Research Handbook on State Aid in the Banking Sector

Chapter 7. Preserving cross-border banking in the face of the crisis: State aid policy under the financial trilemma

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In 2009, Dutch economist Dirk Schoenmaker coined the term "financial trilemma" to describe the fundamental choice facing policymakers grappling with the European Union's battered financial system.[1] The concept of the financial trilemma posits that any two of the policy objectives of financial stability, cross-border banking, and national sovereignty over financial policies can be achieved at the same time, but not all three. '[O]ne has to give.'[2] Given that financial stability is a prerequisite for both sustained economic growth and price stability,[3] this suggests that there can be only two economically desirable equilibria in the European Union: one fragmented financial system in which Member States retain full sovereignty over their financial policies, or an integrated one in which they relinquish control over them to a supranational authority.[4]

The premise is simple: absent a binding supranational coordination and decision-making mechanism, national governments always put the national interest first.[5] Assuming they are rational, national governments will save a failing bank only if the benefit of intervening exceeds the cost.[6] But, since they are accountable to their national parliaments only, national governments tend to focus solely on domestic costs and benefits, while ignoring the failing bank's foreign operations and cross-borders externalities in general.[7] This means that, in the case of highly integrated cross-border banks with significant foreign activities, the bank's home government – which in principle has the greatest interest in intervening – may not be prepared to bear the cost of rescuing the bank in its entirety. Since the governments of the other countries in which the bank has substantial operations will

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1 The concept draws on Robert Mundell's monetary trilemma (or impossible trinity), which contends that a fixed exchange rate, capital mobility and national monetary policy cannot be achieved together. See Robert Mundell, 'Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates' [1963] Canadian Journal of Economics 29, 475-85.

2 Dirk Schoenmaker, 'The Financial Trilemma' [2011] *Economics Letters* 111, 57-9 (Schoenmaker 2011).

3 See, e.g., Andrew Crockett, 'Why is Financial Stability a Goal of Public Policy', in Federal Reserve Bank of Kansas City, *Maintaining Financial Stability in a Global Economy* [1997]; and Hanna Freystätter, 'How Can We Simultaneously Maintain Both Price Stability and Financial Stability in the Euro Area?' [2015] Bank of Finland Bulletin 4/2015. See too Case C-526/14 *Kotnik and Others* [2016] ECR I-000, para. 50 (*Kotnik and Others* 2016); and Joined Cases C-8/15 P to C-10/15 P *Ledra Advertising and Others v Commission and European Central Bank* [2016] ECR I-000, para. 72.

4 See Shawn Donnelly, 'Power Politics and the Undersupply of Financial Stability in Europe' [2013] *Review of International Political Economy* 21(4).

5 See Dirk Schoenmaker, 'Firmer Foundations for a Stronger European Banking Union', Bruegel Working Paper 2015/13 (2015), 3 (Schoenmaker 2015).

6 Schoenmaker 2011, 57-9; and Schoenmaker 2015, 6.

7 Schoenmaker 2015, 6.

also focus on the domestic costs and benefits of intervention, they may not be ready to cover the shortfall. Faced with such a coordination failure, the governments in question will either break up the bank along national lines or let it fail, which, in turn, is liable to put financial stability at risk.

Yet, the combination of cross-border banking and national sovereignty over financial policies very much reflects the situation in which the European Union and its Member States found themselves on the eve of the financial crisis. Starting in the late 1980s, the EU banking sector experienced a material surge in cross-border financial activity under the impulse of a dual process of internationalization and multinationalization.[8] First, the global trends towards disintermediation and financial globalization, coupled with the introduction of the Single Banking License in 1989 and of the single currency ten years later, fueled a surge in cross-border lending across the European Union (internationalization). Second, the expansion of EU-based financial institutions across the Single Market in the 2000s took the financial integration process one step further by giving birth to highly integrated cross-border banks (multinationalization). Between 2003 and 2008, the number of branches and subsidiaries of banks from other EU Member States grew by 38%[9] and European banks embarked on high-profile cross-border mergers and acquisitions.

At the same time, financial policies remained firmly in the hands of Member States.[10] When the financial crisis struck, the EU banking system lacked both a comprehensive supranational regulatory framework and a proper resolution mechanism to tackle cross-border bank failures. Crisis management and resolution tools were exclusively national in scope, if they existed at all.[11] As former Bank of England Governor Mervyn King famously put it, large cross-border banks were 'global in life, but national in death'.[12]

When financial stability broke down following the collapse of Lehman Brothers in the fall of 2008, Member States were thus left to their own devices to stabilize their banking industries. State support to distressed banks, the Commission acknowledged, quickly reached 'unprecedented levels'.[13] In 2008 alone, 17 Member States together made available the equivalent of one quarter of the European Union's GDP in crisis aid to the financial sector.[14] By February 2015, 112 financial institutions had received a total of €1,959 billion in aid from 22 Member States.[15]

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8 Franklin Allen *et al.*, 'Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies' [2011] Centre for Economic Policy Research.

9 ECB, EU Banking Structures [2010]; and ECB, EU Banking Structures [2008].

10 *Ibid.*

11 Gert-Jan Koopman, 'State Aid Control in the Banking Union. The Role of EU State Aid Control During the Crisis and Going Forward', Presentation at the Institute for International and European Affairs (9 October 2013) (Koopman 2013), 5.

12 Mervyn King, Speech to British Bankers' Association (17 June 2009).

13 Commission Staff Working Paper, 'The Effects of Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis', 5 October 2011, Staff Working Paper 2011, 105.

14 Figures extracted from the Commission's 2015 State aid scoreboard <http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html> accessed 28 August 2016.

15 Guillaume Adamczyk and Bernhard Windisch, 'State Aid to European Banks: Returning to Viability' [2015] *Competition State Aid Brief* 1, 1. These figures exclude support granted under State aid schemes in amounts smaller than the thresholds above which a notification would have been required.

But while it lacked dedicated bank supervision and resolution powers to coordinate these unilaterally crafted initiatives, the Commission was empowered to assess them under EU State aid rules. As such, the Commission reviewed plans for the restructuring or orderly wind-down of no fewer than 79 banks between 2008 and December 2014. As Competition Commissioner Joaquin Almunia later explained, the Commission became the European Union's 'de facto a central crisis management and resolution authority'[16] in the process.

In this capacity, the Commission first and foremost sought to facilitate the return to financial stability. But the Commission in its discourse also placed considerable emphasis on the role of State aid control in preserving cross-border banking activity and thus preventing the fragmentation of the Single Market in financial services along national lines (Section 1). From a financial trilemma perspective, this implied that national sovereignty over financial policies would have to give. But while the Commission's crisis-time State aid policy provided a common framework for coordinating unilateral Member State interventions, both the limited scope of State aid rules and an often reactive approach to national rescue and (to a lesser extent) restructuring efforts meant that the scope, overall coherence, and effective contribution of the Commission's State aid decisions to market integration objectives varied from case to case. In effect, Member States retained a significant degree of control over their financial policies (Section 2). The persistence of national sovereignty over financial policies resulted in massive coordination failures, with the breakup of the European Union's most highly integrated cross-border banks along national lines (e.g., Fortis and Dexia) and the difficult stabilization of financial institutions engulfed in the sovereign-bank loop (Section 3), which paved the way for a more comprehensive response to the financial trilemma in the form of the Banking Union (Section 4).

1. Combining financial stability and cross-border banking within the framework of EU State aid rules

When Member States took unprecedented action to stabilize their banking systems in the wake of the Lehman Brothers bankruptcy, then-Competition Commissioner Neelie Kroes emphasized that EU State aid control would not get in the way. Financial stability would be the overriding goal of the Commission's crisis-time State aid policy (Section a). But the Commission was not prepared to give Member States a free hand in devising their responses to the crisis. Rather, the Commission took the view that, without solid State aid enforcement, uncoordinated national interventions would ultimately jeopardize the progress towards greater cross-border banking activity (Section b).[17]

a) The overriding goal of financial stability

As early as October 6, 2008, Commissioner Kroes explained to the European Parliament's Economic and Monetary Affairs Committee that the Commission had done and was

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16 Joaquin Almunia, 'Competition among Financial Market Operators', Speech at the ECMI Annual Conference (13 October 2013). See too Johannes Laitenberger, 'From Bail Out to Bail In: Laying Foundations for a Restructured Banking Sector in Europe', Presentation at Universidade Católica Portuguesa (25 January 2016).

17 Neelie Kroes, 'Dealing with the Current Financial Crisis', Address to the European Parliament's Economic and Monetary Affairs Committee (6 October 2008) (SPEECH/08/498).

‘continuing to do everything it c[ould] to help stabilise European banks’.[18] The Commission, she emphasized, was ‘acting to approve rescue measures for banks [under State aid rules] very quickly, in order to protect financial stability and avoid spill-over effects on the rest of the economy’.[19] The Commission’s October 13, 2008 Crisis Communication echoed this concern:

> Given the scale of the crisis, now also endangering fundamentally sound banks, the high degree of integration and interdependence of European financial markets, and the drastic repercussions of the potential failure of a systemically relevant financial institution further exacerbating the crisis, the Commission recognizes that Member States may consider it necessary to adopt appropriate measures to safeguard the stability of the financial system.[20]

In December 2008, as the crisis intensified and calls to temporarily suspend the State aid rules gathered pace,[21] Commissioner Kroes maintained that State aid control was ‘part of the solution’ and reaffirmed DG COMP’s commitment to financial stability.[22] The Directorate’s ‘guiding principle’, she stressed, was to ensure ‘that whenever State aid is used, it is really to serve financial stability and not to distort competition’.[23]

In the weeks and months that followed, the Commission stayed the course even as the crisis showed little sign of abating. In 2009, in its Restructuring Communication, the Commission described financial stability as ‘the overriding goal’ of State aid policy in a time of crisis.[24] The same year, Deputy Director General for State aid Policy Herbert Ungerer

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18 *Ibid.*

19 *Ibid.*

20 Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270/8 (First Banking Communication), para. 4.

21 When asked whether State aid rules should be suspended, Henri Guaino, advisor to then-President of France Nicolas Sarkozy, said: ‘*A situation exceptionnelle, règles exceptionnelles. C’est du bon sens*’. See Ivan Best and Philippe Mabille, ‘*Henri Guaino : C’est le moment, puisqu’il faut investir, investissons*’, *La Tribune* (1 December 2008). See too Ilona Wissenbach, ‘EU Squabbles Over Bank Aid and Recession Response’, *Reuters* (2 December 2008), quoting Sweden’s then-finance minister Anders Borg: ‘we have to call off these legions of state aid bureaucrats’. For Commissioner Kroes’s reaction, see ‘The Role of State Aid in Tackling the Financial and Economic Crisis’, Introductory remarks at press conference (8 December 2008) (SPEECH/08/683): ‘Some negative publicity was made last week, which I found unfair. The Commission is not an army of bureaucrats trying to annoy Member States.’

22 Neelie Kroes, ‘EU State Aid Rules – Part of the Solution’, Speech at EStALI conference (5 December 2008) (SPEECH/08/679).

