	0.1	19.9
United Kingdom	33.5	158.2	150.7	115.2	21.9	9.1	14.1	158.2
Total	400.4	35.8	799.8	589.0	492.1	352.3	204.5	1,188.1
						% 2014 EU GDP		**8.5%**

Source: European Commission

Main objectives

Guarantees have been used by Member States to reassure the depositors and markets and ensure banks' liquidity. At the very beginning of the crisis, the Commission's approach towards guarantees was focused on deposit guarantees, which were not subject to a pan-European legal framework. The Commission thus acknowledged that

> […] [i]n the present exceptional circumstances, it may be necessary to reassure depositors with financial institutions that they will not suffer losses, so as to limit the possibility of bank runs and undue negative spillover effects on healthy banks. In principle, therefore, in the context of a systemic crisis, general guarantees protecting retail deposits (and debt held by retail clients) can be a legitimate component of the public policy response.[58]

But the Commission also acknowledged that guarantees covering other liabilities (such as certain short-and medium-term debt instruments issued on the markets, or certain types of wholesale deposits) were also necessary when the interbank lending markets had dried up due to an erosion of confidence between financial institutions.[59] In practice, such guarantees have accounted for the bulk of the Commission State aid decisions.

One additional reason for the use of funding guarantees in bank rescue schemes is that, from a public finances perspective, guarantees (as long as they are not called upon) represent a contingent liability and are therefore typically not recorded in public accounts – in particular in the Member state's public debt or deficit under ESA Rules – when they are granted, unless the beneficiary's cash generating abilities are limited or the tradability of its assets is severely limited.[60] To the extent the State receives remuneration for the guarantee (an obligation that has been imposed by the Commission under its State aid rules), a guarantee may even have a positive effect on the level of the deficit by generating additional resources for the State. However, once the guarantee is called, the State becomes liable for the amount so called which is then recorded as a capital transfer under public accounts, thus strongly increasing the government deficit and debt. [61] For governments aiming to minimize the impact of bank rescues on their accounts and creditworthiness – as well as the risk of a political backlash against the cost of bank rescues – funding guarantees may therefore constitute an appealing tool, although they generally do not allow them to clean up banks' balance sheets and address structural problems in business models.[62]

The positive effect of a guarantee for the beneficiary depends on the market reaction to this State support. Whether the beneficiary will be able to raise the necessary liquidity from the market will depend on a combination of factors including, crucially, (i) the guaranteeing State's credit rating and (ii) the existence of a decision from the Commission authorising the guarantee.

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[58] 2008 Banking Communication, para. 19.

[59] See e.g., *ibid*., para. 21.

[60] Eurostat, ESA 2010 Rules, para. 20.245.

[61] Eurostat, Manual on Government Deficit and Debt, Debt Related Transactions and Guarantees, 362.

[62] On the impact of ESA rules on the use of certain rescue instruments, see Christopher Gandrud and Mark Hallerberg, *Bad Banks in the EU – The Impact of Eurostat Rules*, Bruegel Working Paper, December 2014 <http://bruegel.org/wp-content/uploads/imported/publications/Bad_Banks_in_the_EU.pdf> accessed 30 August 2016 (Gandrud and Halleberg 2014).

ii) State aid control of guarantees

Main legal texts

Even before the financial crisis, the Commission had a long experience of guarantees as potential State aid measures. One of the emblematic pre-crisis State aid cases regarding the financial sector involved an implicit guarantee granted by German and Austrian States to public banks (in particular *Landesbanken*). A few months before the collapse of Lehman Brothers, the Commission had issued a general notice[63] on the application of State aid rules to guarantees. This notice, which applied to all sectors including banking, provided a "safe harbour" to companies (in particular SMEs) and Member States determining conditions under which a guarantee could escape the qualification of State aid or could be considered as compatible State aid.[64] A few months later, the 2008 Banking Communication set out a number of conditions for the approval of guarantees granted to banks in the context of the financial crisis (limited scope, required approval every six months, remuneration, etc.)

In 2010 and 2011, the Commission issued two staff working documents specific to guarantee schemes for banks.[65] The first working document updated the conditions for the compatibility of the renewal of government guarantee schemes, increasing the fees and requiring the demonstration by the bank of its long-term viability. The Commission intended to encourage gradual disengagement from the use of guarantees while allowing certain flexibility 'to permit access to guarantee schemes to the extent necessary to maintain progress in reinforcing financial stability'.[66] In the second working document, the Commission considered that 'a further price increase and/or tightening of viability requirements'[67] was not necessary.

The 2013 Banking Communication is now the primary basis for the assessment of guarantees together with the remuneration formula contained in the Second Prolongation Communication. The main applicable rules under these Communications[68] are the following:

- ***Scope/ underlying instruments.*** Funding guarantees may only be granted for new issues of credit institutions' senior debt. They cannot cover subordinated debt.
- ***Maturity.*** Guarantees may only be granted on debt instruments with maturities from three months to five years (or a maximum of seven years in the case of covered bonds). Guarantees with a maturity of more than three years must, except in duly justified cases, be limited to one third of the outstanding guarantees granted to the individual bank.

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63 Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees OJ 2008 C155/02 (2008 Guarantee Notice).

64 2008 Guarantee Notice, para. 1.1.

65 DG Competition Staff Working Document on the application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010 and DG Competition Staff Working Document on the application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2011.

66 DG Competition Staff Working Document on the application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010, 3.

67 *Ibid.*, 5.

68 2013 Revised Banking Communication, paras. 59-60.

- ***Remuneration.*** The minimum remuneration level of the State guarantees must be in line with the formula set out in the 2011 Prolongation Communication.[69] For debt with a maturity of one year or more this formula is based on:
    - a fixed basic fee (40 basis points); and
    - a variable component based on (i) the ratio between the bank's specific credit risk (measured by its median five-year senior credit default swap spread) and the average risk of the sector (measured by the median iTraxx Europe Senior Financials five-year index); and (ii) the ratio between the average credit risk of all Member States and the credit risk of the guarantor Member State (each measured by their median five-year senior CDS spread). The underlying objective is to ensure that the remuneration increases with (i) the bank's own risk relative to the sector and (ii) the Member State's own creditworthiness relative to its peers.

For debt with a maturity of less than one year, the Communication provides for a 50 basis points fixed fee and an additional fee depending on the bank's credit rating (from 20 basis points for a rating of A+ or A to 40 basis points for a rating of A – or less or with no rating).

- ***Restructuring/winding down**.* When the total outstanding guarantee liabilities exceed 5% of the bank's total liabilities and a total amount of €500 million, a restructuring plan must be submitted to the Commission within two months. If the guarantee is called upon, an individual restructuring or wind-down plan must be submitted within two months after the guarantee has been activated.
- ***Behavioural measures.*** The recipients of the guarantee must refrain from advertising referring to State support and from employing any aggressive commercial strategies which would not take place without the support of the Member State.
- ***Guarantee schemes.*** When guarantees are granted through a scheme, the following additional criteria must be met:
    - the scheme must be restricted to banks without a capital shortfall as certified by the competent supervisory authority;
    - guarantees with a maturity of more than three years must be limited to one third of the total guarantees granted to the individual bank;
    - Member States must report to the Commission on a three-monthly basis on: (i) the operation of the scheme; (ii) the guaranteed debt issues; and (iii) the actual fees charged; and
    - Member States must supplement their reports on the operation of the scheme with available updated information on the cost of comparable non-guaranteed debt issuances (nature, volume, rating, currency).

[69] 2011 Prolongation Communication, Annex.

Implementation in leading cases

Germany implemented one of the most significant guarantee schemes only days after the collapse of Lehman Brothers. The scheme was approved on 27 October 2008 by the Commission.[70] The guarantee was capped at €400 billion and covered new issuances of debt in return for market-oriented remuneration. The measure was limited to six months and was modified and extended several times up to the end of 2010.[71] In March 2012, the Commission approved the reactivation of the German scheme, which was then extended until June 2013.[72]

In **Greece**, the original scheme approved in November 2008[73] was relatively modest with an overall maximum for the guarantee of €15 billion. After two prolongations, the Commission approved an amendment increasing the guarantee upper limit to €30 billion,[74] then €55 billion,[75] and finally to €85 billion.[76] The scheme was prolonged 11 times, without major changes in commitments.

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70 Commission Decision N512/2008 Rescue package for credit institutions in Germany OJ 2008 C293/1.

71 Commission Decision N625/2008, Amendment to German banks rescue scheme OJ 2009 C/143, Prolongation: N330/2009, OJ 2009 C160, Prolongation: N665/2009, OJ 2010 C28, Prolongation OJ 2010 C178.

72 Commission Decision SA.34345, Reactivation of German rescue scheme OJ 2012 C108, Prolongation: SA.34897, OJ 2012 C220.

73 Commission Decision N560/2008 Aid scheme to the banking industry in Greece (guarantees, recapitalization & others) OJ 2009 C125/6.

74 Commission Decision N163/2010 Amendment to the Greek bank support scheme OJ 2010 C166.

75 Commission Decision N260/2010 Extension and amendment of the support measures for the Credit Institutions in Greece OJ 2010 C238/1.

76 Commission Decision SA.32767 Amendment OJ 2011 C164/5.

Similarly, Ireland,[77] Italy,[78] Denmark,[79] Latvia,[80] Lithuania,[81] Poland,[82] Spain,[83] Sweden,[84] Slovenia,[85] Portugal,[86] Hungary,[87] the UK,[88] and the Netherlands[89] all implemented guarantee schemes.

A number of individual guarantee measures have also been approved by the Commission. In the context of the rescue of the French mortgage lender Crédit Immobilier de France (CIF), the Commission approved an €18 billion guarantee to cover CIF's urgent liquidity needs.[90]

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[77] Commission Decision NN 48/2008, Guarantee scheme for banks in Ireland, OJ 2008 C312, Prolongations: N 349/2009, OJ 2010 C72; N 198/2010, OJ 2010 C191; N 254/2010, OJ 2010 C238, N 347/2010, OJ 2011 C37; N 487/2010, OJ 2010; SA.33006, OJ 2011 C317; SA.33740, OJ 2012 C23; SA.34746, OJ 2012 C312; SA.35744, OJ 2013 C8. .

