Title	The application of Article 107(3)(b)TFEU in systemic banking crises: The need for a new State Aid Crisis Framework for the European Banking Sector in light of the European Commission's interpretation of the "serious disturbance" exemption as a response to the 2008 financial crisis.
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Publication Date	2019-09-27
Publisher	NUI Galway
Item record	http://hdl.handle.net/10379/15469

Title: The application of Article 107(3)(b)TFEU in systemic banking crises: The need for a new State Aid Crisis Framework for the European Banking Sector in light of the European Commission's interpretation of the "serious disturbance" exemption as a response to the 2008 financial crisis

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PhD Thesis

Year 2019 Month January

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Abstract

The 2008 financial crisis illustrated the problems that arise when EU State aid rules are relaxed and Member States are allowed to prop up ailing banking sectors. Member States in effect become subject to a constant drain on their resources as the threat of greater financial instability becomes omnipresent. The objective of this Thesis is to establish a new future Crisis Framework so that Member State resources are better protected in the event of a new crisis. This will be achieved via utilising pre-existing State aid rules and principles in conjunction with certain economic and organisational theory principles.

I declare that the work contained therein is my own: Patrick O'Sullivan

Table of Contents

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Commission Communication on the application from the 1st January 2012, of State aid support measures to banks in favour of banks in the context of the financial crisis, [2011] O.J. C 356/02 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011XC1206%2802%29&from=EN [last accessed on 07/11/2018].

Commission Communication (2012/C 8/02) of 11/01/2012 on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest [2012] OJ C 8/4 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012XC0111(02)&from=EN [last accessed on 07/11/2018].

Commission Communication, A Roadmap towards a Banking Union, of 12/09/2012, COM(2012)510, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0510&from=EN [last accessed on 07/11/2018].

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Introduction

The 2008 financial crisis posed an existential threat to the global financial system and provided a stark illustration of how the demise of financial institutions may trigger instability across the world. This Thesis seeks to examine these failings and recast a new set of State aid rules for future circumstances in which a “serious disturbance” may arise in either one Member State or the Union as a whole. With the advent of lax regulatory and monetary controls, capital could flow from one corner of the globe to the other as financial institutions sought to target their funds where the highest returns were available. Instead of financial institutions continuing to follow the traditional retail banking model, more and more sought to diversify their business models in addition to expanding their traditional market base. With this drive towards expansion came the need for additional funds beyond those generated from normal bank depositors, and so there was an exponential growth in the demand and supply of wholesale bank funding. With this increased reliance on wholesale funding came the increased threat of financial contagion.

An environment developed within the global financial industry where, on one side, financial institutions such as the German Landesbanken sought to invest in high-risk products to increase their revenue and profits, while on the other side were financial institutions such as Irish and Icelandic banks that sought increased funding from other financial institutions via wholesale funding. In both cases, each side of this global interchange of funding became exposed to the strengths or weaknesses of other international financial institutions and markets. This level of financial interconnectedness would become clear from 2007 through to 2008 when the non-performing loans in the United States residential sector would not only impact on the financial institutions that provided this credit but also on European banks that had invested in these loans via mortgage-backed financial securities. Although the subprime crisis would in and of itself pose challenges for both governments and financial regulators, the resulting contagion of economic instability greatly complicated matters.

A globalised economy that requires continuous access to credit is more likely to fall into a recession (if not a depression) where this credit provision becomes suddenly constrained or closed off. If a strict interpretation of European State aid law was applied by the European Commission, then an uncontrolled banking collapse from Ireland to Poland was highly likely. Thus, under the application of Article 107(3)(b)TFEU, State aid rules were relaxed so that even substantial sums of State support could fall under the qualifications of "appropriateness" and "minimum necessary".[1] Furthermore, competition concerns did not rank high on the list of priorities for competition and State aid policymakers.

Aim

The central aim of this thesis is to formulate a new State Aid Crisis Framework for a future systemic crisis so that a balance is struck between engendering short-term financial stability and better ring-fencing of the resources of EU Member States from their domestic banking sectors. Furthermore, this aim does not entail simply focusing on one particular strand of the past State aid response for the 2008 financial crisis but examining the parameters of a new framework from recapitalisation, guarantee schemes, asset relief schemes and right the way through to a new bank resolution architecture.

Literature Review

Although there is a wide body of academic commentary and critique of the DG Competition's application of Article 107(3)(b)TFEU from State aid experts ranging from Nicolaides to Hancher,[2] in the vast majority of cases

[1] Article 107(3)(b)TFEU available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107 [last accessed on 07/11/2018].
[2] Nicolaides P. and Rusu I.E., "The Conflicting Roles of State Aid Control: Support of Financial Institutions versus Safeguarding the Internal Market," (2010) Vol.17(3) M.J.E.C.L. pp.223-229; Hancher L., Ottevanger T. and Slot P.J., *EU State Aids*, 4th Ed., (London: Sweet and Maxwell, 2012).

these commentaries do not include any proposals for a possible future crisis State aid framework. The missteps of both the Commission and Member States are set out in depth by Gerard across a number of different publications.[3] While other commentators, such as Jenny have delved into the question of systemically important financial institutions, there remains an absence of any macro-level proposals for a future crisis framework.[4] In particular, critique of the Commission's application of Article 107(3)(b)TFEU and the Banking Communications in respect of bank guarantee schemes and asset relief schemes remains conspicuous by its absence. In most cases experts in the State aid and competition field have mainly sought to recount the practice of the Commission in applying Article 107(3)(b)TFEU rather than to propose a new State Aid Crisis Framework for the European Banking sector.

However, despite the absence of commentators proposing a new holistic approach to how the Member States and the Commission should respond in a future financial crisis, existing commentary plays a key role in this thesis. Existing viewpoints and positions from various State aid and indeed competition commentators, such as Lyons, Bacon, Verounden and Werner, ensures that the proposals set out in this Thesis remain built from existing commentary.[5]

Methodology

To achieve the aim of this Thesis three core steps were taken. First past examples of bank failings were examined to provide the context to the 2008 financial crisis. From this examination one could ascertain the key differences between why past bank failures did not pose systemic wide threats to the world economic overall. This in turn require an examination of how European

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[3] Gerard D., "Managing The Financial Crisis in Europe: The Role of EU State Aid Law Enforcement", in in M. Merola, J. Derenne and J. Rivas (eds.), *Competition Law at Times of Economic Crisis – In Need for Adjustment?* (Brussels: Bruylant, 2013), p. 231.
[4] Jenny F., "The Economic and Financial Crisis, Regulation and Competition" (2009) Vol.32(4) World Competition pp.449-464.
[5] Lyons B., "Competition Policy, Bailouts and Economic Crisis," (2009) Vol.5(2) C.P.I. pp. 25-48; Bacon K., European Union Law of State Aid, 4th Ed., (Oxford: Oxford University Press, 2017); Werner P. and Verouden V., *EU State aid Control Law and Economics* (Netherlands: Kluwer Law International, 2016).

State aid law was applied by Member States and the rules interpreted by the Commission when support was provided to failing undertakings in a non-banking context. From this, the next step was to examine the Commission and Member States' responses to the financial crisis via the application of a crisis specific framework issued by the former. By examining both these Communications and the Commission's decisional practice a number of underlying flaws could be identified with this framework. The final strand of work then entailed formulating a new approach that resolves these flaws by applying different economic theories and by utilising the Commission's approach in other State aid fields. Each of these steps were required in order to achieve the objective of formulating a new crisis framework. This also meant that the conclusion of this work would see not just a proposed framework rooted in State aid law but also other fields so as to better reflect the complexities of the European banking sector. Gray and de Crecco make the point that had the Commission sought to apply the State aid exemption under Article 107(3)(b)TFU in a rigid manner that Member States would then have sought to invoke the Article 108(2)TFEU exemption as an alternative approach. Under this Treaty provision the European Council is able to set aside State aid decisions by the Commission.[6] A new State Aid Crisis Framework for the EU banking sector will need to draw on other disciplines and policies areas to sufficiently address the complexities of the financial sector.[7]

Findings

In an interview with the *Financial Times* in August 2017 the Chair of the Single Resolution Authority, Elke König stated that the Banking Communication from 2013 was now outdated. She was mainly referring to the provision of liquidation aid for financial institutions and questioned

[6] J. Gray and F. de Cecco, "Competition, stability and moral hazard: the tension between financial regulation and State aid control", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.20at p. 28-29.
[7] *Ibid*.

whether this was really necessary in the current environment.[8] However, one could easily extrapolate from this that there are other areas within the pre-existing State aid framework for financial institutions that also require revision. On the one hand, it may be that a more stringent threshold should be applied for financial institutions that do not pose a systemic threat to the wider economy of a Member State or indeed the wider EU banking sector. In these cases perhaps the existing State aid rules and Bank Recovery and Resolution Directive will suffice to resolve such an institution. However, the focus of this Thesis has been to establish a specific future State aid framework in times of future systemic crises.

While undertaking this research it has become evident that both Member States and the Commission had to respond in a legislative vacuum with no real benchmark when applying the Article 107(3)(b)TFEU exemption. Previous cases in which this had been applied were mainly related to macro-economic reforms within certain Member States rather than failing financial institutions. During the 1990s the Commission remained reluctant to utilise this State aid exemption for the French banking group Credit Lyonnais and even during the initial stages of the 2008 financial crisis Article 107(3)(b)TFEU remained in abeyance. However, once the crisis deepened and financial institutions across numerous Member States required financial assistance the Commission had no real option other than to apply this "serious disturbance" exemption. In time the Commission established a specific State aid framework across a series of Communications.

But while these Communications may have partly addressed the wider systemic crisis facing individual Member States and the Union as the whole, certain inherent failings were evident. First, the Commission failed to establish a specific set of criteria for what does or does not constitute a systemically important financial institution. After initially refusing to apply Article 107(3)(b)TFEU the Commission then adopted a reverse policy of applying this exemption to all financial institutions. The next failing of the

[8] J. Brunsden, "Tighter EU curbs on the winding down of banks", Financial Times (7th August 2017), available at https://www.ft.com/content/545c1790-7b7f-11e7-ab01-a13271d1ee9c [last accessed on 07/11/2018].

Commission was the absence of any effective limitation on the levels of State aid provided by Member States to their domestic banking sectors. In this way Member States such as Ireland, Spain and Greece became trapped in a bank-sovereign debt loop resulting in their entry into IMF-EU economic assistance programmes.

This Thesis seeks to address these failings. By applying a specific State aid prism, this Thesis seeks to develop a new framework that strikes the correct balance between engendering financial stability and protecting the resources of Member States. Furthermore, this thesis develops a new series of safeguards against competition distortion for the European banking sector that not only address competition conflicts between financial institutions but also promote a more competitive market for consumers. In a parallel strand, the proposed systemic resolution tools ensure that the new State Aid Crisis Framework is sufficiently entwined with bank resolution objectives.

Chapter One: Background to the 2008 Financial Crisis

Introduction

The objective of this is Chapter is to examine the main causes of the 2008 financial crisis. To provide a wider context, past banking collapses, such as Herstatt Bank and Barings Bank, are also set out to act as a comparison to the 2008 crisis. These past examples illustrate the different ways in which financial institutions may fail and how governments and financial regulators responded to the challenges posed by these particular bank failures. Not only do these case studies provide a comparison to the 2008 crisis they will also provide a context for what internal and external factors may trigger a bank's collapse. This in turn leads into the second part of the Chapter which focuses on how the regulatory environment developed in both the United States and the European Union prior to the 2008 crisis and whether general lowering of supervisory standards in turn contributed to lax corporate governance standards within certain financial institutions.

While this Chapter seeks to discuss the global dimension of the 2008 crisis, due to the critical review of State aid policy for Irish financial institutions throughout the Thesis, there is also an examination of the pre-crisis Irish banking sector. Drawing from the Oireachtas Inquiry into the Irish banking crisis, the failings of both the Irish financial regulator and corporate oversight within Irish banks from Anglo Irish Bank to Bank of Ireland are set out. In conjunction with setting out these issues, the concluding parts of the Chapter specifically examine the responses of the Irish authorities to the 2008 crisis. Particular focus is placed on the possible options the then Irish government could have pursued and provides an explanation as to why the State aid option was then chosen in respect of Irish banks. There is a particular focus on the options considered for both Anglo Irish Bank and Irish Nationwide Building Society as these two financial institutions posed the greatest risks to the Irish banking sector.