23 Neelie Kroes, ‘The Role of State Aid in Tackling the Financial and Economic Crisis’, Introductory remarks at press conference (8 December 2008) (SPEECH/08/683).

24 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), para. 2. See too Herbert Ungerer, ‘Economic Crisis and State Aid Perspectives – Application of EU State Aid Rules in Times of Financial and Economic Crisis’, Speech at the Conference of the Romanian Competition Council (24 February 2009).

conceded that the Commission 'clearly ha[d] to give primacy to the reestablishment of financial stability'.[25]

The Commission's steady focus on financial stability was rooted in the specificity of the banking sector.[26] Not only do banks play a key role in financing, and transmitting monetary policy to, the real economy, they are also characteristically susceptible to systemic risk. Banks take and pool short-term funds (which can be withdrawn at par on demand) and lend them to economic operators on a long-term basis. In other words, banks 'borrow short and lend long'.[27] This maturity mismatch implies that a sudden surge in withdrawals may force banks to liquidate their assets at a substantial discount to honor their obligations towards creditors who have decided to prematurely withdraw their funds. But the proceeds of such a fire sale are typically insufficient for the bank to meet its obligations so that creditors who have not yet withdrawn their funds lose all or part of their capital. This means that, if enough creditors expect other creditors to prematurely withdraw their funds, then all creditors have an incentive to be the first in line to do so. As the process progresses, it generates its own momentum in a form of self-fulfilling prophecy: the more creditors withdraw their funds, the likelier the bank is to default, which in turn encourages further withdrawals.

Given that banks often invest in the same assets (common asset exposure) or lend to, and borrow from, one another (direct linkages), the failure of one bank will inflict losses on its creditor banks. Where the flailing bank is systemically important, its failure – or even the mere anticipation thereof – is liable to trigger a system-wide domino effect, as depositors lose confidence in the financial system and withdraw their funds from the creditor banks as well. The risk of contagion is particularly acute in banking systems characterized by high levels of cross-border integration, as a bank failure in one Member State is liable to wipe out a sizeable chunk of cross-border liabilities, thereby putting capital and banking assets in another Member State at risk.[28] This implies that, unlike that of an ordinary firm, the failure of a systemically relevant bank may also justify rescue and restructuring aid from a purely economic point of view.

b) The risk of market fragmentation

Yet the Commission was not ready to give Member States a free hand. Even before the financial crisis, the Commission had repeatedly pointed to the European banking sector's persistent fragmentation and to the numerous remaining barriers to cross-border banking, particularly in retail. In a January 2007 report, for example, the Commission's staff concluded that 'the retail banking sector in the European Union remain[ed] largely

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25 Herbert Ungerer, 'An EU Perspective on National Intervention and State Aid in the Current Financial and Economic Crisis', Address at Kreab Gavin Anderson Roundtable (3 June 2009).

26 Koopman 2013, 4.

27 John Vickers, 'The Financial Crisis and Competition Policy: Some Economics' [2008] *Global Competition Policy*, 5.

28 See Hans Degryse *et al.*, 'Cross-border Exposures and Financial Contagion' [2010] *International Review of Finance* 10, 209-40. See too *Kotnik and Others* 2016, para. 50: 'the banks are often interconnected and certain of their number operate internationally. That is why the failure of one or more banks is liable to spread rapidly to other banks, either in the Member State concerned or in other Member States'; and Joined Cases C-8/15 P to C-10/15 P *Ledra Advertising and Others v Commission and European Central Bank* [2016] ECR I-000, para. 72.

fragmented along national lines and [that] integration [wa]s far from complete'.[29] As the Commission had found in a number of merger control decisions, differences in competitive conditions across Member States meant that markets for retail banking and certain related activities remained national in scope.[30]

Against this background, the Commission recognized in its discourse early on in the crisis that without solid State aid enforcement, unilateral Member State initiatives to stabilize the banking system could jeopardize the progress made towards greater market integration in the area of financial services. This concern was a key reason for the Commission to refrain from turning the review of rescue and restructuring aid to distressed banks into a pure 'rubber-stamping exercise'.[31] After all, the purpose of State aid law has always been to 'prevent trade between Member States from being affected by benefits granted by the public authorities which, in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of certain goods'.[32]

These considerations permeated the Commission's discourse from an early stage. In October 2008, Commissioner Kroes warned that 'the European economy would descend into chaos' if the Commission were to cease pursuing a 'solid competition policy'.[33] Without common State aid rules, she explained, 'we are lost in a wilderness; a jungle without a level playing field'.[34] The Commission's October 2008 Framework for Action echoed this view and urged Member States to 'avoid a fragmentation of the Internal Market and to maintain a level playing field among beneficiaries and non-beneficiaries of public sector assistance'.[35]

In early December 2008 Commissioner Kroes ratcheted up the rhetoric and claimed that maintaining State aid discipline was nothing short of paramount to preventing 'the disintegration of the single market in financial services'.[36] Shortly thereafter, in 2009, the Commission's Impaired Assets Communication warned of a 'drift towards financial protectionism and fragmentation of the internal market',[37] while the Restructuring

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[29] Report on the retail banking sector inquiry, Commission staff working document SEC(2007) 106 accompanying the Communication from the Commission – Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report) [COM(2007) 33 final], 13.

[30] See, e.g., Case COMP/M.3894 – Unicredito/HBV, Commission Decision of 18 October 2005, para. 41; Case IV/M.873 – Bank Austria/Creditanstalt, Commission Decision of 11 March 1997, para. 23; Case COMP/M.2125 – Hypo Vereinsbank/Bank Austria, Commission Decision of 14 November 2000, para. 17.

[31] Neelie Kroes, 'EU State Aid Rules – Part of the Solution', Speech at EStALI conference (5 December 2008) (SPEECH/08/679).

[32] Case C-310/85 *Deufil v Commission* [1987] ECR 901, para. 8.

[33] Neelie Kroes, 'In Defence of Competition Policy', Opening remarks at the conference titled 'Competition Policy, Growth and Consumer Purchasing Power', 13 October 2008 (SPEECH/08/521).

[34] European Parliament Economic and Monetary Affairs Committee, 'Kroes: State Aid Rules "Part of the Solution" to Banking Crisis' (6 October 2008).

[35] Commission Communication, 'From Financial Crisis to Recovery: A European Framework for Action' (COM(2008)0706).

[36] Neelie Kroes, 'EU State Aid Rules – Part of the Solution', Speech at EStALI conference (5 December 2008) (SPEECH/08/679). See too Neelie Kroes, 'The Role of State Aid in Tackling the Financial and Economic Crisis', Introductory remarks at press conference (8 December 2008) (SPEECH/08/683).

[37] Commission Communication on the Treatment of Impaired Assets in the Community Banking Sector [2009] OJ C72/01 (Impaired Assets Communication), para. 16.

Communication cautioned against short-term initiatives to safeguard systemic stability that could 'result in longer-term damage to the level playing field and competitive markets'.[38]

The risks identified by the Commission stemmed from the fragmented nature of the European Union's financial regulatory landscape, which was characterized by the lack of an EU-wide bail-out mechanism or resolution authority.[39] If they existed at all, crisis management and resolution tools were national. And those tools that existed displayed significant differences across Member States. This raised the possibility that Member States would engage in uncoordinated efforts to rescue ailing banks, providing support at uneven levels or on different terms.[40] Such interventions would, the Commission feared, 'by their very nature, tend to promote focus on the national markets and hence seriously risk leading to retrenchment behind national borders and to a fragmentation of the single market'.[41] This in turn would risk creating entry barriers and disincentives to cross-border activity and investment while shifting the burden of structural adjustment to other Member States.[42]

In practice, the threat was threefold. First, Member States could be tempted to outright 'protect national champions and interests under the umbrella of supports and rescues of systemic relevance for the financial system'.[43]

Second, Member States risked encouraging beneficiaries to gear their restructuring efforts towards preserving their competitive position in their home markets.[44] On the one hand, this may have reflected the incentives of national regulators and governments, who care first and foremost about domestic depositors, borrowers, owners and, ultimately, taxpayers. On the other hand, rather than a true national bias, it may simply have reflected the fact that financial institutions often have a stronger and more established presence in their home markets than in other Member States. Under those circumstances, their long-term viability arguably may command that they refocus on their home markets.

Third, if left unchecked, unilateral national interventions could have triggered wasteful and distortive subsidy races between Member States.[45] As Commissioner Kroes put

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38 Restructuring Communication, para. 29.

39 See, e.g., Koopman 2013, 4.

40 *Ibid.*

41 Restructuring Communication, para. 29. See too Herbert Ungerer, 'An EU Perspective on National Intervention and State Aid in the Current Financial and Economic Crisis', Address at Kreab Gavin Anderson Roundtable (3 June 2009); and Herbert Ungerer, 'State Aid 2008/2009 – 12 Months of Crisis Management and Reforms', Keynote address at the 7th Experts' Forum on New Developments in European State Aid Law (14 May 2009).

42 Restructuring Communication, para. 29; and Commission, 'State Aid: Commission Presents Guidelines on Restructuring Aid to Banks – Frequently Asked Questions' (23 July 2009) (MEMO/09/350). See too Andrea Bomhoff *et al.*, 'Restructuring Banks in Crisis – Overview of Applicable State Aid Rules' [2009] *Competition Policy Newsletter* (Bomhoff 2009), 5.

43 OECD Secretariat, Competition and Financial Markets: Background Note [2009], 30. See, too, Philip Lowe, '*La justice face à la crise*', Speech at the Paris Court of Appeal (7 December 2009).

44 See Christian Ahlborn and Daniel Piccinin, 'The Great Recession and Other Mishaps: the Commission's Policy of Restructuring Aid in a Time of Crisis', in Erika Szyszczak (ed) *Research Handbook of State Aid Law* [2011]), 150-51.

45 See, e.g., Neelie Kroes, 'In Defence of Competition Policy', Opening remarks at conference on 'Competition Policy, Growth and Consumer Purchasing Power' (13 October 2008) (SPEECH/08/521); Joaquin Almunia, 'Competition, State Aid and Subsidies in the European Union', Address at the 9th Global Forum on Competition (18 February 2010) (SPEECH/10/29). See too Herbert Ungerer, 'Economic Crisis and State Aid

it, uncoordinated action to either defend national champions or attract/retain depositors to prevent a run on domestic banks could ultimately have escalated into a spiral of retaliatory action,[46] with 'governments […] stealing the bread from each other's table, instead of creating ways to bake new bread'.[47]

This risk materialized following the collapse of Lehman Brothers in the fall of 2008, when several Member States rushed to implement State guarantee and deposit insurance schemes to stave off runs on their domestic banks.[48] The example of Ireland's blanket guarantee on the debts of six privately-owned banks provides a vivid illustration: the comparatively high level of protection afforded by the Irish authorities triggered a deposit run to Ireland, which if left unchecked could have left banks in neighboring Member States short of liquidity within days, thus forcing these Member States to outbid Ireland to save their own banks.[49]

But the Commission's concerns were by no means confined to guarantee schemes. In late 2008, the Commission identified a similar risk with regard to recapitalization measures, fearing that excessively generous capital injections 'in one Member State could also prompt a subsidy race among Member States'.[50] Likewise, in 2009, the Commission voiced the concern that the introduction of asset relief measures 'by a first-mover Member State [could result] in pressure on other Member States to follow suit'.[51]

2. Coordinating national interventions within the framework of EU State aid rules

In the absence of an EU-wide bank supervision and resolution system, State aid rules provided a comprehensive – and arguably the only – common framework to coordinate national responses to the crisis. To borrow from Commissioner Kroes, State aid rules formed a 'baseline against which national interventions to stave off the financial crisis can be judged, a sound floor on which all national governments can stand, knowing that all the others are standing there with them.'[52] Applying the EU-wide standards of State aid law to otherwise disparate national interventions would 'bring a European angle to issues that Member States naturally view form their national perspective only' and thus provided:

Perspectives – Application of EU State Aid Rules in Times of Financial and Economic Crisis', Speech at the Conference of the Romanian Competition Council (24 February 2009).