[78] Commission Decision N520a/2008, Guarantee scheme for Italian banks, OJ 2008, Prolongations: N 328/2009, OJ 2009 C174; SA 34032 , OJ 2010 C141.

[79] Commission Decision NN 51/2008, Guarantee scheme for banks in Denmark, OJ 2008 C273, p.2.

[80] Commission Decision N 638/2008, Guarantee scheme for banks, OJ 2009 C46, p.3, Prolongations: N 326/2009, OJ 2009 C177; N664/2009, OJ 2010 C18; N 223/2010, OJ 2010 C185.

[81] Commission Decision N200/2009 and N47/2010 – Support Package for Lithuanian Financial Institutions [OJ], Prolongations: SA.32188, OJ 2011, C53; SA.33135, OJ 2011 C274; SA.34288, OJ 2012 C82; SA.35129, OJ 2012 C284; SA.36047, OJ 2013 C132.

[82] Commission Decision N 208/2009, Polish support scheme for financial institutions (guarantee and liquidity support), OJ 2009 C250, Prolongations: N 658/2009, OJ 2010 C57; N 236/2010, OJ 2010 C205; N 533/2010, OJ 2011 C29; SA. 33008 and SA. 32946, OJ 2011 C237; SA. 34081, OJ 2012 C177; SA.34811, OJ 2012; SA.35944, OJ 2013 C81 ; SA.36965, OJ 2014 C23 ; SA.38023, OJ 2014 C2010 ; SA.39015, OJ 2014 C418.

[83] Commission Decision NN 54b/2008, Spanish guarantee scheme for credit institutions, OJ 2009 C122, Prolongations: N 336/2009, OJ 2009 C 174; N 588/2009, OJ 2010 C25; N 263/2010, OJ 2010 C190; N 530/2010, OJ 2011 C7; SA.32990, OJ 2011 C206; SA. 34224, OJ 2012 C82 ; SA.34904, OJ 2012 C232 ; SA.36020, OJ 2013 C220.

[84] Commission Decision N 533/2008, Support measures for the banking industry in Sweden (guarantees), OJ 2008 C308, Commission Decision N 26/2009, Amendment, OJ 2009 C37; Prolongations: N 154/2009, OJ 2009 C123, Commission Decision N 544/2009, Prolongation of the Swedish guarantee scheme, OJ 2009 C299; N 127/2010, OJ 2010 C147; N 207/2010, OJ 2010 C194; N 543/2010, OJ 2010 C357.

[85] Commission Decision N 531/2008, Guarantee scheme for credit institutions in Slovenia, OJ 2009 C9, Prolongations: N 331/2009 C157, OJ 2009; N 651/2009, OJ 2010 C31; N 245/2010, OJ 2010 C298.

[86] Commission Decision NN 60/2008, Guarantee scheme for credit institutions in Portugal, OJ 2009 C25, Prolongations: N 51/ 2010, OJ 2010 C96; N 315/2010, OJ 2010 C283; SA.32158, OJ 2011 C111; SA.33178, OJ 2011 C344; Amendment: SA.34034, OJ 2012 C99; Prolongations: SA.34958, OJ 2012 C246; SA.35743, OJ 2013 C36; SA.36869, OJ 2014 C2; SA.37698, OJ 2014 C50; SA.38900, OJ 2014 C348.

[87] Commission Decision N 664/2008, Financial support measures to Hungarian financial industry in form of recapitalisation and guarantee scheme, OJ 2009 C147, Prolongation: N 355/2009, OJ 2009 C235.

[88] Commission Decision N 507/2008, Aid scheme to the banking industry in the UK (guaranteed, recapitalisation & other), OJ 2008 C290, Amendment: N 650/2008, OJ 2009 C54, Prolongations: N 193/2009, OJ 2009 C154; N537/2009, OJ 2010 C1; N677/2009, OJ 2010 C72.

[89] Commission Decision N 524/2008, Guarantee scheme for Dutch financial institutions, OJ 2008 C328, Prolongations: N 379/2009, OJ 2009 C186; N 669/2009, OJ 2010 C25; N 238/2010, OJ 2010 C205.

[90] Commission Decision SA.35389 Rescue aid in favour of Crédit Immobilier de France OJ 2013 C134/1.

The German bank Hypo Real Estate holding[91] also benefited from an important guarantee measure capped at €35 billion and so did HSH Nordbank (€30 billion),[92] the Spanish bank BFA/Bankia (€53.9 billion),[93] and the Belgian-French bank Dexia (€85 billion).[94]

Key legal and practical issues

Legal certainty and conditional approval of the Commission. An important practical issue raised by State aid clearance of funding guarantees is the tension between the imperative of legal certainty, which is essential for the guarantees to be effective, and the conditional nature of the Commission's clearance decisions.

As explained above, a key pre-condition for the effectiveness of a guarantee is its irrevocable and unconditional character. This feature is a key element in the market's (and rating agencies') assessment of the underlying debt instruments. On the other hand, in application of its guidelines, the Commission has in a number of cases made its clearance subject to the fulfilment of a number of conditions or commitments regarding the bank's commercial behaviour and/or the implementation of a restructuring plan. This begs the question of whether the Commission's clearance (and therefore the validity of the guarantee) could be jeopardized should the bank deviate from these conditions or commitments. Indeed, under Article 20 of Regulation 2015/1589 laying down detailed rules for the application of Article 108 TFEU ("the Procedural Regulation"), in cases of "misuse of aid" where conditions or commitments mentioned in a clearance decision are not complied with, the Commission may open a formal investigation and adopt a new decision revoking its prior clearance and deeming the guarantee to constitute illegal State aid.

This possibility is not entirely theoretical: in a few cases involving banks the Commission did open or re-open the formal investigation procedure following a breach (even limited) of the bank's commitments, although the impact of such breaches has generally remained limited as they were typically counter-balanced by further commitments or the liquidation of the bank.[95]

Another variant of this scenario is a case where the Commission would "temporarily" authorize a funding guarantee as a rescue measure, subject to the presentation of a restructuring plan within six months. This was for instance the case in Banco Privado Português (BPP), where further to an initial temporary clearance the Portuguese State failed to fulfil its commitment to transmit a restructuring plan of the bank and the guarantee was retroactively found to constitute illegal State aid from the time it was initially granted.[96]

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91 Commission Decision NN 44/2008, Rescue aid to Hypo real Estate, OJ 2008 C293/1.

92 Commission Decision SA.29338, Increase of the ceiling amount of a second-loss guarantee for HSH Nordbank AG, OJ 2012 L225/1.

93 Commission Decision SA.35253, Restructuring and recapitalisation of the BFA/Bankia Group, OJ 2013 C77/2.

94 Commission Decision SA.33763, Additional measures to restructuring of Dexia – by Belgium – Guarantee (C-2), first prolongation of guarantee (C-2), OJ 2014 L110/1.

95 See e.g. European Commission, State aid SA.35062, CGD, Decision of 24 July 2013, OJ 2014 L323, para. 82; European Commission, C9/2009 Dexia, Decision of 28 December 2012 OJ 2014 L110. European Commission, State aid SA.32554, Hypo Group Alpe, Hypo Group Alpe Adria, Decision of 3 September 2013 OJ [2014] L176.

96 See Commission decision 2011/346 EU of 20 July 2010 (OJ 2011, L159, 95), confirmed in appeal (case T-487/11 Banco Privado Português *et al.* v. Commission [2014] and C-667/13, Estado português v Banco Privado Português *et al.* [2015]).

Another sub-variant of this scenario was the *Dexia* case, where the Commission (i) temporarily cleared a funding guarantee granted in 2011 to help the bank overcome its severe liquidity issues and (ii) in the same decision, opened a formal investigation on new restructuring aid granted to the bank, including on the temporarily cleared guarantee.[97] In these two cases, the validity of the guarantee was ultimately not called into question: in BPP, the Commission only requested the recovery of the advantage granted to the bank, which was measured by the difference between the cost of the guarantee and that of a privileged loan; and in Dexia, further to the formal investigation the Commission definitely cleared the guarantee and other aid subject to the implementation of the bank's orderly resolution plan.

But it cannot be excluded in the future that a national court might find that a guarantee that has been held to constitute illegal and incompatible State aid can no longer be invoked by the lender or debt-holder, a solution that was expressly contemplated by the Court of Justice in the *Residex* case.[98] This would in particular be the case if the Commission found that the guarantee also constituted aid to the lender and not just to the borrower.[99] So far, the Commission avoided such findings in bank-related cases. For instance, in the *BPP*[100] case mentioned above, the State guarantee was a *sine qua non* condition for six major Portuguese banks to offer BPP a €450 million loan. The Commission considered that BPP was the beneficiary of the aid and refrained from ordering its recovery from the lenders, i.e., the other banks.

Notification: individual or scheme? Funding guarantees can be granted either on an individual basis or as part of a scheme. Both solutions have specific advantages and it may be challenging to assess early on which way to follow: although schemes imply additional requirements (e.g. absence of capital shortfall, limitation of guarantees of more than three years to one third of the total guarantee granted to the individual bank),[101] each participant in the scheme receives less detailed scrutiny from the Commission than an individual recipient.

Valuation issues and determination of the aid element. When determining that a guarantee constitutes State aid, the Commission is in principle not obligated precisely to quantify the amount of aid granted to the beneficiary. In bank State aid cases, however, such quantification plays an important role to determine the magnitude of the restructuring measures required. Thus, while the Commission typically refrained from quantifying the aid amount contained in guarantee schemes, it did try to quantify the amount granted through individual guarantees or in the context of restructuring cases. In principle, and in line with its 2008 Communication on guarantees, the Commission quantified the aid element of an individual guarantee by reference to market rates payable for a similar guarantee, thus using

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[97] State aids SA.33760 (11/C) (ex 11/N) – Additional measure to restructuring of Dexia – France, SA.33763 (11/C) (ex 11/N) – Additional measure to restructuring of Dexia – Belgium, SA.33764 (11/C) (ex 11/N) – Additional measure to restructuring of Dexia – Luxembourg, SA.30521 (MC 2/10) – Monitoring of Dexia, SA.26653 (C 9/09) – Restructuring of Dexia OJ C345, 13 November 2012, 50-62.