1.1. Past Bank Failings

To provide a comparison to the 2008 financial crisis, a number of past bank failings will be examined to illustrate the challenges facing governments and policymakers in 2008 that may not have been evident in past banking failures. For instance, the collapse of the German investment bank Herstatt Bank in 1974, did raise similar concerns to those in 2008 that its demise would constitute a systemic threat to other financial institutions throughout the globe.[1] Like financial institutions prior to the 2008 financial crisis, Herstatt Bank had a monoline business model that mainly consisted of currency based investments.[2] However, despite the bank's cross-border links with other financial institutions, its closure did not have the same impact as that of Lehman Bros. for two primary reasons.[3] One, the level of financial inter-linkage between financial institutions in the 1970s was not as extensive as it was in 2008. Herstatt Bank operated in a specific market segment and so its closure while it may have caused losses within that particular banking sector this did not translate to similar losses in others. Two, as there was not the same level of cross-industry impact other financial institutions were in a financial position to participate in an industry led bank resolution. This second point meant that State funds did not have to be provided in an open-ended manner to first rescue Herstatt Bank but then to restructure it with further State resources. In contrast with the collapse of Herstatt Bank, the closure of Continental Illinois in the United States did require the State support via the Federal Deposit Protection Corporation, which was established under the *Banking Act 1933* to insure bank deposits, providing a $30 billion guarantee for insured and uninsured liabilities.[4] In this case, the bank had engaged in an aggressive market expansion and had become over-

[1] Bank Failures in Mature Economies, Basel Committee on Bank Supervision, Working Paper No.13, April 2004, at p.5 available at http://www.bis.org/publ/bcbs_wp13.pdf [last accessed on 07/11/2018].
[2] *Ibid*.
[3] E. Mourlon-Druol, "'Trust is good, control is better': the 1974 Herstatt-Bank crisis and its implication for regulatory reform", (2015) Business History pp.1-24 at p.17 available at http://eprints.gla.ac.uk/95628/1/95628.pdf [last accessed on 07/11/2018].
[4] The Collapse of Continental Illinois National Bank and Trust Company: The Implications for Risk Management and Regulation, Financial Institutions Centre Wharton School, University of Pennsylvania, at p.8 available at http://fic.wharton.upenn.edu/fic/case%20studies/continental%20full.pdf [last accessed on 07/11/2018].

reliant on wholesale funding.[5] A reliance that other financial institutions would also develop in the build up to the 2008 financial crisis as will be discussed below. However, the collapse of Continental Illinois remained an isolated event and so the intervention of the Federal Deposit Protection Corporation and Federal Reserve with other financial institutions financing some of the resolution costs was possible.[6]

Another past bank collapse of note was that of Barings Bank where the activities of one rogue trader saw the insolvency of this financial institution and the residual business acquired by a Dutch banking group. In this case, despite its financial links with other investment banks, the demise of Barings Bank did not trigger wider economic instability as, first the reason behind the financial institution's closure remained linked to a specific individual rather than due to wider market factors, and second, the bank did not have a retail presence.[7] Thus the need for a macro State aid crisis framework for a bank collapse of this nature was not required. State resources were not necessary to resolve the problems in Barings Bank as the market itself resolved the failure via a competing undertaking acquiring the bank.

The above examples of bank failings are those of isolated events within the United States and Europe. However, there are also past examples of country-wide banking crises that have required more recourse to State resources than those examples discussed above. For example, in the late 1980s to early 1990s, there was the Nordic banking crisis where due to currency fluctuations and over-exposure to property related lending, banks in Sweden, Norway and Finland, required State assistance.[8] This will be further discussed in Chapter 7 and 6.

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[5] *Ibid* at p.17.

[6] M. Clarkson and J. Rose, "Can a Bank Run be Stopped? Government Guarantees and the Run on Continental Illinois" Bank of International Settlements Working Papers, March 2016 at p.7 available at http://www.bis.org/publ/work554.pdf [last accessed on 07/11/2018].

[7] Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, 18th July 1995, at 1.42-1.4.6 available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/235622/0673.pdf [last accessed on 07/11/2018].

[8] P. Englund, "The Swedish Banking Crisis: Roots and Consequences", (1999) Vol.15(3) Oxford Review of Economic Policy pp.80-97 at p.91 *op cite* Wallander 1994 available at

1.2.Environment Prior to the Financial Crisis: Developments in the US and EU

The above examples illustrate how a financial institution may fall into insolvency due to different factors and that this may occur in different jurisdictions. However, the 2008 financial crisis wrought a systemic threat to the global banking sector and in particular American and European financial institutions. To determine how this crisis came about one must first examine the regulatory environment that applied in both the United States and the European Union. In the former, legislators had sought to deregulate the United States financial system via the passage of Acts such as the *Deregulation and Monetary Control Act 1980* and the *Gran-St Germain Depository Institutions Act of 1980*.[9] These Acts allowed for Savings and Loan institutions to lower their capital buffers so that more capital could then be utilised for customer lending. [10] However, it was the repeal of the *Glass-Steagall Act* that one can draw a clear link to the 2008 financial crisis as this allowed for financial institutions to securitise their loan portfolios and resell these to other financial institutions.[11] For example under the *Gramm Leach Bliley Act 1999*, which repealed the *Glass-Steagall Act*, financial institutions were now allowed to engage in both retail and investment banking thereby facilitating the emergence of too-big-to-fail financial institutions.[12] Securitisation became a key part of how financial institutions such as Bear Stearns operated.[13] Under this process high risk loans could be placed on off-

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http://www.contrahour.com/contrahour/files/theswedishbankingcrisisrootsandconsequences.pdf [last accessed on 07/11/2018]; S. Honkapohja, "The 1990s financial crisis in Nordic countries", Bank of Finland Research Discussion Paper 5, 2009, at p.21 available at http://www.riksbank.se/Upload/Dokument_riksbank/Kat_foa/2009/6_8nov/Honkapohja.pdf [last accessed on 07/11/2018].

[9] The Savings and Loan Crisis and its Relationship to Banking in An Examination of the Banking Crises of the 1980s and Early 1990s, Volume a, Federal Deposit Insurance Corporation, pp.167-188 at p.175 available at https://www.fdic.gov/bank/historical/history/167_188.pdf [last accessed on 09/10/2017].

[10] *Ibid*.

[11] M. Sherman, "A Short History of Financial Deregulation in the United States", Centre of Economic Policy and Research, July 2009, at pp.4-9 available at http://cepr.net/documents/publications/dereg-timeline-2009-07.pdf [las accessed on 07/11/2018].

[12] *Ibid* at p.10.

[13] U.S. Securities and Exchange Commission, Office of Inspector General, Office of Audits, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated

balance sheet entities and resold to other financial institutions.[14] This transfer of subprime loans between financial institutions further connects the financial position of one bank with that of another as if the securities in question lose value then both the original loan originator and the purchasing institution will be affected by this development.[15]

Developments in Europe also helped create an environment where financial institutions began to expand their balance sheets and also acquire competing financial institutions. The introduction of the common currency meant that financial institutions in small banking markets such as Ireland could now access wholesale funding provided by other European financial institutions.[16] In this way European financial institutions became intertwined with each other. However, another form of inter-connectedness was also evident between financial institutions and EU Member States. Under Basel II capital requirements, sovereign bonds were categorised as low risk thereby incentivising financial institutions to hold these assets as non-performance was considered unlikely.[17] As a result of this European financial institutions had considerable exposures to European sovereigns such as Ireland, Greece and Spain.[18] Once the performance of these bonds became subject to market speculation the financial viability of the financial institutions holding these bonds also became a concern for market investors.

The regulatory regime in both the United States and Europe also meant that the possible systemic threats were not detected in time. In the United States,

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Supervised Entity Program, September 25th 2008, at p.5 available at https://www.sec.gov/files/446-a.pdf [last accessed on 07/11/2018].

[14] A. B. Ashcraft and T. Schuermann, "Understanding the Securitisation of Subprime Mortgage Credit", Federal Reserve Bank of New York, Staff Reports, Staff Report no.318, March 2008, at p.5 available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr318.pdf [last accessed on 07/11/2018].

[15] *Ibid*.

[16] Report of the Joint Committee of the Inquiry into the Banking Crisis, Volume 1, January 2016, at p.25 available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2016/01/02106-HOI-BE-Report-Volume1.pdf [last accessed on 07/11/2018].

[17] A. Blundell-Wigg and P. Slovik, "The EU Stress Test and Sovereign Debt Exposures", OECD Working Papers on Finance , Insurance and Private Pensions, No.4, August 2010, at p.9 available at http://www.oecd.org/finance/financial-markets/45820698.pdf [last accessed on 07/11/2018].

[18] *Ibid*.

financial regulators failed to appreciate the internal operations and interconnected threat posed by financial institutions such as Lehman Bros and Bear Stearns.[19] This failure to appreciate the possible "too-big-to-fail" threat posed by certain investment banks also meant that the existing regime for resolving failing financial institutions, the Federal Deposit Insurance Corporation, was not specifically tailored to resolve investment banks.

In Europe, Member States such as Ireland had adopted a dual-model financial regulator environment that meant information may not have been transferred from one regulator to the other as required.[20] Furthermore, one of the Irish regulatory arms had the contradictory role of promoting Ireland as a centre for financial services while also ensuring that rules and regulations were complied with.[21] The reliance placed by senior management within the Irish banking sector on wholesale funding was not subject to regulatory examination nor was the ever increasing provision of credit to the wider Irish economy subject to regulatory restrictions.[22] Competitive pressures from foreign financial institutions in the Irish market saw the prevalence of hundred per cent mortgages, a development that further inflated the property sector.[23] Limited steps were taken to restrict these practices but were done so too late to alleviate the crisis when it occurred in September 2008.[24]

However, within other EU Member States financial regulators had also failed to appreciate the risks associated with an ever increasing credit bubble. In the

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[19] Report of A.R. Vakulas, Examiner, Volume 3 of 9, March 11th 2010, at p.910-913 available at http://web.stanford.edu/~jbulow/lehmandocs/VOLUME%203.pdf [last accessed on 07/11/2018]; U.S. Securities and Exchange Commission, Office of Inspector General, Office of Audits, "SEC's Oversight of Bear Stearns and Related Entities: The Consolidate Supervised Entity Program", September 25th 2008, at p.18 available at https://www.sec.gov/files/446-a.pdf [last accessed on 07/11/2018].
[20] Honohan P., "The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank" at p.45 available at http://www.bankinginquiry.gov.ie/the%20irish%20banking%20crisis%20regulatory%20and%20financial%20stability%20policy%202003-2008.pdf [last accessed on 07/11/2018].
[21] *Ibid* at p.44.
[22] N.16 at pp.26-27.
[23] "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland" Report of the Commission of Investigation into the Banking Sector in Ireland, March 2011, at p.21 available at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf [last accessed on 07/11/2018].
[24] N.20 at p.105.

United Kingdom, while the Financial Services Authority did focus on conduct related matters within the British banking sector it failed to consider the inadequacies of corporate governance within financial institutions such as Halifax Bank of Scotland until *ex post* the financial crisis.[25] The financial regulator in Germany, the Baffin, failed to detect the ever increasing exposure of German Landesbanken to subprime loans from the United States.[26] While in Spain, the financial regulator had failed to restrict bank exposure to the domestic property sector.[27] Therefore, across different Member States financial regulators had failed to take pre-emptory measures against a possible systemic crisis. Furthermore, when the crisis did hit there was a lack of co-ordination between financial regulators across different jurisdictions a situation clearly evident in the demise of Icelandic saving bank Icesave.[28] In this case the Icelandic regulator refused to compensate British and Dutch depositors when this bank became insolvent due to the limited funds available within the Icelandic deposit scheme. This meant that the UK and Dutch deposit schemes had to be extended to protect Icesave depositors.[29]

The move towards de-regulation in both the United States and European banking resulted in the creation of securitisation products which facilitated the transfer of toxic assets from one jurisdiction to another. Inter-bank funding markets also became more important in the capital needs of banks which linked financial institutions from different countries tighter together

[25] "Review of the reports into the failure of HBOS", House of Commons Treasury Committee, Fourth Report of Session 2016-2017, at p.19 available at http://www.publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf [last accessed on 07/11/2018].

[26] Hans-Joachim Dübel, "Germany's path into the financial crisis and resolution activities", Presentation to CEPS Task Force on Banking Resolution Procedures, Oct 12th 2009 Brussels, at p.3 available at www.finpolconsult.de/.../16/...Financial_Crisis/Germany/Duebel_CEPS_09_SHT.ppt1 [last accessed on 07/11/2018].

[27] J. Daghar, "Regulatory Cycles: Revisiting the Political Economy of Financial Crises", January 2018 IMF Working Paper18/8 at p.46 available at https://www.imf.org/en/Publications/WP/Issues/2018/01/15/Regulatory-Cycles-Revisiting-the-Political-Economy-of-Financial-Crises-45562 [last accessed on 07/11/2018].

[28] P. Orbech, "The Icesave Bank of Iceland: From Rock-Solid to Volcano Hot: Is the EU Deposit Guarantee Scheme Resisting Financial Meltdown", (2010) Vol.6 *CYELP* pp.127-152 at p.129 available at http://www.cyelp.com/index.php/cyelp/article/view/106/75 [last accessed on 07/11/2018].

[29] Case E-16/11 *EFTA Surveillance v. Iceland*, 28th January 2013, available at http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf [last accessed on 07/11/2018].

particularly in the European Union. However, there was no specific State aid architecture in place to resolve the complexities posed by this inter-connectedness as Member States adopted a State resource response to failing banking sectors. This will now be discussed below.