46 Neelie Kroes, 'The Role of State Aid in Tackling the Financial and Economic Crisis', Introductory remarks at press conference (8 December 2008) (SPEECH/08/683).

47 Neelie Kroes, 'In Defence of Competition Policy', Opening remarks at conference on 'Competition Policy, Growth and Consumer Purchasing Power' (13 October 2008) (SPEECH/08/521).

48 Commission submission to the OECD's roundtable on 'Competition and Financial Markets' [2009], 241.

49 See, e.g., 2011 Staff Working Paper, 24; and Joaquin Almunia, 'The Impact of the Crisis State Aid Regime for Banks' (4 October 2011) (SPEECH/11/632).

50 Commission Communication on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2 (Recapitalization Communication), para. 8.

51 Impaired Assets Communication, para. 13. See too Philip Lowe, '*La justice face à la crise*', Speech at the Paris Court of Appeal (7 December 2009).

52 Neelie Kroes, 'The State Aid Action Plan: A Roadmap for Reform and Recovery', Speech at the conference on 'The New Approach to State Aids - Recent Reforms under the State Aid Action Plan and Next Steps' (21 November 2008) (SPEECH/08/634).

> […] the ideal framework for ensuring effective coordination of Member States policies to counter the financial crisis and to tackle the recession. By applying the EU's state aid policy and working together with Member States we will ensure that by solving one problem we do not create new problems – that one Member States' problems are not exported to other Member States provoking a downward spiral of retaliatory measures […] [State aid rules] give national governments the freedom to take aim at the root causes of the crisis, but stop them from shooting themselves in the foot, or their neighbours in the back.[53]

Against this background, EU State aid rules served as a basis for developing an *ex ante* coordination framework to guide Member States in designing crisis aid measures (Section a). Within this framework, the Commission sought to give Member States the leeway they needed to restore financial stability (Section b). At the same time, the Commission endeavored to limit the detrimental effects of the Member States' rescue efforts on the integrity of the Single Market in financial services by both systematically enforcing the fundamental State aid principles of non-discrimination, necessity, and proportionality and routinely conditioning crisis aid on more or less far-reaching 'competition measures' (Section c).

a) Laying the foundations of an **ex ante** *coordination framework for crisis aid*

On 7 October 2008, the ECOFIN Council stated that 'public intervention ha[d] to be decided on at national level but within a coordinated framework and on the basis of a number of EU common principles'.[54] On that occasion, the Commission offered to issue guidance to Member States and financial institutions on the assessment of State aid to distressed banks under Article 107(3)(b) TFEU. Less than a week later, on October 13, the Commission followed through on its promise and issued a Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the crisis.[55] In the months and years that followed, the Commission issued six further communications to ensure the coherence of Member State interventions.[56]

In the absence of a dedicated EU-wide regulatory framework, Commissioner Almunia later explained, the rules articulated in these Crisis Communications quickly came to be seen as 'the best instrument in [the Commission's] hands – and in some cases the only

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53 *Ibid.* See too Commission, 'State Aid: Recapitalization of Spanish Banks – the Commission's Role under EU State Aid Control' (28 November 2012) (MEMO/12/918).

54 Council of the European Union, 'Immediate Responses to Financial Turmoil. Council Conclusions – Ecofin Council of October 7, 2008', 2.

55 2008 Banking Communication.

56 Recapitalization Communication; Impaired Assets Communication; Restructuring Communication; Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis; Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis; and 2013 Banking Communication.

one – to manage and coordinate the rescue and restructuring operations of Europe's banks from an EU perspective'.[57]

The Crisis Communications provided detailed guidance on each of the three successive steps generally involved in solving a financial crisis,[58] leaving only relatively little to the discretion of individual Member States:

- Step 1 requires stopping or preventing bank runs. The Commission addressed this in its October 2008 Banking Communication, which set forth key principles for guarantee schemes and emergency liquidity assistance at a time when Member States did 'not always fully take into account the effects their measures had on financial markets in other Member States'.[59]
- Step 2 concerns the recapitalization of distressed financial institutions, which the Commission addressed briefly in its October 2008 Banking Communication and in greater detail in its December 2008 Recapitalization Communication. The Recapitalization Communication aimed to provide 'a coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalization' at a time when 'the nature, scope and conditions of recapitalisation schemes […] being envisaged var[ied] considerably'.[60]

  Step 3 involves restructuring distressed banks and cleaning up their balance sheets by relieving them of their toxic assets and underperforming loans. The Commission addressed both issues in 2009. In March, the Commission adopted the Impaired Assets Communication to articulate a 'common and coordinated Community approach to the identification of the assets eligible for relief measures' and 'to ensure the effectiveness of asset relief measures in the single market as far as possible'.[61] Notably, the Impaired Assets Communication foresaw that several Member States might engage in coordinated action to provide asset relief to cross-border banks.[62]

  In August of the same year, the Commission adopted the Restructuring Communication, which was designed to complement the Commission's earlier communications 'with a view to enhancing predictability and ensuring a coherent approach, by explaining how the Commission w[ould] assess' restructuring aid under Article 107(3)(b) TFEU.[63]

Although these communications were not legally binding on Member States,[64] they were difficult for them to ignore. While Member States in principle remained free to argue

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57 Joaquin Almunia, 'Restructuring EU Banks: The Role of State Aid Control', Speech at CEPS lunchtime meeting (24 February 2012) (SPEECH/12/122).

58 See Jürgen Föcking *et al.*, 'Competition and the Financial Markets: The Role of Competition Policy in Financial Sector Rescue and Restructuring' [2009] *Competition Policy Newsletter* (1), 8.

59 *Ibid.*

60 Recapitalization Communication, paras. 3 and 8.

61 Impaired Assets Communication, paras. 18 and 33.

62 *Ibid.*, para. 17.

63 Restructuring Communication, para. 4.

64 See *Kotnik and Others* 2016, para. 45; and Opinion of AG Wahl in *Kotnik and Others* 2016, paras. 38-9.

that aid measures that did not comply with the principles set out in the Crisis Communications were nonetheless compatible with the internal market under Article 107(3)(b), there was little scope for them to do so in practice. As Advocate General Wahl acknowledged in his opinion in *Kotnik*:

> […] it may often not be easy for a Member State to convince the Commission that, because of the particular features of a case, one of the basic principles laid down in the Banking Communication […] should not apply. It is likely that, because of the more complex legal analysis required by the Commission (the case does not fall within one of the situations examined a priori in the communication), the examination of the compatibility of the planned aid may become more uncertain as to its outcome and more time-consuming, possibly leading to the opening of a formal investigation procedure under Article 108(2) TFEU.[65]

Given that the standstill clause of Article 108(3) TFEU prohibits Member States from implementing State aid prior to the Commission's approval, engaging in such a protracted procedure may cause significant delays. In a financial crisis context, where time is often of the essence, Member States might be disinclined to take that risk.

b) Giving Member States the freedom to stabilize their banking systems

Rescuing and restructuring failing credit institutions entailed affording Member States far greater leeway to rescue and restructure struggling banks aid than did the generally applicable 2004 Rescue and Restructuring Guidelines (R&R Guidelines).[66] Conversely, the Commission had to 'approve all necessary measures taken by Member States to safeguard the stability of the financial system, including rescue measures and recapitalisation schemes'.[67] To that effect, the Commission relied on the exceptional legal basis of Article 107(3)(b) TFEU, which provides for the authorization of aid to remedy a serious disturbance in the economy.[68] The table below summarizes the main differences between the 2004 R&R Guidelines and the Commission's Article 107(3)(b) regime.[69]

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65 Opinion of AG Wahl in *Kotnik and Others* 2016, para. 42.

66 See, e.g., Koopman 2013, 4; and Carl Baudenbacher and Frank Bremer, 'European State Aid and Merger Control in the Financial Crisis – From Negative to Positive Integration' [2010] *JECLAP* 1(4) (Baudenbacher 2010). For a contrary view, see Ulrich Soltesz and Christian von Köckritz, 'From State Aid Control to the Regulation of the European Banking System – DG COMP and the Restructuring of Banks' [2010] European Competition Journal.

67 Commission Communication 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, para. 22.

68 Before the risk of a systemic crisis materialized with the collapse of Lehman Brothers, the Commission consistently reviewed State aid to struggling banks under the stringent conditions of the R&R Guidelines. In the process, the Commission repeatedly rejected calls to apply Article 107(3)(b). See Commission Decision in Case NN70/07 - Northern Rock, 5 December 2007; Commission Decision in Case NN25/08 - Rescue Aid to WestLB, 30 April 2008; and Commission Decision in Case C9/08 - SachsenLB, 4 June 2008.

69 For a more detailed overview, see Baudenbacher 2010.

Table 1. Overview of the differences between the R&R Guidelines and the Article 107(3)(b) TFEU regime

Conditions and Restrictions	R&R Guidelines	Article 107(3)(b) TFEU regime
Reversibility	Rescue aid is 'by nature temporary and reversible assistance'.	Rescue aid may be of a structural nature (e.g., asset relief, capital injections).
'One time, last time' principle	A firm may receive rescue or restructuring aid only once in ten years.	The 'one time, last time' principle does not apply.
Aid schemes	Rescue and restructuring schemes are limited to SMEs.	Access to rescue and restructuring schemes may be granted to financial institutions of all size.
Duration of guarantees	Rescue guarantees must come to an end no more than six months after the disbursement of the first installment to the beneficiary.	Rescue guarantee schemes may cover a period of up to two years.
Duration of restructuring periods	Two to three years.	Up to five years.

c) Aligning national interventions with market integration objectives

At the same time, the Commission sought to ensure that national interventions to stabilize the banking sector did not undermine the integrity of the single market in financial services. To align national interventions with market integration objectives (among other public policy goals), the Commission required that crisis aid comply with fundamental State aid principles (Section i). This translated into a practice of conditioning crisis aid on more or less-far reaching commitments (Section ii).

i) Maintaining fundamental State aid principles

Any State aid to distressed banks had to comply with the fundamental State aid principles of non-discrimination on the one hand and proportionality and necessity on the other hand. This, the Commission explained in its 2008 Banking Communication, was 'necessary for the preservation of the proper functioning of the internal market'.[70]

Non-discrimination

[70] First Banking Communication, para. 16.