[98] Case C-275/10, *Residex Capital IV* [2011] ECR I-13043.

[99] According to the Commission Notice on the application of Article 87 and 88 of the EC Treaty to State aid in the form of Guarantee, para. 2.3.1:

> Even if usually the aid beneficiary is the borrower, it cannot be ruled out that under certain circumstances the lender, too, will directly benefit from the aid. In particular, for example, if a State guarantee is given ex post in respect of a loan or other financial obligation already entered into without the terms of this loan or financial obligation being adjusted, or if one guaranteed loan is used to pay back another, non-guaranteed loan to the same credit institution, then there may also be aid to the lender, in so far as the security of the loans is increased.

[100] Commission Decision on State aid NN 71/2008 granted by Portugal to Auxílio estatal ao Banco Privado Português "BPP", OJ 2009 C174/1.

[101] 2013 Banking Communication, para. 60.

e.g. a bank's credit default swaps as a basis. However, at the peak of the crisis, such references were not always available as some beneficiaries were not in a position to receive a guarantee at all on the open markets. In this context, the Commission decided either that the aid element should be equal to the difference between the remuneration received by the State and the market remuneration that would have been received for a loan (rather than a guarantee); or, in some cases where the bank would arguably not even have been able to receive any loan, that the aid element could be as high as the full amount of the State guarantee.[102]

This last scenario raises a number of practical issues. First, such an approach may considerably inflate the amount of aid embodied in a funding guarantee. Second, since the Commission typically did not quantify aid in the case of schemes, it may lead to a difference of treatment between economically equivalent guarantees depending on whether they are granted under a scheme or individually. Finally, it may lead to an overestimation of the impact on competition on funding guarantees compared with structural aid measures, in particular recapitalizations or impaired asset measures (including asset guarantees).[103]

3. Tailor-made kit: structural aid

The longer the crisis lasted, the more creative Member States came with fine-tuned structural aid measures aimed at putting a definitive end to their banks' troubles. These structural measures can be broken down into two categories: recapitalizations (a) and impaired assets measures (b).

a) Recapitalizations

i) Overview

Definition, modalities and statistical overview

Recapitalizations are one of the most used instruments to support the financial sector: as of 2015, they accounted for an overall authorized aid amount €802.1 billion, of which €453.3 billion had effectively been used.[104] Recapitalizations take the form of the subscription by the State to various capital instruments issued by the bank such as core equity (voting or not), alternative Tier 1 (such as hybrid securities or non-cumulative preference shares) or Tier 2 instruments (for example, cumulative preference shares or deeply subordinated debt instruments). Recapitalizations can take the form of a purely private transaction between the bank and the State, or of a wider public issuance (such as a rights issue).

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102 Commission Decision N255 and 274/2009 Fortis Bank and Fortis Bank Luxembourg OJ 2009 C178, 1 para. 55. See also Commission Decision C9/2009 Dexia OJ 2010 L 274/54, para. 145; and Commission Decision C 10/2008 IKB OJ 2009 L278.

103 See François-Charles Laprévote, 'Selected Issues Raised by Bank Restructuring Plans under EU State Aid Rules' (2012) 11 European State Aid Law Quarterly 1, 93-112.

104 State Aid Scoreboard 2015.

In a number of cases, State recapitalizations have also taken the form of the subscription of convertible contingent bonds (CoCos), which typically give rise to a coupon paid to the State and may/must be converted into ordinary shares upon certain trigger events (for instance if a coupon payment is missed or if the bank falls below a certain CET1 ratio).[105]

The Second Company Law Directive [106] harmonizes rules applicable to recapitalizations of public limited liability companies in the EU. Among others, the Directive provides for pre-emption rights for the benefit of existing shareholders in the case of a capital increase by contribution in cash. In other terms, the newly issued shares must first be offered to the existing shareholders in proportion to the capital represented by their existing shares. This pre-emption right may only be restricted by a decision of the general meeting of shareholders to which the management body will have provided a written report indicating the reasons for such restriction or withdrawal of the pre-emption rights, and justifying the proposed issue price. More stringent rules may apply in some Member States, such as minimum issue prices. The Second Company Law Directive does not provide for a direct link between the capital ownership of a company, its governance rules and the composition of its Board. In practice, State recapitalizations typically involve *ad hoc* negotiations on these issues, subject to the requirements imposed by the Temporary Framework and the Commission's decisional practice.

Set out below is the total amount of recapitalization measures granted per Member State during the 2008-14 period.

Table 6. Total amount of recapitalization measures granted per Member State during the 2008-14 period

Member State	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**Total, 2008-14**
Belgium	14.4	3.5	0.0	0.0	2.9	0.0	0.0	20.8
Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Denmark	0.5	8.0	1.9	0.3	0.0	0.0	0.0	10.8
Germany	20.0	32.9	6.7	3.6	0.9	0.0	0.0	64.2
Germany	20.0	32.9	6.7	3.6	0.9	0.0	0.0	64.2
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ireland	0.0	11.0	35.3	16.5	0.0	0.0	0.0	62.8
Greece	0.0	3.8	0.0	2.6	30.9	3.5	0.0	40.8
Spain	0.0	1.3	9.5	8.5	40.4	2.1	0.0	61.9

[105] For an example of a Coco mechanism, see e.g. Commission Decision in Case SA.43364 Additional restructuring aid to Piraeus Bank, 29 November 2915, paras. 28-35.

[106] Directive 2012/30 of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent

France	13.2	9.3	0.0	0.0	2.6	0.0	0.0	25.0
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Italy	0.0	4.1	0.0	0.0	2.0	1.9	0.0	8.0
Cyprus	0.0	0.0	0.0	0.0	1.8	0.0	1.5	3.3
Latvia	0.0	0.4	0.1	0.0	0.0	0.0	0.0	0.5
Lithuania	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.3
Luxembourg	2.5	0.1	0.0	0.0	0.0	0.0	0.0	2.6
Hungary	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.2
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	14.0	0.0	4.8	0.0	0.0	4.2	0.0	23.0
Austria	0.9	5.9	0.6	0.0	2.0	1.8	0.8	11.8
Poland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portugal	0.0	0.0	0.0	0.0	6.8	1.1	4.9	12.7
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	0.0	0.0	0.0	0.3	0.5	2.4	0.4	3.6
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sweden	0.3	0.5	0.0	0.0	0.0	0.0	0.0	0.8
United Kingdom	49.4	9.7	34.6	3.2	0.0	3.3	0.0	100.1
Total	**115.2**	**90.7**	**93.5**	**35.0**	**90.8**	**20.5**	**7.6**	**453.3**
						% 2014 EU GDP		**3.2%**

Source: European Commission

Main objectives

The objectives served by banks recapitalizations are threefold.

First, recapitalizations help restore the financial stability and confidence from the markets, existing shareholders and potential investors. This objective was of particular importance after the collapse of Lehman Brothers and in the early stages of the crisis, which also impacted on fundamentally sound banks. Indeed, in such circumstances, capital injections may be required to respond to a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk and the increased cost of funding across the entire banking sector.

Second, State recapitalizations typically confer the State a prominent role in the bank's governance, which may allow the State representatives to ensure that banks will continue to lend to the real economy in the future, while undertaking the required reforms and cleaning up their balance sheet.

Third, State recapitalizations may also be an appropriate response to the specific problems of financial institutions facing solvability concerns as a result of their specific business model or investment strategy. A recapitalization can facilitate the cleaning-up of the bank's balance sheet by increasing the coverage ratio of non-performing loans. When the bank is on the brink of failure, a capital injection as emergency support may also help avoiding the short term systemic effects of its possible insolvency. In the longer term, recapitalization can support efforts to prepare the bank's return to long-term viability or its orderly winding-up.

Fourth, recapitalizations may be required to address a capital shortfall resulting from a toughening of regulatory ratios and/or a regulatory stress test or asset quality review. Over the past few years, with the gradual setting up of the Banking Union, this has been an increasing rationale for recapitalizations, which were often conducted at the same time for several banks in a given Member State (e.g. Spain in 2012, Portugal and Slovenia in 2013, Greece in 2014 and 2015, and possibly Italy in 2016).

In principle, the impact of a bank's recapitalization on public accounts depends on whether the government can be considered as acting in the same capacity as a private shareholder (i.e. "provides funds while receiving contractually something (usually financial instrument […]) of equal value in exchange and expecting to earn a sufficient rate of return on its investment").[107] If this is the case, under ESA rules the recapitalization is to be considered as a financial transaction with no impact on the government's net lending/borrowing.[108] In a 2009 decision relating to public interventions during the financial crisis, Eurostat clarified that (i) for subscriptions of ordinary shares, a subscription at market price (or below) would be considered as a financial transaction; and (ii) recapitalizations in the form of preference shares would also be recorded as financial transactions if the remuneration principles set out in EU State aid rules adopted under the Crisis Framework were complied with.[109] Recapitalizations that do not comply with these principles should be counted as government expenditure (capital transfer) – this was the case with the recapitalization of Irish banks in 2010, which were found to constitute capital transfers and dramatically increased the government deficit to over 30% that year.[110] In a further decision adopted in 2013 Eurostat further indicated that 'simple compliance with State aid rules […] cannot be used as the sole element for the classification of the transaction, especially when the entity will exit the market and not exercise future competitive activity'.[111] These principles were applied to the 2012 recapitalization of Dexia, which Eurostat considered as 'an exemplary case' because (i) the bank was only recapitalized by the French and Belgian governments, with no private sector participation; (ii) the company recorded a negative equity position just before recapitalization and (iii) the company was incurring heavy losses and was exiting from the market as a result of the orderly resolution plan approved by the

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107 Manual on Government Deficit and Debt, Eurostat, 2014 Edition, 'Capital Injections into Public Corporations', 142 <http://ec.europa.eu/eurostat/documents/3859598/5937189/KS-GQ-14-010-EN.PDF/> accessed October 28, 2016.

108 *Ibid.*

109 Decision of Eurostat on deficit and debt: The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, 15 July 2009 (2009 Eurostat Decision). See also Eurostat Guidance Note on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, 2009 (2009 Eurostat Guidance Note).