1.3. Responses to the financial crisis: United States and Europe

When the first tremors of the subprime crisis hit in early 2008, policymakers in the United States responded by providing financial support behind Bear Stearns via a non-recourse loan to Morgan Stanley of $29 billion.[30] Due to the central role Bear Stearns performed in the wider investment banking sector as a clearing house and the fact that insolvency would have triggered a fire-sale of assets across other financial institutions, United States policymakers decided to bail-out this bank.[31] When the problems facing Bear Stearns also arose in public-entities Freddie Mac and Fannie Mae, again the first response of the authorities was to support these institutions rather than see them fall into insolvency.[32] Placing both Freddie Mac and Fannie Mae into "conservatorship" meant that the financial liabilities of both could be gradually unwound without triggering further market instability.[33] However, despite policymakers in the United States deeming Bear Stearns, Freddie Mac and Fannie Mae to be systemically important and thus require a State bail-out, when the vulnerable position of Lehman Brothers became evident no similar response was forthcoming. Just prior to the financial market turmoil of 2008, Lehman Brothers had altered its corporate strategy and started to invest in high value property investments.[34] This decision allied with the

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[30] G. Shorter, "Bear Sterns: Crisis and Rescue for a Major Provider of Mortgage Related Products" (2008) CRS Report for Congress p. 7 available at http://assets.opencrs.com/rpts/RL34420_20080326.pdf [last accessed on 07/11/2018].

[31] *Ibid* at p.8.

[32] W. S. Frame, A. Fuster, J. Tracy and J. Vickery, "The Rescue of Fannie Mae and Freddie Mac", Federal Reserve Bank of New York Staff Reports, Staff Report No.719, March 2015, at p.1 available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr719.pdf [last accessed on 07/11/2018].

[33] Federal Housing Finance Agency Press Release, "Statement of FHFA James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac", 09/07/2008 available at https://www.fhfa.gov/Media/PublicAffairs/pages/statement-of-fhfa-director-james-b--lockhart-at-news-conference-annnouncing-conservatorship-of-fannie-mae-and-freddie-mac.aspx [last accessed on 07/11/2018].

[34] Report of A.R. Vakulas, Volume 1 of 9, March 11th 2010, at p.59 available at https://web.stanford.edu/~jbulow/Lehmandocs/VOLUME%201.pdf [last accessed on 07/11/2018].

investment bank's exposure to securities resulted in Lehman Bros. experiencing a liquidity squeeze.[35] Counterparties became reluctant to provide finance to Lehman Bros. due to the high risk of non-payment.[36] Within Lehman Bros. there was efforts made to sale the institution to foreign financial institutions from the United Kingdom and South Korea. But these proposals failed to materialise into any concrete solutions.[37] When these possible alternative responses failed to materialise Lehman Bros. entered Chapter 11 bankruptcy.[38] This resulted in the disorderly collapse of the institution with complex securities and derivative chains having to be unwound in a matter of days triggering further instability across multiple jurisdictions.

Within the United States policymakers had responded in two different ways to the threats posed by failing investment banks. In the initial response, Bear Stearns, a State bail-out was provided to facilitate the failing institution's merger with JP Morgan Chase. However, Lehman Bros. was not supported in this way and allowed simply to fall into Chapter 11 bankruptcy. The costs associated with bailing-out Lehman Bros. would have been substantially more than that used to bail-out Bear Stearns but this additional cost would have presumably led to the benefit of a stabilised financial system within the United States and further afield. When the credit crunch began to impact the European banking sector, the fallout from the Lehman Bros. collapse meant policymakers on this side of the Atlantic had limited options to utilise.

In Ireland, the government undertook a detailed scoping exercises to determine what response was best to ensure that the Irish financial system did not collapse. Anglo Irish Bank and Irish Nationwide Building Society were deemed to be the most vulnerable Irish financial institutions. Irish policymakers had limited legislative options to utilise other than non-banking examinership and receivership regimes that failed to address the nuances of a

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[35] Report of A.R. Vakulas, Examiner, Volume 2 of 9, March 11th 2010, at p.614 available at https://web.stanford.edu/~jbulow/Lehmandocs/VOLUME%202.pdf [last accessed on 07/11/2018].
[36] *Ibid* at p.609.
[37] *Ibid* at p.618.
[38] *Ibid* at p.726.

systemic financial crisis. Both of these options were primarily designed to impose losses on creditors so that the company in question could then restructure its operations and return to viability.[39] But examinership was considered inadequate to protect depositors and other creditors.[40] Liquidating these financial institutions would cause the same systemic threat to the wider Irish banking sector. [41] Another option was to merge both financial institutions and so achieve viability via consolidation.[42]

One proposal to contain the crisis and to deter deposit outflows from the Irish banking sector was to introduce a blanket guarantee scheme.[43] Despite the possible adverse consequences for the Irish State that were set out from adopting this response, a blanket guarantee for Irish bank deposits and most wholesale bank debt was introduced.[44] The United Kingdom had introduced a blanket deposit guarantee for Northern Rock depositors in 2007.[45] However, as will be discussed further in Chapter 4, only Ireland introduced a blanket guarantee scheme for not just deposits but also inter-bank deposits and wholesale funding such as bank bonds including certain subordinated debt held by Irish financial institutions.[46] From this intervention flowed other State supports such as recapitalisations schemes and the establishment of an Irish "bad-bank", the National Asset Management Agency, designed to acquire

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[39] *Companies Act 2014* at s.509(1) and s.509(2), and s.437(1)-(3) available at http://www.irishstatutebook.ie/eli/2014/act/38/enacted/en/print[last accessed on 07/11/2018].

[40] Note of Meeting with NTMA, 3.00 pm, Thursday, 10 April, 2008, at Slide 4, available at https://assets.documentcloud.org/documents/2701350/34429029-Bank-1.pdf [last accessed on 07/11/2018].-

[41] Public Accounts Committee Section A, *Department Paper: Financial Stability Issues—Scoping Paper* January 24, 2008, p.3, available at https://assets.documentcloud.org/documents/2701350/34429029-Bank-1.pdf [last accessed 07/11/2018].

[42] *Paper re INBS Options given to Secretary General Department of Finance by INBS Chairman previous week Monday 22/09/2008*, DOF01B02, DOF03315-001-006, at pp.66-71, at p.70, available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2016/01/BIDOFCoreBook17.pdf [last accessed on 07/11/2018]: Something expanded further in Chapter 6 in other jurisdictions.

[43] Note from Meeting from 26th September 2008, DOF01B02, DOF03375-001-002, pp.198-199, at p.198 available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2016/01/BIDOFCoreBook18.pdf [last accessed on 07/11/2018].

[44] *Ibid*.

[45] "Northern Rock deposits guaranteed", BBC News, Monday 27th 2007, available at http://news.bbc.co.uk/2/hi/business/6999615.stm [last accessed on 07/11/2018]

[46] *Credit Institutions (Financial Support) Act 2008* at s.6(1) available at http://www.irishstatutebook.ie/eli/2008/act/18/enacted/en/print.html [last accessed on 07/11/2018]

property development loans from Irish banks and resale these once the economic environment improved. These interventions will be discussed further in Chapters 5-6 and 7. However, one of the key aspects of the intervention measures eventually implemented by Member States was the use of State resources as a crisis management response. Acting as a restraint on this were the existing State aid rules but such rules were not designed for a systemic banking crisis.

In contrast to the response of European Union Member States, the authorities in Iceland decided against bailing-out domestic financial institutions and instead established new banks.[47] A response that may have best suited the economic footprint of Iceland, a country that also had its own currency, but could yield a destructive outcome if repeated across the Eurozone. However, the responses of Member States saw crisis management conflict with European Union State aid law. Despite the systemic threat posed by the subprime crisis and the related affects this had on other segments of the economy, Member States did not seek to circumvent European Commission oversight from State aid enforcement. Instead the utilisation of State support via guarantee schemes, bank recapitalisations and asset relief measures, was subject to the Commission's competition enforcement division, DG Competition's review and determination. As will be discussed further in Chapter 5, initially Member States sought to apply Article 107(3)(c)TFEU for State aid intervention for their domestic banking sectors. But with the crisis deepening, this Treaty provision did not suffice and so the "serious economic disturbance" exemption under Article 107(3)(b)TFEU became the key benchmark for authorising or not authorising State aid. Before one can delve into the nuances of European State aid law as applied to the banking sector, an overview of this particular strand of European law will be set out in Chapter 2.

[47] "The financial strength of the deposit guarantee schemes in the EU and Iceland", The Institute of Economic Studies, University of Iceland, Reykjavik. July 14th 2012, at p.4 available at http://www.ioes.hi.is/sites/hhi.hi.is/files/Icesave_C12_06.pdf [last accessed on 07/11/2018].

Conclusion

The aim of this Chapter was to provide a background context as to how the 2008 financial crisis arose. In the United States the roll back of legislation such as the *Glass-Steagall Act* and failure to recognise the systemic threat posed by new banking conglomerates meant that there was no pre-existing bank resolution architecture in place to implement a controlled liquidation of an investment bank such as a Lehman Bros. Within the European Union financial regulation across different Member States remained weak due to structural or resource issues. Furthermore, under Basel II capital adequacy bonds of European Union Member States were considered a low risk investment for financial institutions, this meant that when the repayment of these bonds became subject to market speculation these financial institutions were exposed in some cases to their own domestic sovereign but also other European ones. This sovereign-bank link would be further entwined when Member States had to intervene and bail-out their banking sectors. However, links between financial institutions were also developed and solidified before the financial crisis via the inter-bank wholesale funding market that financial institutions from growing economies such as Ireland sought to access for the purposes of increasing their credit provision.

Chapter Two: Background to European Union State Aid Law

Introduction

The purpose of this Chapter is to set out the primary Treaty-based provisions of European Union State aid law. In this way a background and context to the proposals in the next Chapters can be set out while also providing an insight into how Member States have in the past utilised the State aid exceptions under the European Treaties. By setting out the applicable law under each of the State aid Articles, a clearer picture can be established of how the original concept of State aid control in a European wide context was envisaged. The Chapter starts with a discussion on how State intervention, via State resources, may perform a central role beyond merely that of subsidising an inefficient undertaking. Wider economic and social considerations have also played a key role on how EU State aid policy has developed from the 1960s up to the present day. This Chapter also includes an examination of the Commission’s role of via its Competition Directorate, DG Competition, in interpreting and applying the exact parameters of State aid exemptions under the EU Treaties.

Each of the specific State aid exemptions established under the founding Treaties of the European Union were drafted to address the precise limits of State intervention in the market place under different market environments. This Chapter should provide the reader with a historical view of how Member States have sought to avail of the State aid exemptions. In particular, how State resources can be used as a form of financial support for specific industries and undertakings where wider social and economic factors may need to be considered. Hence, in a financial crisis the State aid response adopted by Member States was not an isolated event but rooted in historical practices of taxpayers rescuing failing undertakings in industries with particularly large employment and economic footprints.

2.1. Member States and European State Aid Law

When seeking to establish a common market, it became clear to the drafters of the European Community Treaties that one possible obstacle to this objective could be Member State interference. In particular, this interference could take the form of continuing to subsidise unprofitable domestic undertakings so that these businesses would continue to provide a source of employment. If one examines the political and economic history of Member States such as France and the United Kingdom, a picture of repetitive State support for inefficient companies is quickly drawn. In France policymakers from the late 1700s sought to adopt an economic model that was heavily dependent on the State, a form of controlled economy.[1] This meant the State becoming the dominant shareholder in strategic industries such as coal, steel and ship building. In the United Kingdom, industrial strife in the 1960s and 1970s saw private owned corporations such as British Leyland nationalised and propped up with taxpayer funds.[2] These two examples illustrate that for any common market to work constraints would have to be placed on how much support Member States could provide to domestic undertakings be they public or private

Therefore, specific Treaty provisions, which will be discussed below, were established prohibiting State aid unless certain exemptions were met. In this way Member States could no longer utilise their resources for the purposes of ensuring an inefficient undertaking could retain market share at the expense of more efficient unaided rivals within the same market segment. State aid could arise where a Member State sought to provide State funds in a selective manner to certain economic undertakings and this support could cause a trade distortion within the common market between different Member States.[3]

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[1] B. Clift, "Economic Patriotism, the Clash of Capitalisms and State Aid in the European Union", online version of accepted paper from Journal of Industry, Competition and Trade, at p.23 available at http://wrap.warwick.ac.uk/43616/1/WRAP_Clift_0370082-pais-270312-economic_patriotism__state_aid_final.pdf [last accessed on 18/01/2019].

[2] British Leyland: the next decade, An abridged version of a Report presented to the Secretary of State for Industry by a Team of Inquiry led by Sir Don Ryder, at p.66 available at http://filestore.nationalarchives.gov.uk/pdfs/small/cab-129-183-c-75-53-3.pdf [last accessed on 07/11/2018].