From an early stage, the principle of non-discrimination featured prominently in the Commission's crisis-time State aid policy. On 13 October 2008, the Commission emphasized that aid to ailing banks should 'not give rise to disproportionate distortions of competition, for example by discriminating against financial institutions based in other Member States'.[71] The 2008 Banking Communication accordingly required Member States to ensure that the eligibility criteria of financial institutions for coverage by a guarantee scheme be objective and non-discriminatory.[72] This meant that all institutions incorporated in the Member State concerned and with significant activities there (including subsidiaries or branches) had to be eligible.

The Commission's commitment to non-discrimination was immediately put to the test, as certain Member States sought to implement aid schemes that one senior Commission official later deemed 'blatantly discriminatory'.[73] For example, the Irish government's guarantee scheme was initially limited to deposits, covered bonds, senior debt, and dated subordinated debt issued by six privately-owned Irish banks and specific subsidiaries that would have to be approved by the government.[74] The Commission quickly voiced concerns that the plan discriminated against foreign banks operating in Ireland.[75] At the Commission's insistence, the Irish authorities eventually agreed to open the scheme to 'foreign subsidiaries as well as to branches of systemic significance'.[76]

By contrast, the Commission found that the Danish guarantee scheme would not 'involve any unduly adverse spill-over effects on other Member States or undue distortions of competition' because it was 'not limited to purely Danish companies and therefore [was] open and non-discriminatory'.[77] The Commission came to the same conclusion concerning the Spanish State guarantee scheme, which was open to all solvent registered credit institutions with a minimum share of 0.1% of the credit market.[78]

Proportionality and necessity

The Commission also insisted that crisis aid comply with the principles of proportionality and necessity.[79] State aid to distressed banks had to be:

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71 Commission Press Release, State Aid: Commission Gives Guidance to Member States on Measures for Banks in Crisis, IP/08/1495, 13 October 2008.

72 First Banking Communication, paras. 18 and 35.

73 Herbert Ungerer, 'State Aid 2008/2009 – 12 Months of Crisis Management and Reforms', Keynote address at the 7th Experts' Forum on New Developments in European State Aid Law (14 May 2009).

74 Commission Decision on State Aid NN48/2008 – Guarantee Scheme for Banks in Ireland, 13 October 2008, para. 5.

75 See, e.g., Commission, 'State Aid: Commissioner Kroes Meets Ireland's Finance Minister Brian Lenihan to Discuss Bank Guarantees' (6 October 2008) (MEMO/08/606).

76 Commission Decision on State Aid NN48/2008 – Guarantee Scheme for Banks in Ireland, 13 October 2008, para. 16.

77 Commission Decision on State Aid NN51/2008 – Guarantee Scheme for Banks in Denmark, 8 October 2008, para. 24.

78 Commission Decision on State aid NN54/B/2008 – Corrigendum to the Guarantee Scheme for Credit Institutions in Spain, 23 December 2008, paras. 10-11.

79 See, e.g., 2011 Staff Working Paper, 47.

- **Well-targeted** to effectively further the objective of remedying a serious disturbance in the economy, in particular by contributing to restoring financial stability.[80] The Commission's Crisis Communications identified the types of measures that were appropriate for these purposes.
- **Limited to the minimum necessary** in both time and amount to achieve that objective. In particular, the Commission sought to ensure that all crisis aid was both temporary, subject to reasonable and pre-defined budgetary limits (either in total or by beneficiary), and adequately remunerated.
- Designed in such a way as to **minimize negative spill-over effects** on competitors, other sectors and other Member States.

According to Commissioner Kroes, this was meant to prevent 'beggar-thy-neighbour national responses by ensuring that aid does not give recipients a disproportionate advantage, putting them in an artificially privileged position in relation to their competitors'.[81] In practice, and most importantly for market integration purposes, this translated into a requirement that sufficient safeguards be attached to rescue and restructuring aid.[82]

ii) Competition measures

In keeping with its practice under the R&R Guidelines, the Commission conditioned the approval of crisis aid on measures that minimized distortions of competition. DG COMP officials emphasized that, in doing so, the Commission paid greater 'attention to overall national market structures and market opening measures, to avoid that the large number of simultaneous restructuring cases close[d] down national market structures, and to preserve cross border activities of banks'.[83] In the Restructuring Communication, the Commission professed that it would place significant weight on market integration concerns in assessing restructuring plans under the Restructuring Communication[84] and would thus take a positive view of measures that allowed 'markets to remain open and contestable'.[85] Accordingly, structural remedies, behavioral commitments, and market-opening government measures soon would be used as the 'preeminent coordination tool' of the Commission's crisis-time State aid policy,[86] although the Commission's essentially reactive approach to the Member States' remedy proposals meant that their scope, coherence, and effective contribution to market integration objectives varied from case to case.

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80 *Ibid.*

81 Neelie Kroes, 'Preserving the Competitiveness of European Industry – the Contribution of State Aid Policy', Speech at The Centre (28 October 2008) (SPEECH/08/563).

82 See 2011 Staff Working Paper, 47.

83 Bomhoff 2009, 5.

84 Restructuring Communication, para. 6: 'The integrity of the internal market and the development of banks throughout the Community must be a key consideration in the application of those principles; fragmentation and market partitioning should be avoided'.

85 *Ibid.*, para. 33.

86 Damien Gerard, 'Managing the Financial Crisis in Europe: The Role of EU State Aid Law Enforcement', in Massimo Merola *et al.* (eds), *Competition Law at Times of Economic Crisis - In Need for Adjustment?* (Bruylant 2013) (Merola *et al*. 2013).

Structural measures

From the onset of the crisis, structural commitments such as the divestiture of subsidiaries, branches, portfolios of customers, or business units featured as the Commission's preferred remedy to tackle distortions of competition from crisis aid.[87] In the initial (pre-Lehman) stages, though, the Commission may not always have rigorously considered the impact of divestitures on cross-border banking. The risk that distressed financial institutions would simply dispose of their foreign branches and subsidiaries and retrench to their home markets seemed to go largely unnoticed in a number of early cases. For example, the original *WestLB* decision (somewhat counter-intuitively) found that aid measures in favor of WestLB would not have any undue spill-over effects on other Member States, since 'in the context of its strategic reorientation,' the bank would 'refocus on its home market […] and […] reduce its international activities'.[88]

With the publication of the Restructuring Communication in 2009, market integration concerns took a more important position in the Commission's discourse on structural commitments. Not only did the Restructuring Communication claim that the Commission would not normally require banks to dispose of their foreign operations,[89] it also suggested that divestitures would be viewed favorably if they facilitated 'the entry of competitors and cross-border activity'.[90]

At the most basic level, this simply meant that divestitures had to be carried out through an objective and non-discriminatory competitive sales process.[91] But in the presence of national banking markets with significant entry barriers or high levels of concentrations, the Commission took the view that market-opening divestitures might be necessary.[92] In practice, though, the number of cases in which the Commission obtained from banks the commitment that they divest standalone units on their home markets remained quite limited. More often than not, the Commission held that the reduction in the total size of the bank (coupled, in some cases, with behavioral commitments) was both necessary and sufficient to address competition issues, the existence of which was often presumed rather than demonstrated as would be the case in, for instance, merger control proceedings. The required divestitures often concerned foreign subsidiaries or "non-core activities", reflecting the Commission's focus on the bank's future viability or burden-sharing rather than a concern for the preservation or the development of the single market.[93] As a

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[87] Restructuring Communication, para. 35. See too 2011 Staff Working Paper, 96: 'Overall, structural divestment of stand-alone entities that allow for new entry of credible competitors in concentrated submarkets, whilst taking care that financial institutions would not unduly retrench from other EU markets, has been the Commission's favoured remedy to tackling distortions of competition'.

[88] Commission Decision on State aid NN25/2008 – WestLB riskshield, 30 April 2008, para. 56.

[89] Commission, 'State Aid: Commission Presents Guidelines on Restructuring Aid to Banks – Frequently Asked Questions' (23 July 2009) (MEMO/09/350).

[90] Restructuring Communication, para. 35.

[91] *Ibid.*, paras. 18 and 35. See too 2013 Banking Communication, para. 80(a).

[92] Restructuring Communication, para. 32: 'especially [in areas] involving national markets with high entry barriers, divestments may be needed to enable entry or expansion of competitors'.

[93] For a critical assessment, see Christian Ahlborn and Daniel Piccinin, 'The Application of the Principles of Restructuring Aid to Banks during the Financial Crisis' [2010] *European State Aid Law Quarterly*; François-Charles Laprévote, 'Banks and State Aid Control in the EU: Four Years (and More?) of Temporary Framework' [2012]

result, according to commentators, some of these measures might actually have contributed to reversing the trend towards increased cross-border banking activity and to fragmenting the EU's banking and debt markets: 'Eurozone banks have cut cross-border holdings of government and corporate bonds to such an extent they have wiped out all the progress towards the integration of the bloc's debt markets achieved after the euro's launch.'[94]

But even the few cases (e.g., *Lloyds*, *RBS*, *ING*) in which the Member State concerned actually proposed (sometimes at the Commission's request) the divestiture of standalone commercial and retail banking units in the beneficiaries' home markets show that market-opening divestitures are no silver bullet for tackling market integration concerns. The *Lloyds* case[95] is illustrative. In January 2009, the United Kingdom injected £17 billion in capital into the bank to facilitate the takeover of its failing competitor HBOS. The Commission conditioned the capital injection on the divestiture of UK retail banking activities comprising some 600 branches. According to the Commission, the carve-out represented an attractive target for new entrants or smaller competitors wishing to expand their presence in the country[96] and thus provided 'an appropriate means of increasing competition in the concentrated UK retail banking market'.[97] In addition, the Commission imposed a 14% market share ceiling on potential acquirers to ensure new entry rather than a takeover by one of Lloyds's large existing competitors.[98]

Implementing the divestitures in a financial and economic crisis context proved far more difficult than anticipated. Lloyds initially planned to sell the divestment business to British financial institution Co-operative Group. But Co-operative Group broke off the talks in April 2013, citing the lackluster economic outlook and increasing regulatory constraints on financial service providers. Several months later, Lloyds established the carved-out retail business as a standalone entity named TSB. The business was to be floated on the stock exchange and sold to the public in 2014. When that proved impossible, the United Kingdom notified the Commission of amendments to Lloyds's 2009 restructuring plan. On 13 May 2014, the Commission approved both an extension in the timeline for carrying out the divestiture and a reduction in the scope of the divestment business on the grounds that they did not alter the balance of the original restructuring package.[99] Lloyds eventually sold TBS to Spain's Banco Sabadell in July 2015.

Behavioral measures

Competition Policy International; and François-Charles Laprévote, 'Judicial Review (States, Beneficiary & Third Parties)', in Merola *et al*. 2013.