110 See Gandrud and Halleberg 2014.

111 Decision of Eurostat on government deficit and debt: Clarification of the criteria to be taken into account for the recording of government capital injections into banks, 19 March 2013, 2.

Commission's DG COMP. As a result, Eurostat considered that the recapitalization should be included as a capital transfer in the 2012 government deficit for France and Belgium.[112]

ii) State aid control of recapitalizations

The main legal texts

Very early in the crisis the Commission adopted a specific communication dedicated to recapitalization (the 2008 Recapitalization Communication), which was then supplemented by its First and Second Prolongation Communications, as well as the 2013 Banking Communication.

The 2013 Banking Communication implied an important change in the Commission's decisional practice by prohibiting the granting of structural aid (including recapitalization) on a rescue aid basis. Until then, Member States had routinely provided emergency recapitalizations to their banks before a restructuring plan could be agreed with the Commission (and sometimes before even securing any form of clearance from the Commission, which resulted in unlawful aid that was cleared *a posteriori* by the Commission). Typically, the Commission then authorized the aid on a "temporary" basis (i.e. for a duration of six months), subject to the presentation of a full-fledged restructuring plan within six months, which typically led to a "definitive" authorization decision. This practice, which essentially resulted from the need for States to rescue banks within a matter of days (sometimes over one single weekend) and the impossibility for the States and the Commission to prepare and agree to a restructuring plan within such a short timeframe, raised several issues. First, to the extent the aid was granted before any form of clearance, it was technically unlawful and could in principle be challenged before national courts, thus endangering the entire rescue operation. Second, the "temporary" nature of the Commission's clearance did not fit well with the structural nature of the aid granted – indeed, once the recapitalization was realized it was generally impossible to undo, thus jeopardizing the credibility of the Commission's "temporary" clearance. Finally, rescue recapitalizations were the result of the lack of an EU regulatory framework providing for preventative measures and the early restructuring of banks (including so-called "living wills"), which failures were arguably tackled by the adoption of the main Banking Union texts, in particular the Bank Recovery and Resolution Directive (BRRD).

As a result, the 2013 Communication now requires substantial restructuring measures from the bank prior to benefiting from the aid, thus placing new emphasis on the way capital shortfalls are addressed by banks in a pre-emptive manner in order to prevent the intervention of the State. In this context, banks now have to submit a capital raising plan[113] as part of the pre-notification requirements.[114] Only the residual capital shortfall after completion of the plan may be covered by the State recapitalization. Even then, recapitalization aid will in principle only be authorized after the Commission's prior approval

112 Eurostat letter of March 19, 2013, on the recapitalization of the Dexia Group <http://ec.europa.eu/eurostat/documents/1015035/2990735/BE-Dexia-recapitalisation-advice-2013-03-19.pdf/c44c8f62-2572-4386-ad8f-bb2a1c031d6d> accessed 19 August 2016.

113 2013 Banking Communication, para. 29 and following.

114 *Ibid.*, para. 35. Such plans include measures such as rights issues, voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive, securitization of portfolios in order to generate capital from non-core activities, etc.

of the bank's restructuring plan. By way of exception to this rule, the Commission is still able to temporarily authorize structural aid in exceptional cases, provided that (i) the competent supervisory authority confirms the existence of a capital shortfall that would threaten financial stability, and (ii) the Member State submits a restructuring plan within two months of the temporary authorization.

ii) Implementation in leading cases

The major pre-crisis cases

Before the crisis, the Commission already had the opportunity to deal with State recapitalizations of banks on the basis of Article 107(3)(c) TFEU and the Rescue and Restructuring guidelines and to lay down conditions for their authorization.[115]

A good example of such pre-crisis control policy is the *Crédit Lyonnais* case.[116] The French State granted the bank a total of €15 to €22 billion of State aid, most of which was granted through recapitalizations and a transfer of impaired assets to a State-owned defeasance structure.[117] Although the French authorities had initially suggested that competition policy should give way to the necessity of financial stability and prudential policy, the Commission considered that the two objectives were not incompatible. As a result, while the Commission ultimately approved Credit Lyonnais' rescue, it imposed a harsh restructuring plan including a 50% balance sheet reduction, the sale of businesses in France and abroad, and the bank's privatization.

Before the crisis, the Commission adopted its decisions[118] under article 107(3)(c)TFEU which relates to 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. Under this provision, the Commission applied its Rescue and Restructuring Communication, which covered all sectors of the economy and typically required beneficiaries of rescue or restructuring aid to implement ambitious restructuring plans.[119] Thus, the Commission imposed strict conditions including: (i) the limitation of the aid to a six-month period, the granting of more structural aid measures (i.e. recapitalization or aid lasting more than six months) being conditional upon *ex ante* approval by the Commission; (ii) a restructuring plan restoring long term viability within three years; (iii) burden sharing, the principle being that at least 50% of the restructuring costs should be borne by the beneficiary and/or its investors. In the months immediately preceding the Lehman Brothers' demise, the Commission continued to apply Article 107(3)(c) TFEU to individual recapitalizations. The Commission maintained this analysis even in October 2008 when, in the Bradford and Bingley case, the British authorities unsuccessfully argued that '[b]y

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115 See, e.g., Commission Decision N 99/288, Banco di Napoli OJ 1999 L 116, Commission Decision N 2006/600 Banco di Sicilia et Sicilcassa OJ 2000 L 256, Commission Decision N 2005/345 Bankgesellschaft Berlin AG OJ 2005 L 116; Commission Decision 2005/691, 7 May 2004 Bank Burgenland AG OJ 2005, L 263.

116 Commission Decision 98/490, *Crédit Lyonnais*, OJ 1998 L 221/28, section 8.

117 Commission Decision 2000/513/EC, Aid granted by France to Stardust Marine, OJ 2000 L 206/6.

118 Commission Decision, 29 July 1998, Banco di Napoli, OJ 1999, L 116; Commission Decision, 10 November 1999, Banco di Sicilia et Sicilcassa, OJ 2000, L 256 ; Commission Decision, 18 February 2004, Bankgesellschaft Berlin AG, OJ 2005 L116; Commission Decision, 7 May 2004, Bank Burgenland OJ 2005 L263.

119 Communication from the Commission, Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 2004 C 244/2.

contrast to the situation in Northern Rock, it is now apparent that the effects of the credit crunch are far from being restricted to individual banks in the UK […] In these circumstances, there is real systemic risk that has to be addressed, not individual difficulties'.[120]

Individual recapitalizations assessment under Article 107(3)(b) TFEU

After the Lehman Brothers' demise in October 2008 and the growing systemic crisis, it became apparent that the rules applied so far (in particular the short duration of the restructuring plan and the magnitude of the burden sharing required) proved impossible to comply with strictly in the context of a systemic crisis. This realization led to the gradual adoption and implementation of the so-called "Temporary Framework" under Article 107(3)(b) TFEU, which started with the Commission Communication of 13 October 2008). [121] The main recapitalization cases examined by the Commission since then involve individual decisions, recapitalization schemes, and more recently country-wide recapitalizations, often realized simultaneously but assessed at individual levels.

- Individual cases

In a number of countries, especially at the beginning of the crisis, banks were rescued by States through recapitalizations decided on an *ad hoc* basis. These recapitalizations were assessed individually by the Commission and were usually cleared on the basis of a restructuring or winding-down plan. The most significant cases include:

- ***UK banks.*** With a total amount of €100 billion in the 2008-2014, the UK has been by far the largest user of State recapitalizations during the period, essentially from 2008 to 2010. Key cases included RBS[122] (which received a recapitalization of £20 billion on 1 December 2008 and whose restructuring involved the divestment of the entire ownership interest in each of the following businesses: RBS Insurance, Global Merchant Services, RBS Sempra Ownership Interest and Rainbow Business) and Lloyds[123] (recapitalization of £14.7 billion, key restructuring involving the disposal of the Divestment Business and an asset reduction programme).[124]
- ***German banks***. With a total amount of €64.2 billion (mostly in 2008 and 2009), Germany is the second-largest user of State recapitalizations. Key cases include Hypo Real Estate (€7.7 billion) and Commerzbank (€18.2 billion), as well as several large Landesbanken, including WestLB (€3 billion), Bayern LB (€10 billion) , HSH Nordbank (€3 billion) and LBBW (€5 billion).[125]

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[120] Commission Decision NN 41/2008, 1 October 2008, Rescue aid to Bradford & Bingley, para. 27, OJ 2008 C 290.

[121] Commission Communication on the application of State rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ 2009 C10/2.

[122] Commission Decision N422/2009, 14 December 2009, RBS restructuring plan, OJ 2010 C 119.

[123] Commission Decision N428/2009, 18 November 2009, Restructuring of Lloyds Banking Group, OJ 2010 C 46.

[124] See also chapter 9 on the United Kingdom by Conor Quigley.

[125] See also chapter 8 on Germany by Sven Frisch.

- ***Belgian banks***. Belgian banks were among the first affected by the crisis in 2008. As a result, over the 2008-2011 period, Belgium's structural support to its banks reached 8% of the GDP, the highest ratio in the EU after Ireland.[126] Overall, from 2008 to 2014 Belgium granted an amount of €20.8 billion of recapitalizations to its banks. The level of support is even greater if one considers the asset funding guarantees granted by the Belgian State (in particular to Dexia). Virtually the whole banking sector had to be restructured[127] and two major retail brands disappeared: Fortis (which was dismantled and whose Belgian activities were taken over by BNP Paribas) and Dexia (which was initially restructured, and then dismantled/partly nationalized in 2011). The third major bank, KBC, was also recapitalized and benefitted from State guarantees.[128]
- ***Dutch banks***. The Dutch banks received recapitalizations for an amount of €23 billion from 2008 to 2014, which were essentially granted in 2008 and 2010 and coupled with asset and funding guarantees. Major beneficiaries included ABN Amro (which was nationalized as part of the dismantlement of the Fortis group and received an estimated €5 billion in recapitalization aid), ING (with a €10 billion recapitalization), SNS Reaal (€750 million recapitalization) and the pension and insurance group Aegon (€3 billion recapitalization).[129]
- ***Irish banks.*** Irish banks (and public finances) have been particularly hit by the crisis. With a total amount of aid of €62.8 billion, Ireland is the third-largest user of recapitalizations in the EU (and the second-largest in the euro area after Germany). The main cases involved Anglo-Irish Bank (€14.5 billion), Allied Irish Bank (€3.5 billion) and Irish Nationwide Building Society (€ 5.4 billion).[130]

▪ *From recapitalization schemes to country-wide rescues*

A number of Member States also opted early on for schemes either only including recapitalizations[131] or combining recapitalization measures with guarantee and liquidity measures.[132] Most of those schemes were prolonged one or several times and/or reactivated under different conditions (for instance the German scheme, which was reactivated in March 2012).[133] In the early years of the crisis, some of these schemes did not give rise to individual decisions or restructuring plans to the extent they benefitted only "fundamentally sound"

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126 Joaquín Almunia's Speech of 25 September 2013. In Ireland, Anglo Irish bank, the Bank of Ireland, the Allied Irish Banks, the Irish Nationwide Building Society, Irish Life and Permanent, the Educational Building society, and EBS were recapitalized.