[3] Case C-200/97, *Ecotrade v. Altiforne Fierriere di Servola Spa (AFS)*, [1998] E.C.R. I-7926 at para.41 available at

2.2. The Role of the Commission in State Aid Enforcement

It would be the role of the Directorate General for Competition of the European Commission to assess application from Member States and then determine whether the proposed aid fell within the parameters of the specific State aid exemptions of the Treaty.[4] Thus in this way State aid oversight and authorisation was removed from the national competences of Member States and placed within the European Community architecture. From assessing the State aid applications of Member States the Commission gradually developed a jurisprudence of decisions that could provide the parameters of what could or could not constitute compatible State aid under the relevant exemptions. When exercising its role of State aid assessor, the Commission applied key three criteria to State aid applications that would become central to EU State aid policy. These included, (a) whether the aid was required to achieve the objective in question, that is the aid will incentivise a recipient to undertake a function or to restructure; (b) was the aid the "minimum amount necessary" to achieve this objective; and (c) were there safeguards in place to alleviate any possible competition distortions that might arise from this intervention.[5] Furthermore, from this interaction between Commission and Member State a number of questions arose that required the adjudication of the Court of First Instance and the European Court of Justice. Thus questions such as what constituted State aid and the exact parameters of whether or not certain providers of State aid were actually emanations of the State were established by the Union Courts.[6] The exact nuances of the Union Court's interpretation

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http://curia.europa.eu/juris/showPdf.jsf?text=&docid=43754&pageIndex=0&doclang=EN&mode=req& dir=&occ=first&part=1&cid=206136 [last accessed on 07/11/2018].

[4] T. Cottier, G. Malumfashi, S. Matteotti-Berkutova, O. Nartova, J. De Séipbus and S.Z. Bigdell, "Energy in WTO Law and Policy" in Thomas Cottier and Panagiotis , (eds.), *The Prospects of International Trade Regulation: From Fragmentation to Coherence*, (Cambridge: Cambridge University Publishing, 2011) p.211 at p.232.

[5] Common Principles for an Economic Assessment of State Aid under Article 87(3), European Commission, at p.1 available at http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf [last accessed on 09/01/2018].

[6] Case 730/79, *Philip Morris Holland BV. v Commission*,[1980] E.C.R. 0-2671 paras.25-26 available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:61979CJ0730&from=EN#I2 [last accessed on 07/11/2018]; Case C-303/88, *Italy v. Commission of the European Communities* [1991] ECR I-1470 available at http://curia.europa.eu/juris/showPdf.jsf?docid=96321&doclang=EN [last accessed on 07/11/2018]

of what constitutes State aid and the associated questions of selectivity and possible market place distortion will not be examined in detail in this Thesis but simply referred to here to illustrate the wider State aid environment within the European Union.

2.3. Market Economic Investor Principle

When assessing a Member State's provision of financial support to undertakings, it may not necessarily follow that this support falls within the remit of State aid. In certain cases, it may be that a Member State has provided this support on terms that match those of a normal market investor. This is known of the Market Economic Investor Principle as the Member State in question is not necessarily seeking to subsidise an undertaking with public funds but rather investing in this firm as a normal market investor would.[7] This may result in conflict between Member States and Commission with the former seeking to cloak its financial support to an undertaking as an investment while the latter may adopt a more circumspect stance and view this intervention as State aid. For example, in the case of *Tubemeuse* the CJEU made it clear that a private market operator may very well continue to advance capital to a failing undertaking provided that there is some evidence of long-term viability.[8]

This became the central question in the case of *Italy v Commission* as the State-owned ENI-Lanerossi had provided substantial support to four related loss-making subsidiaries.[9] The CJEU found that this level of support was not in line with the actions of a private market operator and thus the parent company's support constituted State aid.[10] Applying a hypothetical private market benchmark ensures that even in more complex situations both the

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[7] Case C-303/88, *Italy v. Commission of the European Communities* [1991] ECR I-1470 available at http://curia.europa.eu/juris/showPdf.jsf?docid=96321&doclang=EN [last accessed on 07/11/2018].
[8] Case C-142/87, *Kingdom of Belgium v. Commission of the European Communities* [1990] available at ECR I- 1005 https://eur-lex.europa.eu/resource.html?uri=cellar:605288d7-0516-492a-a443-f54d63b62961.0002.03/DOC_1&format=PDF [last accessed on the 07/11/2018].
[9] Case C-303/88 *Italy v. Commission of the European Communities* [1991] ECR I-1470 available at http://curia.europa.eu/juris/showPdf.jsf?docid=96321&doclang=EN [last accessed on 07/11/2018].
[10] *Ibid* at para.24.

Commission and the Union Courts can compare the conduct or market activity of State owned undertakings with the normal functioning market developments of a non-public market place. For example, in the case of *LINDE v Commission* two State-owned undertakings sought to exit a contract for the supply of carbon monoxide via in effect subcontracting the performance of this contract to a third party.[11] The Commission concluded that had the State owned entities did not engage in the same manner as private market operators as private operators would not have entered into a contract with an uncompetitive production cost.[12] The applicant in this case sought to have this decision set aside on the basis that the contractual agreement between it and the entities associated with the State was entered into on purely commercial grounds.[13] A normal market operator would seek to in some way divert their contractual obligations to another party where they themselves could not perform the contract as agreed with the purchasing undertaking.[14]

The Court of Justice accepted this argument as "from a commercial point of view, it was logical for the BvS and LWG to try and find a solution enabling them to put an end to their obligation to supply carbon monoxide".[15] One way of successfully achieving this aim would indeed entail outsourcing the performance of the contract to a third party.[16] Further, in this case the decision on the part of both BvS and LWG, the State entities, to award this contract to the applicant was done so on an "economically rational" basis as the latter already had some of the infrastructure in place to produce carbon monoxide.[17] The Court thus found that in this particular case the State had via the two entities BvS and LWG acted as a normal market operator would in the same circumstances.[18]

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[11] Case T-98/00 *LINDE AG v. Commission of the European Communities* [2002] ECR II-3963 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62000TJ0098&from=EN [last accessed on 07/11/2018].
[12] *Ibid* at para.36.
[13] *Ibid* at para. 24.
[14] *Ibid*.
[15] *Ibid* at para. 43.
[16] *Ibid* at para. 44.
[17] *Ibid* at para. 45.
[18] *Ibid* at para. 49.

In more recent years Commission has applied the market economic investor test to State owned infrastructural projects or facilities. For instance, in one decision from 2014 the Commission found that the marketing arrangement agreed between Saarbrucken airport and Air Berlin was in line with how a normal market operator would have engaged with this airline.[19] Under this arrangement the airline would increase its frequency of flights to the airport in return for a fee of €800,000 to €1.7million from the airport.[20] However, as this contract was profitable for the airport and did not increase the actual service costs associated with the new number of flights the Commission found that this contract met the market economic operator principle and thus did not form State aid.[21]

2.4. Treaty based exemptions to State aid law

The core reason for State aid control at a European Union level is to ensure that Member States do not provide certain supports or advantages to domestic undertakings at therefore cause competition distortions. However, there are a number of exemptions to the State aid prohibition that Member States are able to apply if certain conditions are met. In most cases these exemptions relate to an underlying social or economic objective that the proposed State aid seeks to achieve. For example, under Article 106 Member States are able to subsidise undertakings for providing a public service once this subsidy is subject to an open tender and has a specific public service remit to meet.[22] This will be examined in Chapter 6. Under Article 107(3)(c)TEFU, Member States are allowed to provide State aid to a failing undertaking so that it can be restored to long-term viability, this will be examined further in Chapter 3.[23] Other State aid exemptions which will not be examined here but simply mentioned for completion include regional supports to economically

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[19] Commission Decision available at http://ec.europa.eu/competition/state_aid/cases/243806/243806_1653208_366_2.pdf [last accessed on 07/11/2018].

[20] *Ibid* at para.342.

[21] *Ibid* at paras. 343-344.

[22] Article 106(2)TEFU available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E106:EN:HTML[last accessed on 07/11/2018].

[23] Article 107(3)(c)TFEU available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:12008E107 [last accessed on 07/11/2018].

disadvantaged regions within Member States and special supports for cultural promotion.[24]

2.5. Article 107(3)(b) TFEU and serious economic disturbance

One of the least used State aid exemptions established under the Treaty remains Article 107(3)(b)TFEU. Under this provision Member States have discretion to provide aid to "promote the execution of an important project of common European interest or to "remedy a serious disturbance in their economy". A "serious disturbance" would at first glance appear to include natural disasters but State aid to help undertakings from floods, earthquakes and other Acts of God, falls under Article TFEU.[25] Alternatively, it come mean a Member State experiencing internal economic challenges brought about by political developments such as the unification of Germany. However, a specific Treaty provision was enacted for this exact purpose under Article TFEU. But this specific "serious disturbance" exemption has been utilised in the past by Member States during the 1970s oil crisis. The Commission issued a Communication whereby aid under this exemption could be granted so long as the recipient undertakings were either (a) fundamentally sound and only required aid due to the wider macro-economic circumstances or (b) undertakings that did require restructuring but this restructuring could not take place due to the present economic circumstances.[26] Furthermore, due to the exceptional high costs facing undertakings from the sharp increase in oil, Member States were allowed to support employee wages and other operating costs.[27] In this particular case, the "serious disturbance" exemption was applied in a Union wide manner to all Member States. However, it was not until the 1980s that saw on Member State, Greece, seek to avail of this exception. Due to the need to restructure

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[24] Article 107(3)(a)TFEU available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:12008E107 [last accessed on 07/11/2018]; Article 107(3)(d)TFEU available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:12008E107 [last accessed on 07/11/2018].
[25] Article 107(3)(b)TFEU available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107 [last accessed on 07/11/2018].
[26] European Commission Fifth Report of Competition Policy, April 1976, at para. 133 available at http://ec.europa.eu/competition/publications/annual_report/ar_1975_en.pdf [last accessed on 07/11/2018].
[27] *Ibid*.

its economy soon after membership, the Greek authorities were allowed to provide aid to domestic undertakings to alleviate the country's unemployment problems.[28]

German authorities also sought to utilise the serious economic disturbance exemption in respect of subsidising the transfer of car manufacturing plants from the West to the East of the country.[29] However, the Commission applied a high threshold for what could constitute a "serious economic disturbance" within a Member State and concluded that as only one particular region of the unified German State, was economically depressed this did not fall within the purview of Article 87(3)(b)EC.[30] For this exemption to apply in this case, the German economy as a whole would have to be experiencing a "serious economic disturbance".[31] During the financial crisis the "serious economic" disturbance criterion would be met necessitating the introduction of specific State aid framework for banks and a Temporary framework for the wider economy.[32]

Conclusion

This Chapter sets out the core precepts of European State aid law and how these precepts have been applied by both Member States and the European Commission. There are a number of different Article based exemptions that allow for Member States to provide State aid support to undertakings based

[28] Commission Decision 88/167/EEC of 07/013/87 *concerning Law 1386/1983 by which the Greek Government grants aid to Greek industry*, [1988] OJ L76/18 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31988D0167&from=EN [last accessed o 07/11/2018].
[29] Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagon AG and Volkswagon Sachsen GmbH v. Commission* [1999] ECR II-3670 at para. available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61996TJ0132&from=EN [last accessed on 07/11/2018].
[30] Commission Decision (94/1068/EC) of 27th July 1994 *concerning aid granted to the Volkswagon Group for investments in the new German Länder* [1994] OJ L385/1 at 5 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31994D1068&from=EN [last accessed on 07/11/2018].
[31] *Ibid* at L385/9.
[32] Commission Communication (2011/C6/05) of 11/01/2010 Temporary Union framework for State aid measures to support access to finance in the current financial and economic crisis, [2010] OJ C6/5 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011XC0111%2801%29&from=EN [last accessed on 16/12/2015].

on a number of different factors. Instead of trying to devise ways in which to develop a complete bar against Member States propping up national champions ranging from heavy industry to airlines, the founding principles of the original EU Treaties, allowed for State intervention in certain circumstances. These ranged from regional economic development to providing aid in exceptional economic circumstances. Both of these particular exemptions illustrate that EU State aid law was not developed in isolation from factors arising in the real economy. It also illustrates how EU State aid law could be utilised in various manners to address different factors. For instance, with the oversight of the Commission, Member State resources can be used in an efficient and effective manner to promote economic growth in disadvantaged areas within the Union, ensure the continuation of public services and also as a stabilisation mechanism in times of economic crisis.

However, despite the different exceptions Member States are able to avail of when seeking to support a failing undertaking or promote economic development there was no existing financial crisis framework to leverage when the 2008 crisis began. Despite a developed jurisprudence of case law and Commission decisions on the scope and limits of State aid control, what went before may not be necessarily conducive to what will arise in future. While it may be possible to determine what is the “minimum necessary” level of aid to subsidise the relocation of a manufacturing undertaking from one region to another or to subsidise the provision of a public service obligation, this is not as clear cut in determining what level of aid is required to keep a bank open during a financial crisis. In a similar vein, assessing whether State aid intervention may distort trade between Member States may be easier to determine if the sector in question has a limited footprint but more difficult to assess if multiple Member States are providing aid to domestic undertakings in a sector that remains intrinsic to the wider Union economy such as the banking sector.