94 Ralph Atkins and Keith Fray, 'Eurozone Banks Cut Cross-border Debt Holdings', *Financial Times* (10 June 2013) <https://www.ft.com/content/33429faa-cec4-11e2-8e16-00144feab7de> accessed 25 September 2016.

95 Commission Decision on State Aid N428/2009 – Restructuring of Lloyds Banking Group, 18 November 2009.

96 *Ibid.*, para. 78.

97 *Ibid.*, para. 188.

98 *Ibid.*, paras. 105 and 190.

99 Commission Decision on State Aid SA.29834 (2014/N-2) – United Kingdom Amendment to the Restructuring Plan of Lloyds Banking Group, 13 May 2014.

From an early stage,[100] the Commission complemented structural remedies with behavioral commitments.[101] From a market integration perspective, these could serve two purposes, namely (i) to prevent beneficiaries from using State aid to close off markets in which they operate; and (ii) to open up markets with high entry barriers or concentration levels.

Restrictions on aggressive commercial behavior are typically designed to prevent aid beneficiaries from using public funds to gain an undue competitive advantage over their actual or potential competitors that do not enjoy similar State support.[102] As such, they can help prevent beneficiaries from erecting barriers to entry:

- First, behavioral remedies may limit the scope for entry deterrence strategies whereby beneficiary banks misuse aid to impede or prevent new (cross-border) entry.[103] For example, price leadership bans may limit the scope for beneficiaries to engage in below-cost pricing to build a predatory reputation with a view to deterring future entry.
- Second, behavioral commitments such as acquisition or expansion bans may help preserve incentives for (cross-border) entry by giving comfort to potential competitors that domestic aid beneficiaries will not be able to misuse State funds to artificially increase their market shares and deprive new entrants of the fruits of their investment.

The Commission's decisions involving Dutch banks illustrate both the rationale and drawbacks of this approach. In *ABN Amro*, the Commission subjected restructuring aid to the Netherlands' third largest bank to a set of behavioral commitments, which included price leadership and acquisition bans. These were designed to ensure that the beneficiary would not use State funds to grow at the expense of non-beneficiary banks in the Dutch mortgage market.[104] But for these commitments, the Commission found, the aid 'would weaken the incentives of non-beneficiaries to compete, invest and innovate and could undermine incentives for cross-border activities by discouraging entry in the Dutch market.'[105]

Around the same period, the Commission imposed price leadership bans on two of ABN Amro's main competitors in the Dutch mortgage market, namely ING[106] and AEGON.[107] Price leadership bans thus came to cover 80% of the market. This largely removed competitive pressure from Rabobank, the only major Dutch mortgage provider that had not

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100 See, e.g., Commission Decision on State aid NN49/2008, NN50/2008 and NN45/2008 – Guarantees to Dexia, 19 November 2008, para. 73; and Commission Decision on State aid N574/2008 - Guarantees to Fortis Bank, 19 November 2008, para. 58.

101 For a critique, see Thomas Jaeger, 'Merging Antitrust and Regulation into State Aid? Crisis Lessons in Competition Law Coherence' [2010] *European State Aid Law Quarterly*, 577-80.

102 Restructuring Communication, para. 39.

103 See generally Steven Salop, 'Strategic Entry Deterrence' [1979] *American Economic Review*, 335-338.

104 Commission Decision on State aid C11/2009 (ex NN53b/2008, NN2/2010 and N19/2010) implemented by the Dutch State for ABN Amro Group NV, Brussels, 5 April 2011, paras. 324-9.

105 *Ibid.*, para. 321.

106 Commission Decision on State aid SA.28855 (ex N373/2009, ex C10/2009, ex N528/2008) – Amendment to the Restructuring Plan of ING, 29 August 2012, paras. 206-207; and Commission Decision on State aid SA.33305 (2012/C) and SA.29832 (2012/C) implemented by the Netherlands for ING, 16 November 2012, Annex I(d).

107 Commission Decision on State aid N372/2009 - Restructuring Aid to AEGON, 17 August 2010, para. 120.

received any State support. Interest rate levels subsequently came to exceed those in surrounding Member States. Standard economic theory suggests that this would attract new (cross-border) entrants, which in turn would drive interest rates down again. But the difficulties with financing mortgages during the crisis effectively reduced the scope for new entry[108] and market concentration in the hands of domestic banks significantly increased as a result.[109] One may wonder whether price leadership bans had similar inadvertent consequences in Belgium, where at one point three of the four main retail operators (Dexia, KBC, and BNP Paribas Fortis) were subject to pricing restrictions.[110]

Behavioral market-opening measures – in contrast to restrictions on aggressive commercial conduct – are designed not to prevent the erection of new entry barriers, but to dismantle already existing ones. For instance, following the collapse of its banking industry, Ireland chose to rebuild the sector on two pillar banks, Bank of Ireland and Allied Irish Bank. As the main foreign banks present in Ireland prior to the crisis (KBC and Rabobank) had significantly reduced their activities there or exited the market altogether (Lloyds), this would, in the words of Commissioner Almunia, have created 'a de facto duopoly in the Irish market'.[111]

To mitigate the plan's potentially detrimental effects on competition and market integration, the Commission conditioned its approval of Bank of Ireland's first restructuring plan in 2010[112] and of Allied Irish Bank's restructuring plan in 2014[113] on the implementation of a package of market-opening behavioral commitments aimed at facilitating new entry and expansion in Ireland's banking market. In Commissioner Almunia's words, the ultimate goal was to ensure that a 'competitive fringe of new entrants can take advantage of the improved economic environment when demand picks up again'.[114]

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108 See Nederlandse Mededingingsautoriteit, '*Sectorstudie Hypotheekmarkt: Een onderzoek naar de concurrentieomstandigheden op de Nederlandse Hypotheekmarkt*' (May 2011), 64.

109 See IMF, 'The Netherlands: Financial Sector Assessment, Preliminary Conclusions by the Staff of the International Monetary Fund' (14 December 2010), point 8; and Mark Dijkstra *et al.*, 'High Mortgage Rates in the Low Countries: What Happened in the Spring of 2009?' [2014] *Journal of Competition Law and Economics*. An econometric study carried out by the former Dutch Competition Authority (NMA) identified a statistically significant relationship between the increase in mortgage interest margins and the price leadership bans. Yet the NMA concluded that this relationship was not a causal one because margins had begun to increase before the Commission imposed the price leadership bans. See Nederlandse Mededingingsautoriteit, '*Sectorstudie Hypotheekmarkt: Een onderzoek naar de concurrentieomstandigheden op de Nederlandse Hypotheekmarkt*' (May 2011). For a cogent critique of the NMA's reasoning, see Jochem de Kok, 'Competition Policy in the Framework and Application of State Aid in the Banking Sector' [2015] *European State Aid Law Quarterly*, 224-240.

110 See Chapter 12 on Belgium by Jean-Sébastien Duprey. Interestingly, the fourth operator was ING, which was subject to a similar ban in its home market in the Netherlands.

111 Joaquin Almunia, 'Beyond the Banking Crisis: Another Chapter in Ireland's History of Resilience' (17 June 2011) (SPEECH/11/451).

112 Commission Decision on State aid N546/2008 – Restructuring of Bank of Ireland, 15 July 2010 (First Restructuring of Bank of Ireland).

113 Commission Decision on State aid SA.29786 (ex N633/2009), SA.33296 (2011/N), SA.31891 (ex N553/2010), N241/2009, N160/2010 and C25/2010 (ex N212/2010) implemented by Ireland for the restructuring of Allied Irish Banks plc and EBS Building Society (Allied Irish Bank), 7 May 2014.

114 Joaquin Almunia, 'Beyond the Banking Crisis: Another Chapter in Ireland's History of Resilience' (17 June 2011) (SPEECH/11/451). See too State aid SA.33443 (2011/N) – Second Restructuring of Bank of Ireland, 20 December 2011 (Second Restructuring of Bank of Ireland), para. 196.

The market-opening remedies fell into two categories. First, the Irish authorities committed that Bank of Ireland and Allied Irish Bank would provide certain competitors with a services package at cost and on FRAND terms.[115] The package included access to various services such as clearing systems, debit card access to ATM networks, the provision of market intelligence, cash supply and distribution services, or foreign exchange supply and distribution services.[116]

Second, Ireland committed to implementing a customer mobility package. This required Bank of Ireland and Allied Irish Bank to contact their customers on behalf of eligible competitors to present them with alternatives offers for various services such as personal and business current accounts, personal and business credit cards, or mortgages and SME and corporate loans.[117] Bank of Ireland and Allied Irish Bank were to refrain from impeding customers from switching and even from contacting customers for a period of six months after they received marketing information from one of their rivals. This period was to be extended to one year for customers who actually decided to switch to a competitor.

Government measures

For exceptional cases involving closed off or vulnerable banking markets, the Restructuring Communication also foresaw the possibility of going beyond behavioral and structural commitments and directly requiring Member States 'to promote more sound and competitive markets, for instance by favoring entry and exit'.[118] Arguably the most far-reaching measures were imposed in the context of Bank of Ireland's two restructurings.

In Bank of Ireland's first restructuring, Ireland committed to enact reforms to enhance competition in the Irish banking sector by facilitating new entry and the expansion of smaller players. These measures fell into three categories:

- First, Ireland promised to ease customer switching and increase consumer protection. Notably, Ireland committed to ban financial product bundling, unless they were demonstrably advantageous to consumers.[119]
- Second, Ireland vowed to lift restrictions on online banking to mitigate the entry barriers associated with building and maintaining a network of brick-and-mortar branches. This required electronic communications to be placed on the same footing as hard copy paper communications, and credit agreements to be allowed to be signed electronically.[120]
- Third, Ireland committed to improving corporate governance in the financial sector, for example with the introduction of a prohibition on new and

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115 First Restructuring of Bank of Ireland, para. 139; and Allied Irish Bank, paras. 127-8, and point 11.4 of the annex.

116 First Restructuring of Bank of Ireland, para. 138; and Allied Irish Bank, para. 128.

117 First Restructuring of Bank of Ireland, paras. 140-4; and Allied Irish Bank, paras. 127 and 129, and point 11.5 of the annex.