127 Individual rescue plans include Dexia (2008-12), KBC (2008-9), Fortis (2008-9), and Ethias (2009-10).

128 See also chapter 12 on Belgium by Jean-Sébastien Duprey.

129 See also chapter 13 on the Netherlands by Bart Joosen.

130 See chapter 10 on Ireland by Vincent Power.

131 In Finland, Sweden, Spain, Italy and Portugal the schemes only included recapitalization measures.

132 This was the case in the United Kingdom, France, Germany, Greece, Austria, Denmark, Hungary, Portugal, Slovakia, Poland, and Lithuania.

133 Commission Decision SA.34345, Reactivation of German rescue scheme OJ 2012 C 108.

banks and the aid (which typically took the form of hybrid instruments eligible for Core Tier 1 qualification and subject to high coupons) was swiftly repaid.[134] In total, 14 Member States have used recapitalization schemes since the beginning of the crisis.

More recently, recapitalizations have taken the form of country-wide rescues, where all major banks of a given country have been rescued, often in the context of an assistance programme overseen by the so-called "Troika" composed of the IMF, the ECB and the European Commission. Since the Commission now requires an individual restructuring plan for each bank receiving structural aid, these rescues have typically given rise to simultaneous Commission decisions clearing aid granted to several banks under very similar terms. The most significant cases include:

- ***Spanish banks***. From 2010 to 2014 Spain spent a total of €61.9 billion in order to rescue its banks. The main beneficiaries were Caja de Ahorros de Mediterraneo, Caja Castilla la Mancha, BFA Group, Banco Mare Nostrum, Catalunya Banc, Banco de Valencia, CEISS, CalatunyaCaixa and NovaCaixaGalicia.
- ***Portuguese banks***. Portuguese banks, especially the Caixa Geral de Depósitos, Millennium BCP, BPI and Rentipar/BANIF, received recapitalizations worth €12.7 billion, mainly during the period from 2012 to 2014.
- ***Slovenian banks***. In Slovenia, Nova Ljubljanska Banka, NKBM, Factor Banka, Abanka and Banka Celje all received recapitalizations, mainly during the period from 2012 to 2014 for €3.6 billion.
- ***Greek banks***. A total amount of €40.8 billion of recapitalization was granted, mainly to the National Bank of Greece, the Alpha Bank, the EFG Eurobank and the Piraeus Bank in 2012, 2014 and 2015.
- ***Cypriot banks***. In 2012, the Cyprus Popular Bank as well as the Cooperative Central Bank Ltd in 2013 benefited from the State's recapitalization measures amounting to €3.3 billion. Private investors have only subscribed to negligible amounts of the offered shares.

Key legal and practical issues

Application of the market economy investor principle. The market economy investor principle (MEIP) is a cardinal principle, firmly embedded in EU case law and decisional practice, used to assess whether a State measure grants its beneficiary a selective advantage and may thus constitute State aid.[135] The MEIP test allows to exclude the existence of an advantage, and as a consequence of State aid, when the State has contracted or acted in accordance with market conditions. More specifically, the MEIP test must be applied (i) leaving aside all public policy considerations that may otherwise justify the intervention by the State as a public authority; (ii) on an *ex ante* basis i.e. on the basis of the information available at the time the intervention was decided; and (iii) by providing evidence (typically in the form of a business plan and/or independent evaluation by independent experts) showing that the decision to carry out the investment was taken on the basis of economic evaluations comparable to those

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[134] This was for instance the case for a number of French banks, see chapter 11 on France by Claire Froitzheim.

135 See e.g. Joined Cases T-268/08 and T-281/08 *Land Burgenland,* judgment of 28 February 2012, ECR I-000, para. 62, confirmed in appeal.

required by a rational private operator to determine the transaction's profitability or economic advantages. [136]

Since the beginning of the crisis the Commission has only exceptionally accepted that capital injections by the States into banks could escape the qualification of State aid under the MEIP. Generally, these exceptional cases involved a recapitalization where the State was a minority investor alongside a majority of private investors.[137] More generally, to avoid the qualification of State aid, the intervention of private investors must have real economic significance – to be assessed on a case-by-case basis[138] – and not be merely symbolic or marginal, and the participation of the State must take place under the same terms as that of the private investors. To date, only very few cases have met this high threshold. In *Hypo Steiermak*[139] for instance, the Commission excluded the aid qualification for a capital injection granted by the Austrian State alongside a private investor who subscribed to 75% of the capital increase. By contrast, in the *Dexia* case, despite significant participation by private investors, the Commission concluded that it was nevertheless aid as the investment was made by 'historic shareholders' and 'at the height of the crisis under entirely abnormal conditions'.[140]

In this respect, banks that are entirely (or majority) State-owned, either as a result of previous State interventions or because of their pre-crisis status, raise specific issues. In some cases, the Commission has implicitly accepted that capital injections carried out by the State as sole shareholder may not constitute State aid, presumably because they were decided on the basis of an *ex ante* business plan showing clear perspectives of profitability.[141] In other cases, by contrast, the Commission considered that the State did not act as a market investor but rather as a public authority aiming to ensure financial stability. For instance, in the ABN Amro case, the Commission took issue with the very short time period over which the recapitalization was decided and inferred from this that the Dutch State could not have behaved as a market operator:

> The willingness to avoid a serious disruption of the Dutch banking system and economy also explains why the Dutch State took its decisions so rapidly. A market economy investor would have taken much more time to evaluate the potential need for additional capital injections and would also have investigated the financials of the companies in more detail […]The Dutch State having to act swiftly to preserve financial stability in the Netherlands, could not behave like a market economy

136 For a more detailed description of the application of the market economy principle, see chapter 4 by Phedon Nicolaides.

137 See for instance the Commission Decision of July 22, 2009, Hypo Steiermarkt, where the Commission accepted that the participation by the State for 25% of a capital increase otherwise subscribed by private investors did not constitute State aid.

138 See, e.g., Commission Decision of 11 December 2007 Citynet Amsterdam where the private investors held the same stake as the public body.

139 Commission Decision NN 40/2009, Hypo Steiermark, para. 15.

140 Commission Decision 2010.606, Dexia, OJ 2010 L 274, 54, para. 126.

141 For instance, the Commission did not consider that recapitalizations of State-owned Caixa Geral de Depósitos carried out by the Portuguese State in 2008 and 2009 constituted State aid. By contrast ,the Commission considered that later recapitalizations carried out in 2012 did constitute State aid and required a restructuring plan- See Commission Decision SA.35062 (2012/NN), Recapitalization of CGD, July 18, 2012.

investor and take more time to consider the integrated transactions [considered] in further depth.[142]

In another case in 2012, the State-owned CGD received two simultaneous recapitalizations consisting of (i) the subscription of ordinary shares (under conditions similar to those of earlier recapitalizations, which had not been considered State aid) for €750 million and (ii) the subscription by Portugal to convertible contingent hybrid securities for an additional €900 million. The Commission considered that the subscription of the hybrid securities, which unquestionably constituted State aid, had (in the Commission's words) a *'polluting effect'* on the subscription of ordinary shares, which therefore also had to be considered as deviating from the MEIP and constituting State aid. [143]

Going forward, the entry into force of the BRRD may raise additional questions regarding implementation of the MEIP in cases of recapitalizations:

- First, to the extent the BRRD does not provide for any exemption to the bail-in principles for public/State shareholders,[144] could one consider that a recapitalization might be justified under the MEIP by the rational intention of the shareholder (and sometimes debt-holder or guarantor) State to escape bail-in? This would arguably require a counterfactual scenario where the State would demonstrate that its failure to recapitalize the bank would be less favourable to its economic interests as a shareholder, debt holder or even guarantor. In its decisions on the 2015 recapitalization of Piraeus Bank, the Commission left open the possibility to examine such a counterfactual scenario should the bank be recapitalized by the State (which was a majority shareholder), but ultimately found that the measures did not pass the MEIP test. In particular, the Commission noted that (i) the money put at risk via such recapitalization would be disproportionally large compared to the value of the existing stake; (ii) the existing stake was itself a consequence of previous State aid support; (iii) the bank was still relying heavily on liquidity support provided by the State, in particular State guarantees on its bonds; and (iv) during previous recapitalizations, no large private investor invested more than a limited amount in the capital of the bank.

Second, to the extent the BRRD (and the 2013 Communication) mention a number of voluntary capital measures (including, e.g. voluntary liability management exercises on subordinated debt, capital-generating sales of assets, further cost reduction measures), should it be considered for the purpose of the MEIP that a private investor would require such measures to be reviewed (and if possible, implemented) before agreeing to a recapitalization? Such reasoning might make State recapitalizations even more difficult going forward.

Determination of the aid amount. The determination of the amount of aid granted to a bank is important to assess the level of restructuring that might be required to address competition distortions, and in the few cases where the aid is found to be incompatible to calculate the amount to be recovered from the beneficiary. In the case of capital injections, the answer to this question is straightforward, since the Commission typically equates the

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142 Commission Decision of 5 April 2010, on the measures C 11/09 (ex NN 53b/08, NN 2/10 and N 19/10) implemented by the Dutch State for ABN AMRO Group NV, OJ [2011] L 333/1, para. 224.