Chapter Three: Commission Responses to the Financial Crisis: from Rescue and Restructuring Guidelines to Crisis Communications

Introduction

The aim of this Chapter is to set out the conditions of the "Rescue and Restructuring "Guidelines will be set out and how these Guidelines were applied to financial institutions However, while Member States may have applied these Guidelines in the past to isolated instances of a failing financial institution, they were not specifically designed to address the systemic threat a financial institution could pose during a financial crisis. As examined in Chapter 2, only twice before has the "serious economic disturbance" State aid exemption been applied by Member States for wider economic shocks.[1] But after the introduction of a specific banking crisis framework complex questions related to systemic importance, bank-sovereign loops and long-term viability were not it is posited adequately examined and resolved. Therefore, this Chapter seeks to set the context for the central research questions that will be addressed from Chapters 4 through to 8. It does this by first setting out the background of the Rescue and Restructuring Guidelines followed by critically assessing the Communications issued by the Commission in response to the 2008 financial crisis.[2]

3.1.1. Rescue and Restructuring State Aid Guidelines: Key Criteria

The only way to properly assess what the future needs of a State aid crisis framework for the European banking sector will be is by examining the past interaction between State aid and the banking sector. However, to this one must first set out in the existing conditions and parameters that the Commission applied in general when Member States sought to provide aid to an ailing undertaking. Prior to the financial crisis the pre-existing regime for authorising State aid to failing undertakings was the Rescue and Restructuring Guidelines. These were first issued in 1994 and would be subsequently updated and re-issued in 1999 and again in 2004.[3] The core precepts of these

[1] See Chapter 2 at pp.17-18.
[2] The Impaired Assets Communication will be examined separately in Chapter 7.
[3] Commission Communication (94/C368/05) of 23/12/1994 Community Guidelines on State aid for Rescue and Restructuring Firms in Difficulty [1994] OJ C368/12 available at

Guidelines will be set out and the updated Guidelines from 2014 will be examined to determine whether these reflect the challenges posed by systemic crises in the banking sector.

To fall under the compatibility of Article 107(3)(c)TFEU and the Rescue and Restructuring Guidelines, the undertaking in question should be in "difficulty".[4] "Difficulty" for the purposes of the Rescue and Restructuring Guidelines refers to the capital erosion either a limited or unlimited undertaking may experience and that there is an absence of internal funding or private investment to rescue the undertaking from collapse.[5] When this condition is met then rescue aid can then be provided by the Member State. However, introduced under the 1999 edition of the Guidelines, there was an added restriction that applied to rescue aid, this was the "one time, last time" principle whereby if an undertaking received rescue or restructuring aid once then further aid in future could not be provided.[6] This restriction still applies under the 2014 Guidelines but exceptions do apply where "unforeseen circumstances" have occurred or the recipient undertaking was subsequently merged with another and the merged entity now requires rescue aid or restricting aid.[7] The primary aim of rescue aid is to stabilise a failing undertaking until longer-term viability can be restored and this should only be provided for a six month timeframe.[8]

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http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31994Y1223(02)&from=EN [last accessed on 07/11/2018]; Commission Communication (1999/C288/02) of 09/10/1999 Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty [1999] OJ C288/2 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31999Y1009%2801%29&from=EN [last accessed on 07/11/2018]; Commission Communication (2004/C244/02) of 01/10/2004 Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty [2004] OJ C244/02 available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:244:0002:0017:EN:PDF [last accessed on 07/11/2018].

[4] Commission Communication 92014/C249/01) of 31/07/2014 Guidelines on State aid for rescuing and restructuring firms in difficulty [2014] OJ C249/1 at para. available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0731%2801%29&from=EN [last accessed on 07/11/2018].

[5] *Ibid* at paras.19-20.

[6] See 1999 Guidelines at para.48.

[7] N.4 at para.72.

[8] *Ibid* at para.109.

After this rescue phase the undertaking may then receive restructuring aid provided that there is a restructuring plan in place to help restore the undertaking to long-term viability. Restructuring measures may include the closure of loss making business lines or the exiting of certain product lines.[9] These measures may overlap with the *quid pro quo* competition distortion safeguards the Commission may impose as part of the restructuring plan. The aim behind these safeguards is to ensure that the recipient undertaking does not utilise any State aid provided to expand its market presence at the expense of non-aided competing undertakings.[10] The level of restructuring aid provided should remain the "minimum necessary" to facilitate the restructuring plan. To meet this criterion, both the recipient undertaking and any private investors, should contribute funds to the restructuring process.[11] This "minimum necessary" criterion in effect acts as an additional competition distortion measure as it ensures that the costs of restructuring are where possible internalised by the undertaking itself rather than via excessive State support.

During the initial phases of the financial crisis, the above tenets of the Rescue and Restructuring Guidelines were applied to financial institutions such as Northern Rock and WestLB. This will be examined in greater detail in Chapter 5. However, since the financial crisis has abated the Commission issued updated Guidelines that have sought to leverage the experiences of the financial crisis to augment the existing tenets set out above. For instance, the provision of rescue aid is now based on not alone whether the undertaking in question is failing but also whether this firm plays a systemic role either regionally or within its sector.[12] The collapse of such a firm may result in an

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[9] European Commission Press Release: State aid: *Commission approves restructuring plan of French Areva Group*, January 10th 2017 available at http://europa.eu/rapid/press-release_IP-17-36_en.htm [last accessed on 10/01/2017].

[10] Commission Decision SA.49619(2017/N) of 22/01/2018-*Croatia-Rescue aid in favour of Uljanik Shipyard*, OJ C(2018)488 at para.47 available at http://ec.europa.eu/competition/state_aid/cases/272430/272430_1961882_178_2.pdf [last accessed on 07/11/2018].

[11] Commission Decision State Aid SA.48394 (C/2018) (ex2017/N*)* of 08/05/2018 *Romania-Restructuring of National Uranium Company (CNU)*, OJ C(2018)2668 at para.45 available at http://ec.europa.eu/competition/state_aid/cases/274529/274529_1992454_20_2.pdf [last accessed on 07/11/2018].

[12] N.4 at para.44(c),(e),(f) and (g).

increase in regional unemployment, loss of a service to the public or undermine the interest of consumers and other undertakings if the undertaking can no longer provide a specific product.[13]

From these developments in the new Rescue and Restructuring Guidelines one can see how the Commission has learnt from the lessons of the financial crisis and now applied these to non-banking contexts. The systemic role of an undertaking is now recognised where this undertaking has a wider social or market value. This illustrates the wider effects of the financial crisis on the State aid sphere beyond the banking sector. Systemic importance is now recognised in a non-banking context. But there is no in depth examination of how systemic importance may be determined in times of economic crises nor is there any examination of how systemic importance interacts with the question of long-term viability of a recipient undertaking.

3.2.1. Rescue and Restructuring Framework and Financial Institutions in the 1990s

There have been a number of State aid applications under the Rescue and Restructuring Guidelines related to the European banking sector. In a number of these cases the same problems that would face Member States during the financial crisis would also be evident. These include, the question of systemic importance, long-term viability and the level of aid that could be provided under the confines of the Article 107(3)(c) TFEU exemption. Both Rossi and Sansonetti provide a good overview of Commission State aid decisions for the banking sector during the 1990s.[14] Other than the locus classicus case of Credit Lyonnais (discussed in more detail below), other financial institutions also required State support. For example, in the case of the Spanish bank Banesto a State recapitalisation was deemed sufficient to resolve the financial problems facing this financial institution.[15] Interestingly, the overlap between State aid and bank resolution measures was evident in this particular decision as the funding in question was provided by the Spanish Deposit Guarantee

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[13] *Ibid*.

[14] P. Rossi and V. Sansonetti, "Survey of State Aid to the Lending Sector-A Comprehensive Review of Main State Aid Cases" at pp.6-15 available at http://www.side-isle.it/ocs/viewpaper.php?id=75&cf=1 [last accessed on 07/11/2018].

[15] *Ibid* at p.9.

Fund, a vehicle funded by private banks in Spain.[16] Therefore due to the private nature of financial support to Banesto the Commission concluded that there was no State aid involved in this rescue programme.[17]

In contrast with the Banesto decision, in the cases of Credit de Foncier and the GAN insurance group, the support provided was not from private sector sources but from the State. The French authorities extended an explicit State guarantee to Credit de Foncier in conjunction with a recapitalisation scheme.[18] Due to the substantial market presence of the GAN group, when the initial rescue plan failed to succeed, the French State sought to provide further financial assistance via a second State aid application.[19] As Rossi and Sansonetti, note this second State aid provision, at 20 billion francs, was "7 times bigger than the original aid".[20] For this second application to meet State aid guidelines the recipient institution had to dispose of a number of business units and reduce its balance sheet.[21]

Instead of the French authorities seeking to liquidate either Credit de Foncier or the GAN group, the first response was to bail both institutions out with State resources. Similarly, the level of aid provided in respect of the GAN group drastically increased from the first to the second State aid applications.[22] This indicates the main challenge facing Member States when seeking to support a financial institution via State aid intervention namely that if liquidation is not considered a viable option then continued State support may remain the only course of action. A problem which also arose under the financial crisis State aid framework whereby Member States had to continually re-assess the level of State aid required to recuse and restructure

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[16] *Ibid*.
[17] *Ibid*.
[18] Commission Decision (2001/89/EC) of 23/06/1999 *conditionally approving aid granted by France to Credit Foncier de France* [2001] OJ L34/1 at paras.20-21 available at http://eur-lex.europa.eu/legal content/EN/TXT/?uri=uriserv:OJ.L_.2001.034.01.0036.01.ENG&toc=OJ:L:2001:034:TOC [last accessed on 07/11/2018].
[19] Commission Decision (98/204/EC) of 30/07/1997 *conditionally approving aid granted by France to the GAN Group* [1998] OJ L78/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998D0204&qid=1457685925033&from=EN [last accessed on 07/11/2018].
[20] N.14 at p.13.
[21] N.19 at L78/12.
[22] *Ibid* at L78/4-5.

the financial institution in question. For example both the Irish and German authorities had to constantly increase the recapitalisation provisions for Anglo Irish Bank and Hypo Real Estate respectively.[23]

3.2.2. Credit Lyonnais

The support provided to Credit Lyonnais remains a key benchmark for the application of State aid to the banking sector. Credit Lyonnais had a dominant presence within the French banking market and also had an international presence.[24] During the mid to late 1990s the institution generated substantial losses due to a decline in the French real estate market.[25] Somewhat surprisingly, as noted by Rossi and Sansonetti the initial aid provided by the French State was authorised under Article 87(1)(a)EC as the intervention in question would safeguard employment.[26] However, the first recapitalisation failed to resolve the problems at the bank and so a second application was submitted to the Commission for approval. In order for this second application to be deemed compatible with the internal market the institution had to be subject to an in-depth restructuring.[27] This saw the disposal of the institution's international business lines.[28]

There are a number of strands to the Credit Lyonnais State aid applications which again provide pointers as to how Member States would react during the financial crisis. Firstly, the Member State in question sought to invoke a different State aid exemption than the normal Article 87(3)(c)EC rescue and restructuring Treaty clause. The role of Credit Lyonnais was such that restoring the financial institution to long-term viability would not just benefit the recipient institution it would also have a wider economic benefit. Secondly, in both Credit Lyonnais decisions the Commission refused to apply Article 87(3)(b)EC a position also initially adopted by the Commission during

[23] See Chapter 5 at p.138.
[24] Commission Decision (98/490/EC) of 20/05/1998 *concerning aid granted by France to the Credit Lyonnais Group*, [1998] OJ L221/28 available http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998D0490&from=EN [last accessed on 07/11/2018].
[25] *Ibid* at L221/65.
[26] N.14 at p.9.
[27] N.24 at L221/73.
[28] *Ibid*.

the early phases of the financial crisis.[29] Thirdly, the one time, last time principle was relaxed for both GAN and Credit Lyonnais, in effect the complexities of financial institutions are such that policy makers struggle to accurately forecast the required level of aid. This in turn necessitates the need for additional State aid applications as the initial sum may not suffice to stabilise the financial institution in question. Fourthly, financial institutions such as Credit Lyonnais, in effect become subject to State aid support due to their market position rather than objectively meeting long-term viability criteria. All of these issues would also become evident during the financial crisis as per the critical overview provided below. This examination will now begin with the Guarantee Communication and then continue through the subsequent Communications issued by the Commission.