118 Restructuring Communication, para. 45. See too 2011 Staff Working Paper, 64.

119 First Restructuring of Bank of Ireland, para. 263 and point a.1) of annex II.

120 *Ibid.*, para. 269 and point b.1) of annex II.

existing interlocking directorships between competing financial institutions.[121]

When Bank of Ireland required a second bail-out in 2011, the Commission conditioned its approval on even more far-reaching State measures than the previous year. These measures, the Commission explained, 'reaffirm[ed] and complement[ed] the measures committed in the first restructuring plan aimed at restoring the competition and enhancing consumer protection in the Irish financial sector'.[122] In particular, Ireland proposed to (i) facilitate customer mobility even further by increasing the transparency and comparability of costs,[123] (ii) establish a statutory credit risk register to lower the risk associated with new entry,[124] and (iii) further promote electronic banking to allow smaller banks and new entrants to better compete with large financial institutions.[125] The Commission also welcomed the government's plans to restore the Irish Competition Authority's powers to review mergers in the financial sector.[126]

Overall, though, the Commission used market-opening government measures only very sparingly,[127] which officials attributed to the difficulty of targeting general legislative reforms to remedy the undue benefit obtained by individual aid beneficiaries.[128]

3. Dexia, Fortis, and the sovereign-bank loop: accommodating national policies at the expense of cross-border banking?

Despite the inherent limitations of a policy based primarily on coordination and *ad hoc* cooperation between Member States, it was only the massive coordination failures that occurred in cases involving either large cross-border banks that required several multi-State solutions (e.g., Dexia, Fortis) (Section a) or credit institutions caught in the sovereign-bank loop (Section b) that definitively exposed the shortcomings of the Commission's approach.

a) Coordination failures in rescuing highly integrated cross-border banks

Market integration proved particularly difficult to preserve when it came to coordinating Member States' efforts to rescue and restructure highly integrated cross-border banks such

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121 *Ibid.*, para. 275 and point c) of annex II.

122 Second Restructuring of Bank of Ireland, para. 195.

123 *Ibid.*, paras. 196-202.

124 *Ibid.*, paras. 208-10.

125 *Ibid.*, paras. 89, 204-6.

126 *Ibid.*, para. 212.

127 Further examples include the *Dexia* case, in which France committed to ensure that local authorities would develop their competitive procurement practices when procuring funds, while Belgium vowed to monitor contract award notices relating to the financing of local public authorities. See Commission Decision on State aid C9/2009 (ex NN45/2008, NN49/2008 and NN50/2008) implemented by the Kingdom of Belgium, the French Republic and the Grand Duchy of Luxembourg for Dexia SA, 26 February 2010, paras. 85 and 86.

128 Nicola Pesaresi and Geoffrey Hamadi, 'An Overview of Competition Measures in State Aid Banking Cases during the Financial Crisis', Presentation at GCLC Lunch Talk (27 June 2011).

as Dexia (Section i) and Fortis (Section ii). Both banks operated in three core markets. As Commissioner Kroes explained, they therefore ‘required three-state solutions: cross-border solutions for cross-border banks’.[129] But, despite early efforts to coordinate national rescue and restructuring efforts, market conditions and diverging incentives eventually led the Member States involved to break up both banks along national lines.

i) The *Dexia* case

Dexia was a financial services group created by the 1996 merger of two institutions specialized in public finance lending, namely Crédit Local de France and Crédit Communal de Belgique, which also owned a majority stake in Banque Internationale à Luxembourg. In the decade before the crisis, Dexia had significantly expanded outside its core markets of Belgium, France and Luxembourg, with the creation or acquisition of public finance lending entities in Germany, Italy, Spain, the United Kingdom and the United States. By 2008, the bank’s total assets (€651 billion) had more than doubled compared to 2000 (€258 billion), making it one of Europe’s largest financial institutions.

To fund its growth strategy, Dexia heavily relied on low-cost short-term wholesale funding. When interbank markets dried up following the fall of Lehman Brothers, Dexia faced a significant short-term liquidity shortage. To make matters worse, Dexia suffered from (i) impairments on a large portfolio of structured credit assets held or insured by its US monoline subsidiary FSA and (ii) material losses caused by the equity market crash and its exposure to struggling banking and sovereign counterparties.

The rapid deterioration in Dexia’s fortunes prompted Belgium, France and Luxembourg to jointly implement a three-pronged rescue package starting in late September 2008. First, the three Member States publicly announced the implementation of a joint €6.4 billion capital increase, of which €3 billion was subscribed by the bank’s private shareholders. Second, the three governments jointly provided funding guarantees (of up to €150 billion), while Belgium and France guaranteed a $12.5 billion sub-portfolio of structured credit assets held by FSA. Third, Belgium’s central bank provided emergency liquidity assistance to Dexia in cooperation with the French central bank.

On 19 November 2008, the Commission issued a decision approving the joint rescue package,[130] which Commissioner Kroes touted as a ‘swift, coordinated action [that] saw off the immediate threat’.[131] There is reason to believe that the Member States’ coordinated approach weighed positively on the Commission’s compatibility assessment. In determining the applicability of Article 107(3)(b) TFEU, the Commission recalled that the aid must aim to remedy a serious disturbance affecting the economy of a Member State as a whole. In applying this test to the aid granted by Belgium, the Commission found that Dexia’s bankruptcy could have wreaked havoc on the Belgian economy, paralyzing all activities which were dependent on local authorities and creating a crisis of confidence among Belgian households vis-à-vis the banking sector as a whole. This in turn could have resulted

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129 Neelie Kroes, ‘EU State Aid Rules – Part of the Solution’, Speech at EStALI conference (5 December 2008) (SPEECH/08/679).

130 Commission Decision on State aid NN49/2008, NN50/2008 and NN45/2008 – Guarantees to Dexia, 19 November 2008.

131 Neelie Kroes, ‘The Role of State Aid in Tackling the Financial and Economic Crisis’, Introductory remarks at press conference (8 December 2008) (SPEECH/08/683).

in a run on other Belgian banks and would have cut them off from the interbank market, thus threatening to drive them into bankruptcy, too.

By contrast, the Commission dispensed with an assessment of whether the aid was necessary to remedy a serious disturbance in the economies of France and Luxembourg. Instead, the Commission took the view that the aid measures implemented by France and Luxembourg were also apt to remedy a serious disturbance in the Belgian economy. Indeed, France's aid measure was aimed at the same legal entity as Belgium's, while Luxembourg intervened in coordination with Belgium and France with a view to saving Dexia as a whole and not just its Luxembourg subsidiary.

But the subsequent discussions between France and Belgium concerning the bank's restructuring plan highlighted the limits of *ad hoc* coordination. As a Belgian parliamentary report later showed, the two countries were unable to agree on the right formula for splitting the group into a bad and a good bank. This reflected the two Member States' diverging incentives, as Belgium sought to preserve the soundness of one of its largest retail banks and to secure financial stability, while France, where Dexia's retail banking activities were much more limited, aimed to preserve a key actor in local authorities and hospitals funding. As a result, the restructuring package that was eventually approved by the Commission on 26 February 2010 did not foresee the creation of a bad bank at all.[132] Instead, the plan required Dexia to (i) reduce its balance sheet size by one third and re-focus on its core banking activities in its core markets of Belgium, France and Luxembourg; (ii) reduce its public finance lending activities outside these markets and its bond portfolio; and (iii) cease proprietary trading. Commissioner Almunia commented that the plan would 'lead Dexia to refocus on its core activities and restore its long-term viability, in particular thanks to more stable financial resources'.[133]

Yet the imbalance in Dexia's financing sources soon deteriorated as a result of the growing sovereign debt crisis and the bank fell behind with the implementation of the restructuring plan. Under those circumstances, achieving a coordinated outcome became an increasingly distant prospect and the three Member States effectively broke up the bank along national lines. On October 7, 2011, Belgium informed the Commission of plans to nationalize Dexia Banque Belgique (DBB, subsequently rebranded Belfius). On October 17, the Commission approved the measure pending the submission of a new restructuring plan, and opened an in-depth investigation into the matter.[134]

On the following day, Belgium, France and Luxembourg informed the Commission of a series of measures to complement the nationalization of DBB. In particular, the three Member States proposed to extend a €45 billion guarantee on the refinancing of holding company Dexia SA and its French subsidiary Dexia Crédit Local to enable the bank to draw up a restructuring plan, or – should Dexia SA prove not to be viable – a liquidation plan. On 21 December 2011, the Commission temporarily approved the measure for financial

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[132] Commission Decision on State aid C9/2009 (ex NN45/2008, NN49/2008 and NN50/2008) implemented by Belgium, France and Luxembourg in favour of Dexia SA, 26 February 2010. See too Yassine Boudghene *et al.*, 'The Dexia Restructuring Decision' [2010] *Competition Policy Newsletter*.

[133] Commission Press Release, State Aid: Commission Approves Restructuring Plan for Dexia', IP/10/201, 26 February 2010.

[134] Commission Decision on State aid SA.33751 (2011/C ex 2011/N) – Acquisition of Dexia Bank Belgium by the Belgian State, 17 October 2011.

stability reasons.[135] In April 2012, France, Belgium and Luxembourg notified the Commission of a jointly drawn up resolution plan. On 31 May and 6 June, to facilitate the finalization of the resolution plan, the Commission temporarily approved a prolongation and a €10 billion increase in the €45 billion guarantee, respectively.[136]

On 28 December, the Commission authorized the resolution plan, along with a refinancing guarantee of €85 billion and a recapitalization of €5.5 billion for Dexia SA and its French subsidiary Dexia Crédit Local.[137] The resolution plan included the sale of several of the group's entities and businesses of the group and the winding down of the residual group. In particular, the Belgian business's nationalization was coupled with the creation of a new development bank in France, in which the French government and two French public entities would participate.

In parallel, the Commission assessed the sale of Dexia's Luxembourg subsidiary to a consortium composed of Qatar-based Precision Capital (90%) and the Luxembourg government (10%).[138] The Commission found that the transaction was free of State aid because Luxembourg participated on the same terms as Precision Capital. Commissioner Almunia commented that the sale 'set the path for an independent development of the Luxembourgish part of the group'.[139]

ii) The *Fortis* case

Much like Dexia, Fortis underwent a process of renationalization during the financial crisis. Fortis was a financial conglomerate organized around a complex binational holding structure consisting of a Belgian and a Dutch parent. Its activities focused on retail banking, financial services, and asset management in Belgium, Luxembourg and the Netherlands. In June 2008, the bank had a balance sheet of €974 billion and ranked among the European Union's 20 largest banks by revenue, not least due to its acquisition of the Dutch activities of ABN Amro the previous year in a joint consortium with the United Kingdom's RBS and Spain's Santander.[140]

The acquisition's vast financing plan proved difficult to implement at a time when the subprime mortgage crisis had begun to destabilize financial markets. Fortis found it impossible to issue the securities and carry out the securitization operations that were key

135 Commission Decision on State aid SA.33760 (2011/C ex 2011/N), SA.33763 (2011/C ex 2011/N), and SA.33764 (2011/C ex 2011/N) – Additional Measures to Restructuring of Dexia, 21 December 2011.

136 Commission Decision on State aid SA.33760 (2012/N-2), (2011/C) (ex 2011/N), SA.33763 (2012/N-2), (2011/C) (ex 2011/N), SA.33764 (2012/N-2), (2011/C) (ex 2011/N) – Additional Measures to Restructuring of Dexia, 31 May 2012; and Commission Decision on State aid SA.34925 (2012/C) (ex 2012/N) SA.34927 (2012/C) (ex 2012/N), SA.34928 (2012/C) (ex 2012/N) – Increase of Guarantee Ceiling, 6 June 2012.