143 Commission Decision of 18 July 2012 on the State aid implemented by Portugal for recapitalization of Caixa Geral de Depósitos, State aid Case SA.35062, para. 38.

144 See chapter 17 by François-Charles Laprévote and Amélie Champsaur.

amount of aid with the nominal value of the recapitalization, on the grounds that no private investor would have provided such funds to a firm in difficulty. A more difficult question is that of underwriting commitments (or "backstops") undertaken by the State in the context of public issues of shares, whereby the State has committed to take up any amount that would not be subscribed to by the market. The Commission has considered that such backstops constitute State aid, even if they are not materialized by a formal commitment letter and the market ends up subscribing to the entire issue, but has typically not provided a figure for the amount of State aid involved (which is arguably much lower than the amount involved in a straight recapitalization).[145]

***Non-notification issue and other procedural consequences*.** As explained above, some State recapitalizations measures were carried out before they were cleared (or even notified) and thus infringed the standstill obligation laid out in Article 108 TFEU. In practice, this infringement had limited practical impact as (i) the recapitalizations were *in fine* authorized by the Commission, sometimes after "temporary" clearances that were later turned into definitive authorizations following the presentation of a restructuring plan; (ii) in contrast with e.g. funding guarantees, the Commission clearance was not in practice a technical requirement to carry out the recapitalization; and (iii) very few complaints were lodged before national judges, which typically did not have to order the suspension of the aid and/or recovery of the interest for the duration of the violation of the standstill obligation. Nevertheless, such a situation was unsatisfactory and the 2013 Communication aims to ensure that no recapitalization or structural aid can be cleared before a restructuring plan has been presented to, and cleared by, the Commission. In practice, the BRRD might make such non-notified recapitalizations even more difficult (or less attractive for States), to the extent that they might lead to the bank's resolution and the bailing-in of shareholders (including the State) and debt holders.

***State remuneration*.** The general principles for the required remuneration for a recapitalization measure are set out in the Commission's Recapitalization Communication [146] together with the Second Prolongation Communication. As a general matter, the remuneration should be as close as possible to market prices. In practice, this implies an important margin of fluctuation essentially linked to the risk profile of the recipient bank and the terms of the capital acquired by the State. To take into account each case's specificities, the Commission has several tools at its disposal. As a general rule, the lower the risk associated with the form of capital, the lower the required remuneration. The benchmark rate for remuneration also differs depending on whether the recapitalization takes the form of capital instruments bearing a fixed or variable remuneration.[147] In cases where the recapitalization takes the form of a subscription of ordinary shares following a public issuance involving private investors, the Commission will typically be satisfied if the price paid by the State is the same as that paid by the private investors. [148]

When the State recapitalizes the bank on its own, the Commission applies a benchmark remuneration. Under the Recapitalization and Second Prolongation Communications, and in line with the Eurosystem recommendations, the Commission considers a minimum level of remuneration appropriate on the basis of a price corridor

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145 See e.g. Eurobank: Commission Descision SA.34825, HFSF Recapitalisation commitment to EFG Eurobank OJ 2014 L 357, 112; Commission Decision SA.43363, 2015 additional restructuring aid to Eurobank OJ 2016 C 142.

146 Recapitalization Communication, para. 28.

147 2008 Banking Communication, paras 28.

148 See e.g. Piraeus Bank 2015, Commission Decision SA.43364, Additional restructuring aid to Piraeus Bank OJ 2016 C 104, para 133.

defined by (i) the required rate of return on subordinated debt representing a *lower bound*, and (ii) the required rate of return on ordinary shares representing an *upper bound*. This methodology involves the calculation of a price corridor on the basis of different components, which should also reflect the specific features of individual institutions and of Member States. The application of the methodology by using average (mean or median) values of the relevant parameters (government bond yields, credit default swap spreads, equity risk premiums) determines a corridor with an average required rate of return of 7% on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9.3% on ordinary shares.[149] If the recapitalization takes place through the subscription of ordinary shares, it should be made at a discount to the share price that is equivalent to the above-mentioned remuneration.

***The new emphasis on preventative measures since the 2013 Banking Communication*.** While the initial Commission decisions and guidelines regarding recapitalizations were adopted on a rolling basis in reaction to the post-Lehman crisis, the 2013 Banking Communication aims at avoiding future crisis by imposing a set of preventative measures to financial institutions facing a capital shortfall, thus minimizing the need for costly future State recapitalizations. In this respect, the situation today is fundamentally different from that in the early days of the crisis: first, European banks are now subject to a much more developed set of EU-wide rules under the general umbrella of the Banking Union; [150] second, they are now much more capitalized than in 2008- according to the EBA, as of June 2016 EU banks had raised more than €260 billion since December 2010.[151]

The concept of a capital raising plan imposed by the 2013 Banking Communication is the main transposition of this precautionary approach. Point 32 of the 2013 Banking Communication states that as 'soon as a capital shortfall that is likely to result in a request for State aid has been identifies, all measures to minimize the cost of remedying that shortfall for the Member State should be implemented'. The State concerned is invited to enter into pre-notification contacts with the Commission through a capital raising plan implying both capital raising measures and burden-sharing measures from the bank's shareholders. [152] Such measures ensure that the capital shortfall that needs to be covered by State aid will be limited to the minimum. In addition, the 2013 Banking Communication underlines that a 'residual capital shortfall which needs to be covered by State aid requires the submission of a restructuring plan'.[153]

A key question is whether these preventative measures can credibly be imposed under the sole remit of State aid rules. Indeed, the Commission powers under Articles 107 and 108 TFEU are limited to assessing (and authorizing) State aid granted by States, not to prevent such aid being granted in the first place. Absent any State aid measure, the Commission does not have regulatory powers to enforce preventative measures. Even when a Member State envisages a State aid measure and the Commission clears such a measure, it does not have the power on its own to impose burden sharing or capital measures to the bank

149 2008 Banking Communication, paras. 27.

150 See chapter 16 by Stefano Micossi, Ginevra Bruzzone and Miriam Cassella as well as chapter 17 by François-Charles Laprévote and Amélie Champsaur.

151 EBA, '2016 EU-Wide Stress Test – Results', Press Release, 29 July 2016 <http://www.eba.europa.eu/documents/10180/1532819/2016-EU-wide-stress-test-Results.pdf> accessed 30 August 2016.

152 2013 Banking Communication, para. 29.

153 *Ibid,* para. 30.

or its shareholders – although the Commission may clear the aid subject to the implementation by the State of a number of burden sharing measures.

This issue is partially alleviated by the Bank Recovery and Resolution Directive (BRRD),[154] which provides a legal basis to impose in-depth *ex ante* restructuring and burden sharing measures. Under its Title IV, the BRRD provides national resolution authorities with important resolution tools, actions and powers for an institution that is failing or likely to fail.[155] One of the most convincing tools available to the resolution authorities is the bail-in of the shareholders of the bank, which ensures that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution.[156] But the implementation of these tools are in the hands of the resolution authorities, not the Commission, and the conditions for using such tools as laid down in the BRRD may differ from those envisaged in the 2013 Communication. Smooth cooperation between the Commission and the resolution (and supervisory) authorities will therefore be crucial to ensuring the proper implementation of any preventative measures before a recapitalization is carried out by the State.[157]

b) Impaired asset measures

i) Overview

Definition, modalities and statistical overview

Asset relief measures are government support measures aiming at "relieving" banks from assets that are broadly considered as "toxic" or "impaired". The notion of impaired assets evolved during the crisis from assets whose intrinsic value is perceived to lie significantly above their market value, possibly due to dysfunctional markets, to assets that incorporate relatively high expected losses, and even long-term assets without high expected losses ("good safe assets").

Asset relief measures come in various forms that can be broken down into two main categories: (i) asset purchases, whereby impaired assets are transferred from the balance sheet of a beneficiary to another entity, often a special purpose vehicle ("bad bank") owned or supported by the State and (ii) asset guarantees (risk shield or insurance) where the impaired assets remain on the balance sheet of the beneficiary but losses incurred from those assets are guaranteed by the State, which promises to pay the beneficiary bank an amount equivalent to future losses on certain assets owned by the beneficiary and identified under the guarantee.

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154 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ 2014 L173/190.

155 BRRD, Articles 31 and 32.

156 BRRD, para.67.

157 See chapter 17 by François-Charles Laprévote and Amélie Champsaur.

From 2008 to 2014, Member States provided asset relief measures amounting to a total of €188.5 billion. The main users of this tool were Germany (€80 billion), the UK (€40 billion), Spain (€32 billion) and Belgium (€21 billion). These figures only measure the amount of aid (i.e. the advantage) provided through the measures, and the value of the assets covered by these instruments was generally much greater.

Set out below is the total amount of impaired asset measures granted per Member State during the 2008-14 period.