3.3.1. The EU crisis framework for financial institutions: Eligibility and Guarantee Schemes

The first communication issued by the Commission in respect of the financial crisis for the banking sector focused on the exact application of State guarantees and the precise limits of these schemes in respect of participating financial institutions.[30] To prevent a possible subsidy race among Member States the Communication proposed that guarantee schemes should cover "all institutions incorporated in the Member State concerned, including subsidiaries and with significant activities in that Member State should be covered by the scheme".[31] Basing eligibility grounds on the nationality of a financial institution would of course run counter to the foundations of EU competition law. On the other hand, this "invitation clause" would potentially pose problems for Member States with limited resources unable to implement an effective guarantee scheme for all financial institutions within their jurisdiction. It seems that some Member States adopted a flexible approach

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[29] *Ibid* at L221/64; Commission Decision (95/547/EC) of 26/12/1995 Credit Lyonnais [1995] OJ L308/92 at L308/114 available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:31995D0547 [last accessed on 07/11/2018].

[30] Commission Communication (2008/C270/02) of 25/102/2008, "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 C 270/8 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1025%2801%29&from=EN [last accessed on 07/11/2018].

[31] *Ibid* at para.18.

to the application of this particular clause. For instance, the Irish government refused entry of a German investment bank into the Irish guarantee scheme.[32] The institution was later subject to German State aid support as part of the wider efforts to restructure the Hypo Real Estate Group.[33]

3.3.2. Scope of Guarantee Scheme

Member States were allowed some discretion under the first Communication in respect of the scope of any guarantee scheme introduced. Extending a guarantee scheme beyond retail deposits was allowed so long as this did not "delay the necessary adjustment process and [did not] generate harmful moral hazard".[34] Financial liabilities which facilitated the day-to day needs of the wider EU banking sector, such as "wholesale deposits and even short and medium term instruments" could also be subject to a guarantee scheme.[35] Guaranteeing all the liabilities of a financial institution, including subordinated debt, was not considered a prerequisite as according to the Communication this would only bolster the position of institutional shareholders and investors.[36] As DeVito comments applying strict eligibility criteria to the liabilities covered by a guarantee scheme ensures that "unhealthy banks share the burden of the consequences of the crisis, and that they properly contribute to the costs of their rehabilitation".[37] This Communication was adopted post the decision of the Irish State to invoke a blanket guarantee scheme covering all forms of liabilities and in any case arguable failed to provide a sufficient framework for banking guarantee schemes in times of systemic crisis. Instead of adopting set ceilings and

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[32] *Copy of email sent from Irish Banking Association to Office of Taoiseach-Re DEPFA Banks access to Irish Guarantee Scheme* available at https://www.documentcloud.org/documents/1503512-depfa-document.html#document/p1 [last accessed on 07/11/2018].

[33] Commission Decision State Aid NN 44/2008 of 02/10/2008 *Rescue aid for Hypo Real Estate*, OJ C(2008) 5735 at para.5 available at http://ec.europa.eu/competition/state_aid/cases/227668/227668_1072011_33_1.pdf [last accessed on 07/11/2018].

[34] *Ibid* at para.20.

[35] *Ibid* at para.21

[36] *Ibid* at para.23.

[37] J. DeVito, "The Role of Competition Policy and Competition Enforcers in the EU Response to the Financial Crisis: Applying the State Aid Rules of the TFEU to Bank Bailouts in Order to Limit Competition Distortion in the Financial Sector", AAI Working Paper 11-01, April 14th 2011, at p.22 available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809772 [last accessed on 07/11/2018].

restrictions on the scope of guarantee schemes, exemptions were allowed which in turn further undermined the financial position of the Member States in question. Traditional State aid remedies were applied to a non-traditional systemic crisis.

3.3.3. Minimum Necessary and guarantee schemes

The Guarantee Communication established number of conditions to ensure that only the "minimum aid necessary" was provided via a State guarantee scheme.[38] For instance, each participating institution to a guarantee scheme was liable to pay a fee that "should come as close as possible as what could be considered a market price".[39]An obvious problem though arises in cases where the recipient institution may be unable to discharge this fee. Calculating a "market" based price for a non-market based response may require hypothetical benchmarks which fail to reflect actual market realities. For example in the case of the guarantee scheme for Latvian banks the absence of an international credit default swap rating for Latvian financial institutions meant that a sample basis for euro area large banks had to be applied instead.[40] Although this practice was in line with ECB recommendations for bank guarantee fees, and the Guarantee Communication approach. This meant that the Latvian banks would have to discharge an annual fee of 1.048% whereas a financial institution in the larger and more profitable German market would pay a smaller fee.[41] A "reimbursement clause" also applied so that in the case of guarantee scheme been triggered the beneficiary institution would repay, along with the wider banking sector, the relevant funds to the scheme.[42] Yet, such a clause seems somewhat redundant in a market environment, where neither the institution triggering

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[38] N.30 at paras.19-23.
[39] *Ibid* at para. 26.
[40] Commission Decision N638/2008 of 22/12/2008 *Guarantee scheme for banks in Latvia*, OJ C(2008) 8951 at para.11 available at http://ec.europa.eu/competition/state_aid/cases/228884/228884_921114_22_2.pdf [last accessed on 07/11/2018].
[41] Commission Decision State aid N244/2009 of 07/05/2009-*Commerzbank-Germany*, OJ C(2009) 3708 at para.30 available at http://ec.europa.eu/competition/state_aid/cases/231053/231053_959312_23_1.pdf [last accessed on 07/11/2018].
[42] N.39.

the scheme nor competing institutions may be able to provide any sufficient funds to a depleted guarantee scheme.

One must question the wider economic context prevailing at the time a State guarantee may be introduced and how this may affect the objective interpretation of the term “minimum necessary”. Voszka states that although the Commission may have satisfied a “moral stability” principle in authorising substantial State aid interventions in the banking sector, it also failed to “stem the tide of aid” and thus bears some responsibility for entrenching the sovereign-bank link.[43] There remains a balance to strike between stabilising the wider economic environment as effectively as possible on the part of Member States while ensuring that the longer-term costs do not undermine the financial position of the sovereign. If the “minimum necessary” criterion were to be applied to rigidly to a guarantee scheme both in scope and value, then a sovereign-bank link may still arise. However, even during the 2008 crisis State guarantees did not necessarily undermine the financial position of the State guarantor. For example, the French guarantee scheme may have resulted in an overlap between both State and domestic banking sector resources, but this did not develop into a prolonged and entrenched sovereign-bank link.[44] Perhaps the particular structure of the scheme, whereby French banks also provided funds in conjunction with the French State to a central guarantee fund, the SRAEC, ensured that if anything there was a sovereign-bank partnership rather than a sovereign-bank fusion based on the former absorbing the debts of the latter.[45] One could posit that in this particular example, the “moral stability” principle had been met whereas if one considers the longer-term consequences for the Irish sovereign arising from its guarantee scheme, short-term stability was achieved at longer-term costs. The Guarantee Communication like the

[43] E. Voszka, “Competition Policy in Europe-Temporary or Long-lasting Changes?” (2012) Vol.57(1) Public Finance Quarterly pp.71-90 at p.82 available at https://www.asz.hu/storage/files/files/public-finance-quarterly-articles/2012/a_71_90_voszkaeva.pdf [last accessed on 07/11/2018].

[44] Commission Decision State aid N548/08 of 30/10/2008, *French Republic Scheme for refinancing financial institutions*, OJ C(2008) 6617 available at http://ec.europa.eu/competition/state_aid/cases/228173/228173_1018733_33_1.pdf [last accessed on 07/11/2018].

[45] *Ibid* at para.5.

succeeding Communications were not designed to adequately strike the balance between short-term stability and longer-term financial costs to Member States. This will be further discussed in Chapter 4 where proposals to resolve this failing will be set out.

3.3.4. Behavioural Constraints

The Guarantee Communication included behavioural constraints such as barring a beneficiary financial institution from publicising participation in a guarantee scheme and a restriction on balance sheet growth.[46] Both of these constraints though have limited practical benefit, as a financial institution relying on a State guarantee is unlikely to have the resources to expand their balance sheet while there is always likely to be publicity in any case with the introduction of a guarantee scheme. In most cases guarantee schemes are a defensive response designed to retain existing depositors but excessive promotion by a guaranteed institution to “offensively” capture depositors from other Member States should then be followed by censure. For instance, Irish Nationwide Building Society was sanctioned by the Irish financial regulator for openly promoting the Irish guarantee scheme to UK corporate depositors.[47] These were limited behavioural constraints and were not adequately tailored to reflect the nuances of bank guarantee schemes. . Another failure of the Guarantee Communication was failing to align behavioural constraints with longer-term solutions for Member State’s domestic banking sectors. A future State Aid Crisis Framework will have to address these matters so as to reduce the possibility of a yet another future crisis arising.

3.3.5. Liquidation and restructuring

In cases where the guarantee is invoked then the Member State must submit either a restructuring or liquidation plan for the relevant financial institution.[48]

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[46] N.30 at para.27.

[47] *Settlement Agreement between the Financial Regulator and Irish Nationwide Building Society*, 7th October 2008, available at https://www.centralbank.ie/publications/Documents/Irish%20Nationwide%20Settlement%20Agreement%20%20-%207%20October%2008.pdf [last accessed on 07/11/2018].

[48] N.30 at para.30.

A restructuring plan must aim to restore long-term viability, ensure that there is "substantial private participation to the costs of the restructuring", and that competition is not distorted.[49] One must question whether a financial institution that triggered a guarantee scheme can actually be restructured. Any form of "private participation" remains unlikely as presumably depositors will be compensated while other creditors may well have already participated in new share issuances or debt-for-equity swaps prior to the trigger of the guarantee scheme. Presumably a liquidation plan in these circumstances is a better option particularly in light of viable financial institutions having to recompense the guarantee scheme post any trigger. A future State Aid Crisis Framework will have to ensure that while guarantee schemes are allowed as a crisis intervention mechanism by Member States, that insolvent financial institutions are resolved in a controlled manner. An issue that will be examined in Chapter 5.

The Commission has examined the interaction between bank State aid and deposit guarantee schemes when assessing the support provided by the Italian deposit protection scheme to the Banca Tercas.[50] In this case the Italian State argued that the financial support for Banca Tercas was not directly derived from the State but instead came from a private entity namely the Italian deposit guarantee scheme whose membership consists of private banks.[51] To further buttress its argument the Italian State also cited the legal precedent established in a previous State aid case involving the Italian deposit protection scheme.[52] When assessing the funds provided to Banco di Sicilia and Sicilcassa from the same deposit scheme the Commission held that as the scheme remained subject to the oversight of private sector banks then this particular support did not constitute State aid.[53] However, the Commission held in this case that the mandatory nature of the deposit protection scheme

[49] *Ibid* at para.31.
[50] Commission Decision SA.39451 (2015/C) (ex/2015NN) of 27/02/2015, *State support to Banca Tercas*, OJ C (2015) 1404 available at http://ec.europa.eu/competition/state_aid/cases/257219/257219_1639537_16_2.pdf [last accessed on 07/11/2018].
[51] *Ibid* at para.32.
[52] *Ibid* at para.33.
[53] *Ibid*.

whereby all banks in Italy must contribute and the fact a State emanation, the Bank of Italy, had control over the funds of the scheme meant that the support tendered to qualify as State aid.[54] This particular case highlights how the concept of State aid intervention within the banking sector may be construed in a wider manner than say a non-banking context. Although, the funds in this case were from private undertakings the actual authorisation for using these funds remained with a State body. This position would also be adopted in respect of the Single Resolution Fund aid whereby despite the initial funding coming from private banks, the actual utilisation of this aid requires State aid oversight and authorisation from the Commission.[55]

3.3.6. Recapitalisation of fundamentally sound institutions under the Guarantee Communication

The Guarantee Communication was not just setting out parameters for guarantee schemes. It also set out how Member States should consider the recapitalisation needs of financial institutions. For "fundamentally sound" financial institutions, the conditions for State recapitalisations again entailed meeting the "minimum necessary" criterion and safeguarding against competition distortion by imposing operational fetters on the recipient financial institution.[56] Any return the Member State received for this recapitalisation measure should also comply with a market based return.[57] Applying the market economic investor principle in times of financial crisis may seem somewhat contradictory as clearly no private market actor could provide the level of support to a national banking sector that a Member State can. On the other hand, a private market investor in times of financial crisis may forgo a penal rate of return if this aids the long-term financial health of the institution in question. For example, the rate of return applied to capital injection for HSH Nordbank was set by the German authorities at a 10%

[54] Commission Fact Sheet: *State aid to the Italian bank Banca Tercas and the financial sector in general*, 23rd December 2015 available at http://europa.eu/rapid/press-release_MEMO-15-6394_en.htm [last accessed on 07/11/2018].
[55] See Chapter 8 at p.287.
[56] N.30 at para.35.
[57] *Ibid* at para.39.

dividend return on the initial €3 billion recapitalisation.[58] In contrast the rate of return for the capital injection of the same value provided to Hypo Real Estate by the German State via the German Bank Restructuring Fund was also set at 10%.[59] Yet in the latter case the financial institution was clearly unviable and was wound-down over time while in the former case the bank still maintains a market presence. This question of what is or not a financial institution will be further examined in Chapter 6. But the above conditions for repayment again illustrate the focus of the Commission on establishing pre-existing State aid rules to a non-traditional crisis scenario.