137 Commission Decision on State aid SA.33760 (2012/N-2, 2011/C, 2011/N); SA.33763 (2012/N-2, 2011/C, 2011/N); SA.33764 (2012 N-2, 2011/C, 2011/N); SA.30521 (MC 2/2010); SA.26653 (C9/2009); SA.34925 (2012 N-2, 2012/C, 2012/N); SA. 34927 (2012 N-2, 2012/C, 2012/N); SA. 34928 (2012 N-2, 2012/C, 2012/N) implemented by Belgium, France, and Luxembourg in favour of Dexia, DBB/Belfius, and DMA, 28 December 2012.

138 Commission Decision on State aid SA.34440 (2012/C) implemented by Luxembourg concerning the sale of Dexia BIL, 25 July 2012.

139 Commission Press Release, State Aid: Commission Finds Sale of Dexia BIL Contains no State Aid, IP/12/840, 25 July 2012.

140 Case COMP/M.4844 – Fortis/ABN Amro, Commission Decision of 3 October 2007.

to raising the funds needed to pay the purchase price. At the same time, Fortis's €41.7 billion structured credit portfolio was subject to successive asset impairments, whilst delays in completing the sale of one of the group's asset management subsidiaries resulted in a further €2.1 billion shortfall. In response, the group announced a series of measures to strengthen its solvency plan. But this only resulted in a loss of investor confidence.

When interbank markets dried up in the wake of the Lehman Brothers bankruptcy, Belgium, Luxembourg and the Netherlands had to jointly intervene to keep the bank afloat. Yet a conflict that had arisen between Belgian and Dutch banking supervisors following Fortis's takeover of ABN Amro about who would be lead supervisor of the combined entity made cooperation between the Belgian and Dutch authorities difficult. Still, on 28 September 2008, the Belgian, Netherlands and Luxembourg authorities announced that they would invest a total of €11.2 billion in Fortis's banking activities to avert an imminent bank run. Belgium would acquire a 49.93% stake in Fortis Bank, the Belgium-based entity that held the group's banking operations in Luxembourg and the Netherlands. At the same time, Luxembourg would purchase a 49.9% share in Fortis Bank's Luxembourg-based subsidiary Fortis Bank Luxembourg, while the Netherlands would acquire 49% in the bank's Dutch subsidiary Fortis Bank Nederland.

When these measures failed to reassure financial markets, the precarious cooperative equilibrium between the Belgian and Dutch authorities broke down. The Dutch banking supervisor began to voice concerns that Fortis Bank was no longer capable of financing its Dutch subsidiary Fortis Bank Nederland and threatened to place the latter under trusteeship.

This prompted the three Member States to nationalize not only the resolution process of the group's operations in each of the three Member States, but the bank's local entities themselves. On 3 October 2008, the Dutch authorities announced that they had acquired a majority stake in Fortis Bank Nederland, which included the assets purchased from ABN Amro. The Netherlands also nationalized the group's local insurance subsidiaries in the process. Only two days later, Belgium announced that it had nationalized Fortis Bank, of which 75% would be sold to French bank BNP Paribas.[141] In the process, BNP Paribas would acquire a 50% stake in Fortis Bank Luxembourg. Shortly thereafter, the French bank purchased an additional 16% of the company's capital from the Luxembourg government.

In a December 2008 decision jointly addressed to the three Member States, the Commission temporarily authorized the package of aid measures, subject to a price leadership ban in Belgium and pending approval of a restructuring plan.[142] Notably, though, the Commission refrained from demanding that Fortis Bank divest a portion of its market-leading activities in the highly concentrated Belgian banking market:

> […] the Commission notes that the difficulties encountered by Fortis Bank are not the result of an expansion strategy or a predatory-pricing policy on the Belgian market. It is therefore not essential that, in addition to the aforementioned reduction in size following the sale of [Fortis Bank Nederland], Fortis Bank also

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141 COMP/M.5384 – BNP Paribas/Fortis, Commission Decision of 29 October 2008.

142 Commission Decision on State aid NN42/2008, NN46/2008, and NN53/A/2008 – Restructuring Aid to Fortis Bank and Fortis Bank Luxembourg, 8 December 2008.

reduces its size on the Belgian market, which is the largest market on which Fortis Bank will remain active.[143]

The reasoning stands in contrast to the Commission's (arguably somewhat unsystematic) practice of conditioning the approval of crisis aid to divestitures in beneficiaries' highly concentrated home markets (see above). One possible explanation is that the decision simply pre-dates the adoption of the Restructuring Communication, before which the Commission had not adopted an official policy of looking favorably upon market-opening divestitures. Another explanation is that the Commission viewed the sale of Fortis Bank to a new foreign player in Belgium as a form of market opening. And indeed, the transaction was one of the few cross-border transactions to have taken place during the crisis.

Regardless, the 3 December 2008 decision did not mark the end of the Fortis saga. On 12 December 2008, the Brussels Court of Appeal suspended the sale of Fortis Bank to BNP Paribas and requested a consultation of the bank's shareholders. This ultimately resulted in the renegotiation of the deal between the governments of Belgium and Luxemburg, Fortis Holding and BNP Paribas. In particular, Belgium accepted to take on a larger share of the risk of the investment vehicle that would purchase impaired assets from Fortis Bank. At the same time, Belgium also offered to issue new guarantees to Fortis Bank while Luxembourg undertook to recapitalize the bank's local subsidiary, Banque Générale du Luxembourg. In a 12 May 2009 decision addressed to both Belgium and Luxembourg, the Commission approved these measures, subject to a strengthened price leadership prohibition and an expansion ban.[144]

In parallel, on 8 April 2009 the Commission initiated an in-depth investigation into the nationalization of Fortis Bank Nederland[145] and, over the following months, the Dutch government notified the Commission of a series of additional aid measures totaling €6.89 billion to (i) finalize the separation of ABN Amro's Dutch assets from the rest of ABN Amro, (ii) finance the integration of these assets with Fortis Bank Nederland, and (iii) settle certain obligations towards the other members of the ABN Amro purchasers' consortium. The Commission temporarily authorized the package as emergency rescue aid on 5 February 2010,[146] finding that the Netherlands would otherwise face the risk of litigation from the consortium and destabilize Fortis Bank Nederland and ABN Amro by further delaying their separation from their former mother companies. At the same time, the Commission extended the scope of the in-depth investigation opened in April 2009 to include the additional measures.

On 5 April 2011, the Commission's in-depth investigation came to a close with the approval of the banks' restructuring plan, subject to a series of behavioral constraints.[147] These included price leadership and acquisition bans, a requirement to achieve certain

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143 *Ibid.*, para. 94.

144 Commission Decision on State aid N255/2009 and N274/2009 – Additional Aid for Fortis Banque, Fortis Banque Luxembourg and Fortis Holding, 12 May 2009.

145 Commission Decision on alleged aid to Fortis Bank Nederland and the ABN Amro Asset, 8 April 2009.

146 Commission Decision on State aid C11/09 (related to NN2/10 (ex N429/09) and N19/10) – Recapitalization Measures in Favour of FBN and ABN Amro Group, 5 February 2010.

147 Commission Decision on State aid C11/2009 (ex NN53b/2008, NN2/2010 and N19/2010) implemented by the Dutch State for ABN Amro Group NV, 5 April 2010. See too Bruno Zanghellini *et al.*, 'The ABN Amro Restructuring Decision' [2011] *Competition Policy Newsletter*.

profit margins in the private banking sector, and measures to facilitate customer switching. On the other hand, the Commission refrained from requiring any divestiture from the banks, even though the Dutch banking market was one of the most highly concentrated in the European Union. The Commission explained that Fortis Bank Nederland and ABN Amro had not engaged in risky pricing or lending policies, but were still paying the price for the 2007 merger and the 2008 separation from Fortis Bank, which left them severely undercapitalized.

b) The sovereign-bank loop: the case of Greece

The sovereign debt crisis further highlighted the difficulty of preserving cross-border integration with an approach based primarily on the coordination of sovereign financial policies. In 2011, several EU Member States became engulfed in a two-way feedback loop between the solvency of governments and that of their credit institutions. These institutions typically carried large holdings of sovereign bonds issued by their own governments. This meant that a deterioration in a government's credit rating could have a detrimental impact on domestic banks, which might then require State aid to address the resulting capital shortfall. This was liable to further worsen the government's credit, which in turn could inflict additional losses on domestic banks, and so on.

This had severe implications for cross-border banking. The growing disparities in national budgetary situations caused by the sovereign-bank loop meant that there were increasing differences across the European Union in terms of resources for State intervention. A bank's access to funding began to depend less on its individual risk profile than on the financial strength – and ability to intervene – of the Member State in which it was based. This was particularly palpable in the field of burden-sharing, as financial institutions with similar credit faced 'divergent funding costs […] depending on the perceived likelihood of a bail-in as a function of a Member State's fiscal strength'.[148]

The case of Greece stands out in this respect. The 53.5% write-down on the country's sovereign debt completed in February 2012 as part of a bond exchange program known as the second Greek private sector involvement (PSI) resulted in significant losses for – and a corresponding need to recapitalize – domestic banks, which were disproportionately exposed to Greek sovereign debt. These banks benefited from a bridge recapitalization funded through an international assistance program and made available by the Hellenic Financial Stability Fund (HFSF).

In December 2012, Greece launched a buy-back program on the bonds issued in February, at prices ranging from 30.2% to 40.1% of their nominal value. The country's four largest banks, which had by then become dependent on emergency liquidity assistance after being shut out of wholesale funding markets, required another bridge recapitalization from the HFSF. That recapitalization was made permanent the following year.

To put the sector on more solid footing again, the authorities facilitated the consolidation of the banking industry in the hands of the country's four largest ("systemic") banks (Section i); which deleveraged their international operations and retrenched behind their national borders in the process (Section ii).

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[148] 2013 Banking Communication, para. 18.

i) Consolidating the Greek banking sector

To strengthen the industry's capital base while minimizing government involvement, Greece's banks initiated a process of mergers and acquisitions in late 2011. In a matter of months, the Hellenic Competition Commission cleared 12 mergers and acquisitions in the financial sector, including two with remedies. This wave of consolidation profoundly transformed Greece's previously fragmented commercial banking sector, as the country's four large domestic banking groups (National Bank of Greece, Alpha Bank, Eurobank and Piraeus Bank) gradually increased their domestic market share to around 95% by acquiring the subsidiaries of foreign-owned banks, the country's two large state-controlled banks, and a number of smaller banks. So much so that the Vice-Chairman of the Hellenic Competition Commission declared that, '[f]ollowing the gradual disappearance of the smaller and niche banks, it is now clear that we may have reached the limit from a competition law perspective'.[149]

In reviewing the aid involved in some of these transactions, the Commission proved particularly accommodating. The case of the state-owned Agricultural Bank of Greece (ATE Bank) is illustrative. ATE Bank was the fifth-largest bank in Greece and had activities in Romania and Germany. Its situation had already begun to deteriorate in 2008, when poor asset quality and difficulties associated with Greece's nascent sovereign debt crisis combined to weigh on the bank's profitability and solvency. €6.1 billion in aid from the Greek authorities initially succeeded in stabilizing the bank and, on 23 May 2011, the Commission approved the measures after concluding that the restructuring plan submitted by Greece would secure the bank's long-term viability.[150]

But shortly thereafter, ATE Bank's capital deteriorated so significantly due to its participation in the second PSI that a resolution process had to be set in motion. ATE Bank's non-viable business would gradually be resolved in a bad bank while a perimeter of ATE Bank's viable activities would be sold. To that effect, the country's central bank, in its capacity as resolution authority, solicited expressions of interest from the four largest Greek banks. The central bank also contacted two international investment banks, both of which confirmed that there was no foreign interest for ATE Bank's viable activities.