Table 7. Total amount of impaired asset measures granted per Member State during the 2008-14 period

Member State	2008	2009	2010	2011	2012	2013	2014	Total, 2008-14
Belgium	0.0	7.7	0.0	0.0	9.4	4.7	0.0	**21.8**
Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Denmark	0.0	0.0	0.0	0.0	0.0	0.3	0.0	**0.3**
Denmark	0.0	0.0	0.0	0.0	0.0	0.3	0.0	**0.3**
Germany	9.8	24.8	45.0	0.0	0.4	0.0	0.0	**80.0**
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Ireland	0.0	0.0	2.6	0.0	0.0	0.0	0.0	**2.6**
Greece	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Spain	0.0	0.0	2.9	0.0	25.5	4.5	0.0	**32.9**
France	0.0	1.2	0.0	0.0	0.0	0.0	0.0	**1.2**
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Italy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Cyprus	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Latvia	0.0	0.0	0.4	0.0	0.0	0.0	0.0	**0.4**
Lithuania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Luxembourg	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Hungary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Netherlands	0.0	5.0	0.0	0.0	0.0	0.0	0.0	**5.0**
Austria	0.0	0.4	0.0	0.0	0.1	0.0	0.0	**0.5**
Poland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Portugal	0.0	0.0	3.1	0.0	0.0	0.0	0.0	**3.1**
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**

Slovenia	0.0	0.0	0.0	0.0	0.0	0.0	0.3	**0.3**
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Finland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Sweden	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
United Kingdom	0.0	40.4	0.0	0.0	0.0	0.0	0.0	**40.4**
Total	**9.8**	**79.5**	**54.0**	**0.0**	**35.4**	**9.5**	**0.3**	**188.5**
						% 2014 EU GDP		**1.4%**

Source: European Commission

Main objectives

With its Communication on Impaired Assets in 2009, the Commission started to actively encourage Member States to use impaired assets measures as a privileged tool for resolving the structural issues besetting the European banking sector. The Commission considered that these measures could be particularly useful to move toward better transparency on the balance sheets of EU banks, which in turn was crucial to stabilize financial markets, restore confidence and guarantee a gradual recovery of the economy. [158] The Commission's Communication drew on a number of previous experiences of the nineties including the liquidation of the Savings & Loans assets in the US, the handling of the 1992-1993 financial crisis in Sweden, the creation of a consolidation bank in the Czech Republic in 1991 to take up bad loans from Soviet times, and more *ad hoc* cases involving defeasance structures for individual banks such as Crédit Lyonnais (France), Sachsen LB (Germany) or Banco di Napoli (Italy). [159]

The main objectives pursued by impaired measures are the following:

Restore the viability of beneficiary banks and improve banks' solvency position and access to market funding. As underlined by the Commission's Impaired Assets Communication, [160] impaired assets measures are designed to 'address the issue of uncertainty regarding the quality of bank balance sheets and therefore help to revive confidence in the sector'. Although this objective is common with recapitalization measures, the latter address this issue by creating a capital buffer against future losses when impaired asset relief measures aim to protect the recipient banks against the risk of those losses occurring in the first place.

Ensure the flow of credit to the real economy and avoid "zombie-banks". The main purpose of impaired assets management is to remove the uncertainty over their asset valuations and the quality of their balance sheet. This uncertainty is indeed considered a

158 As explained by Joaquín Almunia, then Economic and Monetary Affairs Commissioner in IP/09/322, the Commission provides guidance for the treatment of impaired assets in the EU banking sector: 'We have taken, since last October, a series of measures that have stabilised financial markets, but the job will only be complete if companies and households continue to have access to credit, the lifeblood of economic activity. Dealing with impaired assets is crucial to achieve this, to restore confidence and to guarantee a gradual recovery of the economy.'

159 Impaired Asset Communication, Annex II.

160 *Ibid*., para. 7.

major cause of the limitation of the flow of credit to the real economy and weakens the effect of other government support measures. For instance, the Commission observed that bank recapitalizations had largely been absorbed by banks to cover future asset impairments rather than revive lending to the real economy. This uncertainty may give rise to so-called "zombie-banks", which are no longer in a position to lend to the economy because their liabilities exceed the real value of their assets and can only survive through public support. The counter-example was Japan's banking crisis in the 1990s – in the words of a Commission official 'lessons learned from the financial crisis in Japan were taken to heart: undercapitalized banks with unsound business models ("zombie banks") require appropriate restructuring because without it they could drag down growth for a very long period'. [161]

***Avoid negative feedback loops*.** By ensuring the flow of credit to the real economy, impaired asset measures also aim to avoid a possible feedback loop between the real economy and the financial sector, which gives rise to contagion and so-called "second round effects", whereby the slowing down of the real economy generated by a credit crunch worsens the quality of bank's balance sheets.

***Impact on government accounts*.** The impact of impaired assets measures on government accounts depends on the exact structure and instrument used. Generally, the rules regarding these measures have been tightened over time, so that more of them are now considered to impact public sector debt and / or deficits. Asset guarantees are generally considered as contingent liabilities, like funding guarantees, and therefore not taken into account in public debt or deficit. Asset purchases on the other hand are to be recorded as financial transactions for the true market price of the assets and a capital transfer (i.e. government expenditure) is to be recorded as the difference between the market price and the total amount paid (which is usually higher).[162] If the Member State chooses to establish an asset management company (AMC, or "bad bank") to purchase the assets, a key question is whether such an AMC (and its debt) should be consolidated within the government sector, which can potentially inflate government public debt. In its initial guidance issued in 2009 on the matter, Eurostat considered that majority privately-owned special purpose entities, which are established for a limited period and have as their sole purpose to address the crisis, are to be recorded outside the government sector even if they receive a government guarantee.[163] This allowed a number of structures (such as the French SFEF, the Belgian RPI or the Spanish SAREB) to escape consolidation in government accounts. By contrast, German defeasance structures set up to clean assets of West LB and HRE were considered to belong to the public sector, to the extent that (i) they were publicly owned and (ii) did not appear to have sufficient capital resources to bear the risks associated with the assets transferred – risks which were therefore borne by the government.[164] The new ESA 2010 rules published in 2013 and implemented from mid-2014 puts more emphasis on the degree of risk assumed by the AMC considering the degree of financial support of the government, including through

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161 Gert-Jan Koopman, 'Stability and Competition in EU Banking during the Financial Crisis: The Role of State Aid Control', CPI, Volume 7, Number 2, Fall 2011 <http://ec.europa.eu/competition/speeches/text/koopman_cpi_7_2_en.pdf> accessed 30 August 2016

162 ESA 95 Rules, para. 5.136 and ESA 2010 Rules, para. 20.246. In its 2009 Guidance Note, Eurostat suggested a number of methodologies (including independent valuations) for assessing the market price of the underlying assets.

163 Eurostat 2009 Guidance Note, 10.

164 See e.g. Eurostat letter of July 19,2010 on Erste Abwicklungsanstalt.

guarantees.[165] This approach could arguably result in classifying in the public sector structures that are majority privately-owned but benefit from significant State guarantees.[166]

ii) State aid control of impaired asset measures

The main legal texts

The Commissions assesses the compatibility of impaired assets measures on the basis of the Impaired Assets Communication, as supplemented by the First and Second Prolongation Communications and the 2013 Banking Communication.

The main applicable rules are the following:

- ***Appropriate identification of the bank's problems***. Applications for impaired asset measures should be subject to full disclosure of impairments on assets to be covered. This should be based on independent experts valuations validated by the relevant supervisory authority.[167]
- ***Risk-taking***. Impaired asset measures should include a clause of "first loss", to be borne by the bank (typically with a minimum of 10%) and a clause of "residual loss sharing", through which the bank participates to a percentage (typically with a minimum of 10%) of any additional losses.[168]
- ***Eligibility of assets***. Assets to be covered must be part of pre-defined categories or "baskets". Annex III of the Impaired Assets Communication contains suggestions for such baskets. Banks can also be relieved of impaired assets outside the initial scope of eligibility without a specific justification for a maximum of 10-20% of the overall assets of a given bank.[169] Assets cannot be considered eligible for relief measures where they have entered the balance sheet of the beneficiary bank after cut-off date for eligibility.[170]
- ***Transfer value***. The transfer value of the assets (i.e. their purchase price or insured value guaranteed by the State) should be based on their 'real economic value', which reflects their 'underlying long-term economic value […] on the basis of underlying cash flows and broader time horizons' and is to be assessed independently.[171]
- ***Remuneration of the State***. The State remuneration (which can take the form of a fee or a haircut on the purchase price/insured value) should be higher

165 ESA 2010 Rules 20.46 and MGDD chapter IV.5. See also2012 Eurostat guidance note, 'the impact of bank recapitalisations on government finance statistics during the financial crisis', 3.

166 See Gandrud and Halleberg 2014.

167 Impaired Assets Communication, para. 20.

168 *Ibid*., para. 24.

169 *Ibid*., para. 35.

170 *Ibid*., para. 36.

171 *Ibid*., paras. 40 and 41.

than that of a recapitalization that would have a similar impact on the bank's capital requirements.[172]

- ***Burden sharing***. Impaired asset measures are considered structural aid measures – like recapitalizations – and are therefore subject to the same *ex ante* conditions imposed by the 2013 Banking Communication (e.g. burden-sharing, behavioural commitments, restructuring plan as detailed above).

Implementation in leading cases

- Schemes

Prior to the 2013 Banking Communication, the Commission accepted and officially encouraged impaired assets programs but limited the enrolment window to six months from the launch of the scheme by the State. This aimed at limiting incentives for banks to delay necessary disclosures in the hope of higher levels of relief at a later date and facilitating a rapid resolution of the banking problems before the economic downturn further aggravated the banks' situation.[173] Only Ireland did made an extensive use of its asset relief scheme,[174] under which the National Asset Management Agency oversaw the purchase of around €83.5 billion of impaired assets from five major banks in Ireland.

Other countries that used impaired asset schemes include Germany[175] (with a guarantee of up to €80 billion), Austria,[176] Lithuania[177] and Spain (which set up SAREB, a majority private-owned company benefitting from State guarantees that took over €60 billion of assets from Spanish banks in 2012 and 2013).[178] The United Kingdom set up an asset guarantee scheme that was assessed under the general rules of the Temporary Framework rather than the Impaired Assets Communication because the underlying assets (portfolios of working capital loans to sound companies) could not be considered as "impaired". [179]

- Individual measures

In practice, impaired asset measures have often been implemented as individual measures for specific banks, generally in combination with other rescue measures such as recapitalizations and funding guarantees. Key cases include:

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172 *Ibid*., footnote 1 and Annex IV.

173 *Ibid*., para. 26.

174 Commission Decision of 26 February 2010 N725/2009, Irish impaired asset relief scheme (National Asset Management Agency) OJ 2010 C94.