The level of repayment has been subject to assessment by the General Court in a case where both the Dutch State and financial institution, ING Group, sought to contest a Commission Decision on this matter. In this case the Dutch State had agreed to alter the repayment terms concluded with ING so that the overall recapitalisation increased by some €2 billion.[60] The Commission found that such an amendment could not meet the private market investor criterion and so constituted additional aid.[61] Finding for the Dutch State and ING Group, the General Court found that the Commission had to apply a hypothetical private market investor test in this case and that failing to do so was a manifest error.[62] The Commission had not undertaken an assessment as to whether or not a private market operator would have agreed to alter these terms in line with the agreement made between ING and the Dutch State.[63] Therefore, by default any amendments to this support would still *ipso facto*

[58] Commission Decision N264/2009 (ex-PN59/2009) of 29/05/2009 *Rescue aid (recapitalisation and risk shield) to HSH Nordbank AG* OJ C(2009) 4297 at para.13 available at http://ec.europa.eu/competition/state_aid/cases/231161/231161_979302_94_2.pdf [last accessed on 07/11/2018].

[59] Commission Decision State aids n C15/2009 (ex 196/2009), N333/2009, N557/2009 of 13/11/2009, *Hypo Real Estate-Extension of formal investigation procedure, and temporary find capital injections compatible*, at para.52 available at http://ec.europa.eu/competition/state_aid/cases/233442/233442_1034458_31_1.pdf [last accessed on 07/11/2018].

[60] Case T-29/10 and T-33/10, *Kingdom of Netherlands and ING Groep NV v. Commission*, ECLI:EU:T:2012:98 at para.5 available at http://curia.europa.eu/juris/document/document.jsf?text=&docid=120001&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1530270 [last accessed on 07/11/2018].

[61] *Ibid* at para.99.

[62] *Ibid*.

[63] *Ibid*.

fall within the State aid domain. The Court of Justice upheld the position of the General Court and found that the nature of the investments in question, the bank securities held by the Dutch State, were such that an investor might seek to amend the terms of repayment depending on wider market considerations.[64] Thus while the previous incarnation of this State support may have constituted State aid this did not necessarily preclude the application of the private market economy investor test in the future. This case illustrates the complexities of applying State aid law in cases where the wider market environment may change over time and so the underlying objectives of the Member State may change from those of safeguarding the State to acting as a market investor.[65] A future State Aid Crisis Framework will have to address these complexities and seek to ensure that the relationship between State aid and the role of the State are clearly set out. This is an issue which will be further examined in Chapter 6 trying to establish what level of support a Member State should provide to long-term viable financial institutions.

3.3.7. Controlled liquidation and "Minimum Necessary"

The Guarantee Communication does briefly address the issue of how exactly State aid policy and liquidation may work in conjunction.[66] A series of rather general provisions apply where a Member State decides to liquidate an institution, these include the need for any liquidation process to "minimise moral hazard", not to distort competition and that any aid provided during the process is the "minimum necessary".[67] Yet in certain cases the minimum amount of aid necessary may not necessarily constitute a limited amount of aid either in time or scope. For instance, in the case of Roskilde Bank the Commission accepted the Danish authorities' position that supporting only the claims of depositors would not suffice in restoring wider market

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[64] Case C-224/12P, *Kingdom of Netherlands and ING Groep NV. Commission*, ECLI:EU:2014:213 at paras.33-36 available at http://curia.europa.eu/juris/document/document.jsf?text=&docid=150282&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=1530500 [last accessed on 07/11/2018].
[65] The different roles the State may perform in an economy are further examined in Chapter 6.
[66] N.30 at para.43.
[67] *Ibid* at paras.46-48.

confidence.[68] Therefore, senior creditors were also subject to State protection although subordinated creditors were not.[69] If the Commission was to apply a strict interpretation of the "minimum necessary" principle then arguably the support extended to creditors other than depositors by the Danish State would fail to meet this standard.[70] Instead, the Commission appears to have adopted an interpretation whereby considerable weight is attached to the Member State's need to preserve market stability. Therefore, what level of support falls under the "minimum necessary" criterion very much depends on the prevailing context at the time of the State aid application. One of the central aims of this Thesis will be to establish new criteria for what exactly constitutes the "minimum necessary" in the context of both non-blanket and blanket guarantee schemes. Such a new benchmark should seek to strike the balance between short-term stability needs and reducing longer-term costs for Member States. An issue which will be further discussed in respect of deposit guarantee schemes in Chapter 4.

3.3.8. Emergency Liquidity Assistance and State aid

The final section of the Guarantee Communication examines the interaction between the emergency State aid policy and the monetary assistance provided by a Member States' Central Bank. Market wide measures such as short-term lending programs and collateralised agreements are not considered State aid under the 2008 Communication.[71] However, if a Central Bank provides a specific program to an individual financial institution then this may constitute State aid unless a number of conditions are satisfied. These conditions mirror to some degree the Bagehot principles which govern the liquidity relationship between a Central Bank and a bank in times of crisis.[72] For instance, a financial institution availing of a liquidity support must be (a) solvent, (b) provide collateral in exchange for this assistance, (c) pay a "penal interest

[68] Commission Decision NN39/2008 of 05/11/2008 *Aid for Liquidation of Roskilde Bank* OJ C (2008) 6498 available at http://ec.europa.eu/competition/state_aid/cases/227216/227216_921334_42_1.pdf [last accessed 07/11/2018].
[69] *Ibid* at para.82.
[70] This is further examined in Chapters 4-6.
[71] N.30 at para.51.
[72] G. Rosas, "Bagehot or Bailout? An Analysis of Government Responses to Bank Crises", (2006) Vol. 50(1) American Journal of Political Science pp.175-191 at p.177.

rate" and (d) this market intervention must fall under a Central Bank programme and "not [be] backed by any counter guarantee by the State".[73]

Yet if the above ELA conditions were applied to Anglo Irish Bank and to other insolvent financial institutions which availed of ELA, then according to the qualifying criteria set out in the Guarantee Communication such support would constitute State aid. Another aspect of the Anglo Irish Bank liquidity assistance programme was the financial instrument used to facilitate this arrangement, a promissory note guaranteed by the Irish State.[74] Thus in at least one case an emergency support program for an Irish financial institution satisfied two of the four State aid conditions. Yet in this case the Commission was more concerned about the recapitalisation by the Irish State of Anglo Irish Bank rather than that this support may be used to compensate the Irish Central Bank for the ELA provided. Although a detailed examination of ELA is beyond the scope of this Thesis, the above issue highlights the general lowering of criteria that the Commission applied during the 2008 financial crisis. In the wider State aid field, the Commission also failed to apply restrictive criteria and so State resources continued to be injected into the Union banking sector. A problem that a new State Aid Crisis Framework will have to address.

3.4.1. Recapitalisation Communication: Fundamentally sound and unsound institutions

It was not just guarantee schemes that the Commission had to introduce guidance that Member States could apply in their intervention measures. Recapitalising financial institutions also became a key response mechanism for Member States. Therefore, Recapitalisation Communication sets out three aims of recapitalisation programs undertaken by a Member State, these include ensuring financial stability, promoting lending to the "real economy"

[73] N.30 at para.51.
[74] K. Whelan, "ELA, Promissory Notes and All That: The Fiscal Costs of Anglo Irish Bank", UCD Centre for Economic Research, Working Paper Series 2012, WP12/06, February 2012, at p.18 available at https://www.econstor.eu/bitstream/10419/72231/1/742564525.pdf [last accessed on 07/11/2018].

and "dealing with systemic risk of possible insolvency".[75] Obvious contradictions exist between the first two objectives. For instance, financial institutions availing of State support are unlikely to increase lending to customers where this further undermines their financial position. Financial stability and addressing the risk of systemic risk, may require a multifaceted response rather than just through State recapitalisation in isolation from other intervention steps. In respect of competition distortion, the Recapitalisation Communication notes how any "public scheme which crowds out market-based operations" and "frustrate[s] the return of normal market functioning" should be avoided.[76] The Commission originally proposed that this balance could be best struck by differentiating between "fundamentally sound well performing banks on one hand and distressed well-performing banks on the other".[77] A task both the Irish and German policymakers failed when assessing the long-term viability of both Anglo Irish Bank and Hypo Real Estate respectively. Perhaps in a systemic crisis a more practical benchmark to apply is that of a systemic-importance test followed by an assessment for long-term viability or insolvency. In this way Member States would not then have to categorise all financial institutions as fundamentally sound from the onset of the crisis but could instead recognise their systemic importance without this resulting in State resources being misallocated under an unrealistic restructuring plan.

Under the Recapitalisation Communication the importance of aligning the cost of any State aid intervention with market-based prices and return is evident. This "[c]loseness in pricing to market prices is the best guarantee to limit competition distortions".[78] In certain cases a Member State may decide to apply a rate of return below market rates. While the Recapitalisation Communication did allow for this, the Member State in question still had to

[75] Commission Communication (2009/C10/03) of 15/01/2009 "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", [2009] OJ C10/2 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0115%2801%29&from=EN [last accessed on 07/11/2018].
[76] *Ibid* at para.10.
[77] *Ibid* at para.9
[78] *Ibid* at para.19.

ensure that any rate of return below the market price was in line with the recipient financial institution's risk profile and possible competition distortions that may arise.[79] Thus any recapitalisation scheme which did diverge from current market pricing structures should remain "not too distant" from the latter.[80] As noted above, establishing a price threshold for recapitalisation schemes in times of crisis may prove somewhat futile depending on the underlying financial position of the recipient institution in question. Normal market benchmarks may not provide a realistic threshold in times of systemic crisis. This again highlights one of the main failings of the Commission's response to the crisis in that there remained a reliance on a non-crisis market environment as a form of comparison even though such a comparison has limited value in a crisis where market prices and values become distorted.

3.4.2. Exit Strategies and Behavioural Constraints

The Recapitalisation Communication encompasses a number of possible incentives which could be adopted to accelerate the repayment of State aid. These include restricting dividend payments for non-State shareholders and imposing a punitive rate of return on any State recapitalisation.[81] A recapitalisation programme must "be limited to minimum necessary" while any recipient financial institution should be subject to strict behavioural and structural constraints.[82] Russo argues that the absence of a "one-time last time principle" under the crisis framework fails to sufficiently protect against moral hazard concerns. [83] However, applying such a principle in a financial crisis may have a limited creditability as ultimately Member States may need to provide continuous support to recipient institutions if the crisis in question worsens as noted above. What does become evident however when examining the Commission's decisional practice during the crisis is the failure to ensure that behavioural constraints are tailored to reflect the

[79] *Ibid* at para.24.
[80] *Ibid* at para.25.
[81] *Ibid* at paras.31 and 33.
[82] *Ibid* at paras.34-35.
[83] C. A. Russo, "Bail Out Plans: Do They Really Envision State Aid Exit and Bank Repayments? A View from a Competitive Assessment Perspective", (2010) Vol. European Business Law Review pp.491-517 at p. 513.

possible “too-big-to-fail” threat that a recipient financial institution may pose in future.

Certain financial institutions have sought to challenge the imposition of the behavioural constraints applied by the Commission. For instance, the Dutch lender ABN AMRO contested the acquisition ban placed on it by the Commission as a condition of State aid support from the Netherlands.[84] As part of this constraint ABN AMRO was not be able to acquire businesses of a certain size for a period of three years extending to five years if the Dutch State retained its position as the majority shareholder after the initial three year ban.[85]An intriguing aspect to this case was ABN AMRO’s position that, as the State aid provided to the bank was not necessarily due to poor management, the acquisition ban was “excessive”.[86] The General Court dismissed the challenge, placing particular focus on the fact that the Commission’s ban was not punitive but rather a practical measure to ensure that the support provided to the bank remained “limited to the minimum necessary”.[87] In effect the Commission sought to ensure that the recipient financial institution did not use this aid for purposes other than for maintaining its long-term viability. The applicable behavioural safeguards for financial institutions during the crisis will be examined in more detail in Chapters 5 through to 7. However, a new State Aid Crisis Framework will need to strike the balance between maintaining the viability of certain recipient institutions and also ensuring that these same financial institutions do not continue to pose a too-to-big to fail threat in future as noted above. An issue that has not been adequately addressed under the current Commission framework.

[84] Case T-319/11 *ABN Amro Group NV v Commission* ECLI:EU:T2014:186 available at http://curia.europa.eu/juris/document/document.jsf?text=&docid=150615&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1538552 [last accessed on 07/11/2018].
[85] *Ibid* at para.13.
[86] *Ibid* at para.22.
[87] *Ibid* at para.59.