The Commission held that, under normal circumstances, 'contacting such a limited number of buyers [would] not allow it to conclude that the tender was open'.[151] But a restricted auction was acceptable on the facts of the case for 'reasons of financial stability' and given the apparent lack of foreign interest and the prevailing economic climate.[152] The bank was ultimately acquired by Piraeus Bank, which also purchased Société Générale's Greek subsidiary Geniki, Millennium Banco Comercial Portugues's Greek subsidiary, and, with additional HFSF assistance, the Greek operations of three Cypriot banks.

The case of one of these Cypriot banks, Cyprus Popular Bank (Laiki), provides further illustration of the commercial and policy choices that led to the consolidation of the Greek

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149 Quoted in Greg Olsen and Peter Malone, 'Financial Services and Competition Law: An Overview of EU and National Case Law' [2014] *e-Competitions Bulletin* n° 68263.

150 Commission Decision on State aid N429/2010 – Agricultural Bank of Greece (ATE), 23 May 2011.

151 Commission Decision on State Aid SA.35460 (2013/NN) – Liquidation Aid for ATE Bank Resolution, 3 May 2013, para. 53.

152 *Ibid.*

banking industry in the hands of the country's four systemic banks.[153] In late 2006, Laiki announced the acquisition of Greek financial institutions Marfin Financial Group and Egnatia Bank, which it consolidated into a single Greek subsidiary with its own Greek operations. At the end of 2009, Laiki converted the entity from a subsidiary into a branch of the Cypriot parent bank, which the Cypriot and Greek central banks eventually approved in early 2011.

By then, Laiki had come under severe strain, as losses began to pile up and deposit outflows intensified. When the second Greek PSI translated into a €2.3 billion loss for Laiki, the bank had to seek government assistance. As the Cypriot sovereign was cut off from international capital markets, the prospect of a bail-out from the bank's home State looked bleak. Assistance from the Greek government turned out not to be an option either. Due to its status as a branch, the Greek entity was denied access to the emergency liquidity assistance and recapitalization mechanisms made available to domestic banks. Plans to reconvert the branch into a subsidiary to access these funds ultimately failed.[154] Although the bank eventually benefitted from guarantee and recapitalization aid from Cyprus, it had to be resolved and its Greek operations were sold to Piraeus Bank. Laiki subsequently commenced arbitral proceedings against Greece under the 1992 bilateral investment treaty between Greece and Cyprus, reportedly alleging unequal treatment in relation to other banks operating in Greece.[155] At the time of writing, the case was pending before an International Centre for Settlement of Investment Disputes (ICSID) Tribunal.

ii) Retrenching behind national borders

While they acquired their smaller competitors with significant government assistance, Greece's four systemic banks deleveraged their international operations. The case of Alpha Bank is particularly noteworthy. By the end of 2011, Alpha Bank had suffered from high and rising impairments on its loan portfolios in Greece and abroad, while significant deposit outflows were severely affecting its liquidity position. Much like ATE, the bank had also suffered material losses from its participation in the country's sovereign debt restructuring program.

The bank benefited from several recapitalizations and, on 9 July 2014, the Commission eventually approved the bank's restructuring plan, including the acquisitions of Crédit Agricole's subsidiary Emporiki (which did not involve State aid), Citibank Greece, and selected liabilities of three local co-operative banks (all of which involved State aid).[156] To obtain the Commission's approval, Greece procured that Alpha Bank would both significantly restructure and deleverage its foreign assets and refrain from using State funds to finance acquisitions abroad. Conversely, the Commission 'exceptionally accept[ed] that, in spite of the high aid amount and the [beneficiary's] high market share, the restructuring

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153 See generally Alexander Michaelides and Athanasios Orphanides, *The Cyprus Bail-in: Policy Lessons from the Cyprus Economic Crisis* (Imperial College Press 2016).

154 Panayiotis Tsaggaris, 'Nicosia Asks Athens to Relieve it of Egnatia Burden', *ekathimerini* (11 October 2012) <http://www.ekathimerini.com/145349/article/ekathimerini/business/nicosia-asks-athens-to-relieve-it-of-egnatia-burden> accessed 26 September 2016.

155 See, e.g., Kerin Hope, 'Greek Fund in Legal Move against Cyprus', *Financial Times* (19 January 2013) <https://www.ft.com/content/6a859688-6197-11e2-82cd-00144feab49a> last accessed 26 September 2016.

156 Commission Decision on State aid SA.34826 (2012/C), SA.36005 (2013/NN) implemented by Greece for Piraeus Bank Group relating to the recapitalization and restructuring of Piraeus Bank SA, 23 July 2014.

plan does not envisage any downsizing of the balance sheet and loans in Greece'.[157] According to the Commission, this was justified because the bank's difficulties resulted from external shocks and Greece's protracted recession rather than from excessive risk-taking.

4. The Banking Union: solving the financial trilemma?

In the wake of the sovereign debt crisis and of the Fortis and Dexia breakups, the Commission recognized that 'the crisis has shown that mere coordination is not enough […] and that there is a need for common decision-making'.[158] To break the sovereign-bank loop in the short term while strengthening financial stability and 'curtail[ing] the increasing risk of fragmentation of EU banking markets' in the long term, the Commission called on Member States to relinquish some of their sovereignty over financial policies to create a Banking Union.[159] In 2013 and 2014, the European Union adopted a series of reforms to implement the project, which has resulted in a supranational bank supervision and resolution framework based on three main pillars that complement EU State aid rules.

The Banking Union's first pillar is the **single rulebook**, which ensures that cross-border banks are subject to equivalent rules across the single market. The single rulebook includes:

- Common prudential requirements enshrined in the CRD IV Regulation, which aims to prevent crises in the first place and purports to create a level playing within the Union by reducing the scope for regulatory arbitrage and removing distortions of competition stemming from divergences in national laws.[160]
- Unified deposit guarantee rules to provide a uniform level of protection to depositors while ensuring the same level of stability of deposit guarantee schemes across the European Union,[161] thus avoiding a repeat of the subsidies race that Ireland's 2008 blanket guarantee triggered.
- The Bank Recovery and Resolution Directive (BRRD), which facilitates coordinated action in the event of the failure of cross-border groups such as Dexia and Fortis by ensuring that national resolution authorities have a uniform set of tools and powers at their disposal and cooperate with a view to agreeing on a group resolution scheme.[162]

The Banking Union's second pillar takes the form of the **Single Supervisory Mechanism (SSM)**, a supranational bank supervision system composed of the European Central Bank (ECB) and supervisory authorities in participating Member States. The SSM is entrusted with supervising banks' compliance with prudential requirements to detect

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157 *Ibid.*, para. 353.

158 Commission Communication, 'A Roadmap towards a Banking Union' (12 September 2012).

159 *Ibid.*

160 Regulation No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, recitals 9 and 11.

161 Directive 2014/49/EU of 16 April 2014 on deposit guarantee schemes (recast), recital 6.

162 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, recital 96.

weaknesses at an early stage and ensure that timely action is taken to correct them. Notably, the Banking Union's large and cross-border banks are placed under the ECB's direct supervision.

The Banking Union's third pillar is the **Single Resolution Mechanism (SRM)**, a centralized crisis management scheme that applies only to Eurozone members and those other Member States that decide to opt in. The SRM is designed to ensure a common approach to addressing banks failures by (i) eliminating the risk of divergent decisions by Eurozone members concerning the resolution of cross-border banking groups; and (ii) reducing the dependence of banks on their home country's national budget. As Director General for Competition Johannes Laitenberger has noted, this means that '[t]he market credibility of the banks will therefore depend on their specific risk profile and less and less on the financial strength of the Member States where they are based. This should make it easier for banks in all Member States to access funding on equal terms.'[163]

The SRM is based on a two-tiered structure:

- The Single Resolution Board decides on resolution schemes for failing banks. It is directly responsible for the planning and resolution phases of the Banking Union's cross-border and large banks, as well as all resolution cases drawing on Single Resolution Fund resources.
- The Single Resolution Fund is a fund established at supranational level with contributions from the banking sector to resolve failing banks once all other options (e.g., bail-in) have been exhausted.

The State aid rules set out in the 2013 Banking Communication are an integral part of the new framework.[164] Notably, State aid rules remain applicable whenever the resolution of a financial institution requires national or intergovernmental funds. This serves to ensure that bank resolutions are carried out on the same terms in Member States that are not subject to the SRM. Likewise, when SRF financing is called upon, the resolution plan is assessed under State aid criteria (Article 107(3) TFEU) by analogy to ensure market integration concerns are adequately addressed even when Articles 107 and 108 TFEU do not formally apply.

To be sure, if the goal is to preserve both financial stability and cross-border banking activity, the current Banking Union framework is a significant step in the right direction. As Dirk Schoenmaker has noted, '[t]he idea of Banking Union is very powerful' and 'has been instrumental in arresting the euro sovereign crisis'.[165]

But the union remains incomplete. In particular, deposit insurance,[166] the lender-of-last-resort function, and the initiative to rescue individual banks remain within the hands of Member States. Continued national control over these functions, together with the current framework's tougher burden-sharing and bail-in requirements, raises the risk that Member States will delay taking the necessary measures to clean up their domestic banking industry to protect domestic investors as long as possible. The Italian government's reluctance to

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163 Johannes Laitenberger, 'From Bail out to Bail in: Laying Foundations for a Restructured Banking Sector in Europe', Speech at Universidade Católica Portuguesa (25 January 2016).

164 *Ibid.*

165 Schoenmaker 2015, 25.

166 On 24 November 2015, the Commission proposed a Eurozone-wide deposit insurance scheme (EDIS) for bank deposits. At the time of writing, the proposal had yet to be adopted.

force a bail-in to rescue its troubled banking sector provides perhaps the clearest example to date.[167]

Against this background, despite the substantial progress that has been made since the outbreak of the financial crisis, one may wonder how distant a prospect a sustainable and lasting solution to the financial trilemma in the European Union remains.

[167] See, e.g., Silvia Merler, 'Italy's Bail-in Headache', *Bruegel* (19 July 2016) <http://bruegel.org/2016/07/italys-bail-in-headache/> accessed 24 September 2016; and Nicolas Véron, 'Italy's Banking Problem is Serious but Can Be Fixed', *Bruegel* (14 July 2016) <http://bruegel.org/2016/07/italys-banking-problem-is-serious-but-can-be-fixed/> accessed 24 September 2016.