175 Commission Decision N314/2009, German asset relief scheme OJ 2009 C 199.

176 Commission Decision N 557/2008, Austrian asset relief scheme OJ 2009 C 3.

177 Commission Decision N47/2010, Lithuanian Bank Recapitalisation and Asset Relief Scheme OJ 2010 C 283.

178 Commission Decision N28/2010, Spanish recapitalisation Scheme for credit institutions OJ 2010 C 57.

179 Case N111/2009, United Kingdom – Working Capital Guarantee Scheme, Commission Decision of 24 March 2009.

- With assets worth £282 billion, the Royal Bank of Scotland (RBS) formed an asset pool eligible for the UK Asset Protection Scheme (APS).[180] The APS is a guarantee by which the UK government commits to cover any loss in excess of a "first loss" that amounted to £60 billion for RBS. The participation implied an annual fee of £700 million from 2009-2011 and £500 million thereafter. The measure also included recapitalizations.
- In Germany, the *Landesbank Baden Württemberg* (LBBW) also benefited from individual impaired assets and recapitalization measures. The impaired asset measure was granted in the form of guarantees covering portfolios of €18.143 billion market value and €27-€29 real economic value. The bank bore a "first loss" amounting to €4.65 billion and paid a fee of €336 million a year. A restructuring plan was approved by the Commission,[181] requiring a clear focus on LBBW's regional core business as well as commitments with regard to the reduction of the balance sheet, governance, etc. Other German banks benefitting from impaired asset measures include West LB (risk shield and various asset transfers for an aid amount of more than €18 billion), Nord LB (guarantee scheme on a portfolio of €14.75 billion), Bayern LB (€6 billion risk shield) and HRE (transfer of assets resulting in total aid estimated at around €20 billion).
- In the *Dexia* case, Belgium and France provided a State indemnity against any losses related to impaired assets. The measure was deemed indispensable for the sale of the US subsidiary FSA which is a prerequisite for Dexia's return to viability. Dexia bore an initial loss of US$4.5 billion representing more than 25% of the total nominal value of the portfolio assets. The Member States were reimbursed in securities issued by Dexia.
- In 2012, the Commission approved Spanish measures for the restructuring of *BFA/Bankia*.[182] The measure amounted to €12 billion of State aid and consisted of the transfer of assets to Sareb, the State-owned AMC. The AMC's objective was the management and orderly divestment of those assets.

Key legal and practical issues

***Existence of aid*.** To determine whether an impaired asset measure contains aid, the Commission's Impaired Asset Communication directly refers to the MEIP and states that 'a guarantee is presumed to constitute State aid when the beneficiary bank cannot find any independent private operator on the market willing to provide a similar guarantee'.[183] This is typically the case when the assets' market value is lower than the price at which the assets are sold to (or guaranteed by) the State and/or the remuneration of the State for the

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180 Launched in 2009, the APS was initially open to all UK banks. Lloyds Banking Group had initially announced its intention to take part in the scheme but later withdrew in light of milder market conditions, leaving RBS as the sole participant to the scheme.

181 Commission Decision C17/09 by Germany for the restructuring of Landesbank Baden-Württemberg OJ 2010 L188/1.

182 Commission Decision SA.35253 Restructuring of BFA/Bankia OJ 2013 C77/1.

183 *Ibid*., para. 15, fn 2.

guarantee is lower than at market rate.[184] In practice, most of the impaired asset measures were found to constitute aid, since their very purpose is generally to offload a bank's balance sheets from assets that cannot be sold on the market without generating a fire sale that would imperil the bank's viability.

The Italian "securitization scheme" cleared by the Commission in February is an interesting exception. In this case, the Commission applied the MEIP and found that the intervention of the Italian State designed to assist Italian banks in moving non-performing loans off their balance sheets did not constitute State aid. [185] Under the scheme, an individually managed, private securitization vehicle was set up to buy non-performing loans from several banks. The vehicle was funded through junior notes (initially held by the participating banks), mezzanine notes (issued on the markets), and lower-risk senior notes (also issued on the markets, and benefitting from a State guarantee). An independent servicer was appointed to work out the underlying non-performing loans. The objective of this scheme was to attract a wide range of investors, incentivize banks to workout non-performing loans as quickly as possible, and improve their liquidity. The Commission considered that the risk taken by the State under the scheme was limited and remunerated under market terms for the following reasons:

- The State guarantee would only apply to the senior tranche. An ECB-approved independent rating agency would ensure that notes of the senior tranche would correspond to an investment-grade risk even before the State guarantee was taken into account.
- The risk distribution of the tranches and the set-up of the securitization entities would be tested and confirmed by the market before the State assumed any risk. Indeed, the State guarantee on the senior tranche would only become effective if at least more than half of the non-guaranteed and risk-bearing junior tranche had been successfully sold to private market participants. The transfer of the underlying loans' management to an independent servicer whose fees contain a high performance-related component would further increase the likely recovery and reduce the risk for the State.
- Finally, the State's remuneration for the risk taken was determined to be at market terms. The guarantee fee was based on a market benchmark (a basket of credit default swap prices of Italian-based companies) and included a step-up and a penalty component above a three-year tenor. This fee increase over time was considered as further incentive to increase the efficiency of the workout and likely recovery on the non-performing loans.

This Commission decision constitutes an interesting precedent, which arguably avoids the application of the burden sharing conditions imposed in the 2013 Communication and the BRRD. But the scheme is based on stringent conditions set out in commitments by the Italian authorities and monitored by an independent trustee. A key question is whether such a scheme will be sufficiently massive to address the issue of non-performing loans and sufficiently attractive for the private sector to participate, or whether more radical measures entailing State aid will be necessary to solve the issue of Italy's non-performing loans, which have been estimated to account for as much as €360 billion as of mid-2016.

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184 *Ibid.*, Section 5.3 and Annex IV.

185 Commission decision 10 February 2016, Italian securitization scheme OJ 2016 C161.

Amount of aid and calculation of the real economic value. The Commission considers that the amount of aid involved in an impaired asset scheme is the difference between the transfer value of the assets (which should typically be set at or below the real economic value for the Commission to find the aid necessary and proportionate) and their market value. The market value and real economic value must typically be determined by experts, who in practice are selected by the Commission and cross-check the valuations proposed by the Member States. [186] The use of independent experts and the correlative requirement to provide full transparency on the assets and their impairments are essential to address the asymmetry of information between the aid beneficiary and public authorities. [187] This also reflects the fact that *'*a private market investor will always try to have the most up to date information at hand before deciding whether to buy or guarantee an asset' and would therefore try 'to find out or calculate the value of the assets at that particular time'.[188] But in a number of cases, this has led to significant differences of valuation between the Commission's experts and the assessment made by Member States and their own experts.[189] Since the Commission has generally followed its own experts' assessments and rejected Member States' valuations, this raises the question of whether EU law offers proper ways to adjudicate such differences of appreciation, which might well be considered by EU Courts to remain within the scope of the Commission's discretion in assessing complex economic situations.

In some cases, the valuation of assets on the basis of their current market value may be difficult or even impossible. This is particularly the case when the market for such assets has mostly dried up or entirely disappeared, and where the market value of the assets may be as low as zero. In *WestLB*, where a risk shield was set up to transfer impaired assets from WestLB to a special purpose vehicle in the form of a guarantee, the Commission concluded that the assets were likely to be equal to the nominal value of that guarantee, i.e. €5 billion.[190] In *HSH Nordbank*, the Commission similarly considered that the aid element of the risk shield consisting of a second-loss guarantee amounting to €10 billion was equal to the nominal amount of the guarantee. The Commission acknowledged the difficulty of quantifying the market value of the shielded portfolio, given its significant size and its composition ([60-80]% of the assets covered were loans to customers). In the absence of a market, the market value may effectively be as low as zero for some assets. The Commission nonetheless considered that *'*in any case the market value of the shielded portfolio laid significantly below its real economic value (REV), which reflects the underlying long-term economic value of the assets'[191] – and thus refrained from determining the exact value of the aid amount involved.

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186 *Ibid*., para. 20(a).

187 *Ibid*, para. 19.

188 Commission Decision N 255/2009, Fortis OJ 2009 C178, para. 42.

189 See e.g. LBBW: Commission Decision C17/2009, Recapitalisation and asset relief for LBBW OJ 2010 L188 (German text) para 50 (difference of €1-2 billion); HRE Commission Decision C/2011/5157 paras 54-56 (difference of over €10 billion), West LB Commission Decision 2013/245/EU of 20 December 2011 para 44 (difference of €3.4 billion).

190 Commission Decision C 43/2008 West LB OJ 2009 L345, paras. 57-60.

191 Commission Decision Case SA 29338, HSH Nordbank OJ 2012 L 225, paras. 153-7.

4. Conclusion – the right toolkit?

Since the beginning of the crisis, EU Member States have used a wide range of tools to rescue their banks, ranging from short-term to longer-term solutions, often with very different consequences on banks and on public finances. The Commission, to its credit, has been able to accommodate this creativity by establishing specific requirements under EU State aid rules for each type of instrument while maintaining a single, generally consistent rulebook governing bank rescues. But this very diversity of approaches is also the result of an implicit collective choice, made early in the crisis, to let bank rescues take place primarily on a national basis, with limited European solidarity mechanisms between Member States and common (primarily State aid) rules to ensure a modicum of homogeneity. Eight years after the introduction of the (still ongoing) "Temporary Framework", the limits of this approach are manifest, as illustrated by the most recent stress tests conducted by the EBA in July 2016 and the market perception that the European banking system, despite having raised considerable amounts of capital since 2008, is far from having addressed all its difficulties – starting with the allegedly massive amount of non-performing loans in the Italian banking system. Another illustration is provided by the mixed results in the Commission's encouragements (since the Impaired Assets Communications of 2009) to use impaired asset measures as a way to clean up European banks balance sheets: between 2008 and 2014, these measures have accounted for "only" €188 billion of aid, twice less than the aid granted through recapitalizations and more than five times less than aid granted through funding guarantees. Indeed, while State aid control can be particularly efficient in limiting certain kinds of State interventions, the Commission does not formally enjoy powers under Articles 107 and 108 TFEU to encourage (and even less coerce) Member States into providing State aid in the first place. Going forward, the implementation of European (or euro-area) mechanisms (including the possibility for the ESM to directly rescue banks, the establishment of a proper European deposit guarantee system or even the setting up a European-wide asset management structure)[192] will be crucial to complementing the national toolkits authorized so far by the Commission under State aid rules and restoring confidence in the sector.

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[192] See Reza Mogadham, 'If Europe Is To Survive Brexit, It Must Fix Its Banks' *Financial Times* (6 July 2016) <http://www.ft.com/cms/s/0/9f1df952-4362-11e6-9b66-0712b3873ae1.html#axzz4Gxz6li5F> accessed 30 August 2016.