3.5.1. Viability and Restructuring Communication

Although not directly following on from the Recapitalisation Communication, the Viability and Restructuring Communication again charts the same course as previous banking crisis communications.[88]A number of options for policymakers are set out. These include preserving an institution as a standalone entity after an in-depth restructuring or merging with a more efficient undertaking, depending on which option is "less costly" or "less distortive".[89] As noted above in respect of Anglo Irish Bank and Hypo Real Estate, it may not always be easy for policymakers to ascertain whether a financial institution may return to long-term viability. The Restructuring Communication addresses this problem by setting out a definition for what constitutes long-term viability. According to the Commission, "[l]ong-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking into account the risk profile of the bank".[90] Viability may ultimately depend on the "internal measures" taken by the institution but also the "external factors" which may impact the operations of the institution in question.[91] Through the prism of the Irish financial crisis institutions such as Anglo Irish Bank and Irish Nationwide Building Society would clearly fall foul of this definition.

But long-term viability is not a goal easily pursued without State aid intervention even for banks which perform day-to-day economic functions, such as Allied Irish Banks and Bank of Ireland. In the case of both of these institutions, especially so in the case of Allied Irish Banks, long-term viability was only achieved by the Irish State injecting up to €24 billion into both undertakings.[92] Any State intervention which benefits potential long-term

[88] Commission Communication (2009/C195/04) of 19/08/2009 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 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0819%2803%29&from=EN [last accessed on 07/11/2018].
[89] *Ibid* at para.9.
[90] *Ibid* at para.13.
[91] *Ibid* at para.12.
[92] This is further discussed in Chapter 6.

viable financial institutions also seeks to induce a form of equilibrium in the market place during economic instability. This intervention is designed to return the recipient financial institution to a pre-crisis condition. The Restructuring Communication vaguely addresses the intervention costs on financial stability grounds. Where Member States have "recapitalised banks on terms chosen primarily for reasons of financial stability rather than for a return which would have been acceptable to a private investor" then this State aid must be "redeemed" in such a manner as counters any additional State aid element.[93] However, in the case of insolvent but systemically important financial institutions the continuing presence of this bank in the market place due to State aid does constitute a competition distortion that requires specific responses. These will be discussed further in Chapter 5.

3.5.2 Mergers and Viability

Under the Restructuring Communication, stability via bank merger is considered as a possible alternative response provided that any post-merger "integrated entity will be viable" and any aid for funding this merger is accompanied with "appropriate remedies".[94] Some form of State aid based incentive may be required in order to facilitate the purchase by a viable institution of an insolvent competitor. For instance, the Belgian government provided a guarantee to Fortis Bank in order to complete the merger with the French institution BNP.[95] While in Spain a number of Cajas savings banks were also merged with the support of State aid via recapitalisations and guarantee schemes but in some cases these proposed mergers were more difficult to implement than others.[96] After Lloyds Banking Group purchased Halifax Bank of Scotland, the financial losses in the latter undermined the

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[93] N.88 at para.14.
[94] *Ibid* at paras.17-18.
[95] Commission Decision State aid N 255/2009-Belguim and N 274/2009-*Luxembourg* 12/05/2009, *Additional aid for Fortis Banque, Fortis Banque Luxembourg and Fortis Holding* OJ C(2009) 3907 at para.32 available at http://ec.europa.eu/competition/state_aid/cases/231240/231240_1040772_26_1.pdf [last accessed on 07/11/2018].
[96] Commission Decision State aid N 392/2010 of 08/11/2010 *Restructuring of CajaSur* OJ C(2010) 7710 at para.11 available at http://ec.europa.eu/competition/state_aid/cases/237557/237557_1164518_62_2.pdf [last accessed on 07/11/2018]: See also Chapter 6 at pp.

financial position of the former. The only way in which to prevent the newly merged entity from collapsing was for the United Kingdom to provide further financial support via State aid recapitalisations and guarantees.[97] During the Japanese financial crisis of the early 1990s a number of so-called mega-mergers were also rushed through in order to prevent a banking collapse.[98] But recourse to State support was still necessary to "strengthen the capital base" of the newly merged financial institutions.[99] One possible negative consequence of this merger policy is the possibility that the merged financial institutions may constitute a "too big to save problem" over time.[100] This again illustrates the balance both Member State and Commission must strike to ensure that short-term stability measures do not result in longer-term costs.

A merger may be done via an "open and unconditional competitive tender and the assets go to the highest bidder [and] the sale price is considered to be the market price".[101] In these cases there is no provision of State aid as the sale has followed normal market procedures. Where there is a "negative sale price", that is the acquiring financial institution appears to be purchasing the bank in question at below market price, this may not constitute State aid if the alternative of liquidation poses a substantial cost for the Member State.[102] One example of a "negative sales price" was the sale of the German bank Sachsen LB to Landesbank Baden-Württemberg.[103] The final sale price paid by Landesbank Baden-Württemberg was €328 million rather than the initially listed price of €900 million but this sale price did not constitute State aid.[104] In any case Landesbank Baden- Württemberg itself would need access to

[97] Commission Decision State aid N 28/2009 of 18/11/2009 *Restructuring of Lloyds Banking Group* OJ C(2009) 9087 at para.11 available at http://ec.europa.eu/competition/state_aid/cases/232373/232373_1069315_136_2.pdf [last accessed on 07/11/2018].

[98] *Competition and Financial Markets Key Findings*, Organisation of Economic and Co-operation, 2009 at p.31 available at http://www.oecd.org/daf/43067294.pdf [last accessed on 07/11/2018]: See Chapter 7 at p.225.

[99] *Ibid*.

[100] *Ibid*.

[101] N.88 at para. 20.

[102] *Ibid*.

[103] Commission Decision C17/2009 (ex N265/2009) of 30/06/2009 *Aid measures provided to LBBW* OJ C(2009) 5260 at para.8 available at http://ec.europa.eu/competition/state_aid/cases/232152/232152_971719_69_1.pdf [last accessed on 01/09/2017].

[104] *Ibid*.

State support as the financial crisis deepened. An example of how the concept of long-term viability may become difficult to determine in times of financial crisis.

3.5.3. Orderly Liquidation

If distressed financial institutions cannot be restructured to either minimise future losses or return to the path of profitability, then an "orderly winding-up" is proposed under the Commission's Communications. The aim of implementing an "orderly winding-up" remains twofold: (a) to accommodate the exit of a non-viable financial institution; but also (b) to ensure that the exit of this market participant does not trigger further stability concerns.[105] However, the key challenge for Member States during the financial crisis was the fact that orderly liquidation could not be implemented without triggering further instability. A future State Aid Crisis Framework for the banking sector will not alone resolve this issue and specific systemic resolution tools may need to be introduced also. An issue examined in Chapter 8.

An "orderly winding-up" mechanism may also encompass the establishment of a "good/bad bank" solution by the relevant Member State. Under this scenario the good parts of the financial institution are either supported as an independent entity or merged with a competing financial institution while the loss-making units are wound down.[106] Laprévote and Paron note how the difference between a restructuring plan and a liquidation plan may not always be easy to ascertain.[107] They comment on how the break-up of the Spanish institutions BFA Bankia, NCG and Catalunya based on the establishment of both a Core and Non-Core Unit for each bank contains a resolution strand as the latter unit will in time be wound down.[108] Laprévote and Paron also question whether the Core-Unit part of the restructured entity will remain

[105] N.88 at para.21.
[106] *Ibid*.
[107] F.C. Laprévote and M. Paron, "The Commission's Decisional Practice on State aid to Banks: An Update", (2015) Vol.14 EStAL pp.88- 116 at p.100.
[108] *Ibid*.

subject to the behavioural constraints which applied to the Legacy Unit once the latter has been successfully wound down.[109]

3.5.4. Contribution of Recipient Financial Institutions

Under the Restructuring Communication, financial institutions should use both own funds and subordinated debt to meet their associated restructuring costs.[110] From an Irish perspective, imposing losses on subordinated bondholders was a difficult task due to the initial blanket guarantee.[111] In certain cases imposing losses on creditors may prove a more attractive option for a State aid recipient rather than divesting of business lines and units. Soltësz and Von Köckritz note how in most cases the Commission will increase the level of divestment in line with the level of support the financial institution in question has received.[112] Thus prior to the financial crisis a recipient financial institution was in most cases subject to a balance sheet reduction of roughly 20% to one third of their total business.[113] In contrast, under the crisis framework the level of balance sheet reduction has been even more substantial, with financial institutions such as WestLB and BayernLB having to reduce their balance sheets by up to 50%.[114] Similarly, the Commission has imposed considerable behavioural constraints on large recipient financial institutions. For example, Polito comments how Commerzbank was subject to "stringent behavioural conditions" mainly due to the market share of the bank and the level of aid it received.[115] These constraints included the financial institution limiting its market growth both internally and via an acquisition ban on certain market segments where it already had more than 5% of the market.[116] While divestment plans are a routine response by competition enforcement bodies to counter the possible

[109] *Ibid*.
[110] N.88 at paras.22-26.
[111] See Chapter 1 at pp.9-10.
[112] U. Soltész and C. Von Köckritz, "From State aid control to the Regulation of the European Banking System-DG Comp and the Restructuring of Banks", (2010) Vol.6(1) ECJ pp.285-307 at p.304.
[113] *Ibid*.
[114] *Ibid*.
[115] S. Polito, "EU and UK Competition Laws and The Financial Crisis: The Price of Avoiding Systemic Failure", in Barry E. Hawk ed., *Annual Proceedings of the Fordham Competition Law Institute* (New York: Juris Publishing, 2010) p.121 at p.146.
[116] *Ibid*.

competition distortions that may arise from State aid, in the banking sector divestment plans may result in unintended consequences.

For example, as part of its State aid application Allied Irish Banks agreed to dispose of its Polish subsidiary.[117] Yet the sale of Bank Zachodni WKB has further consolidated Allied Irish Banks' domestic focus while the fact that this sale was part of a Commission imposed divestment strategy may have undermined the final price agreed with Santander. As Heimlar comments if divestment conditions curtail "the competition possibilities of the restructuring firm, the possibility for it to successfully restructure is being reduced".[118] In a similar vein if a financial institution has to divest of profitable non-core market business lines this may reduce its long-term viability as well as undermine an open and competitive pan-EU banking market.

In contrast, no such divestment conditions applied to either Allied Irish Banks or Bank of Ireland in their domestic core Irish market. Government policy remains firmly based on a "two pillar bank" market within the Irish banking sector. McCloughan suggests that this, "pillar-bank model might (inadvertently) constitute a significant barrier to new competition".[119] The Irish authorities did have an opportunity to open up the Irish banking sector to competition via the sale of Educational Building Society. But the building society was instead merged with Allied Irish Banks so that the "new merged entity will become a stronger and more domestically focused institution which will leave it better placed to service the needs of the Irish economy".[120] In certain cases the Commission may authorise a "consolidation process"

[117] Commission Decision State aid N553/2010 of 21/12/2014 *Second emergency recapitalisation in favour of Allied Irish Banks plc*. OJ C(2010) 9475 at para.16 available at http://ec.europa.eu/competition/state_aid/cases/238609/238609_1189205_61_2.pdf [last accessed on 07/11/2018].

[118] A. Heimlar, "European State Aid Policy In Search Of A Standard: What is the Role of Economic Analysis?", in Barry E. Hawk ed., *Annual Proceedings of the Fordham Competition Law Institute* (New York: Juris Publishing, 2010) p.91 at p. 107.

[119] P. McCloughan, "Balancing regulation and competition-the case of Irish banking", (2013) Vol.24(12) E. C. L. R. pp.658-659 at p.659.

[120] Department of Finance, Press Release on AIB-EBS Merger, 26th May 2011, available at http://oldwww.finance.gov.ie/viewdoc.asp?DocID=6858&CatID=78&UserLang=GA&StartDate=01+January+2011 [last accessed on 07/11/2018].

whereby a recipient institution acquires another bank if the objective is to "restore financial stability".[121] But this consolidation should also "ensure effective competition" and there should be an "equal opportunity" for other possible institutions to acquire the bank in question.[122] However, it appears from the Educational Business Society case that these steps were not taken by the Irish authorities and so an opportunity to open up the Irish banking to additional competition was missed. A future State Aid Crisis Framework will need to ensure that where possible Member States' domestic banking sectors can be opened to new market entrants so that existing market operators do not retain a position of too-big-to-fail. A matter addressed in Chapter 6.

3.6.1. State support package set out in the 2011 Communication

Under the 2011 Communication the original two track process for State aid applications, where fundamentally and unsound financial institutions were subject to either a viability or restructuring plan, was set aside.[123] This former approach where a financial institution received State aid of more than "2% of the bank's risk weighted assets" a restructuring plan was then required.[124] Conversely, banks not falling under this category were subject to a viability plan.[125] However, under the 2011 Communication the Commission considered that a restructuring plan should now be submitted for all financial institutions.[126]

The Commission appears to have concluded that applying this distinction was no longer necessary yet other than oblique references to the general improvement in market conditions the exact reasons behind this decision remain unclear. Conflating restructuring with viability and vice versa perhaps hints at the difficulty for both the Commission and the Member States in

[121] N.88 at para.41.
[122] *Ibid*.
[123] Commission Communication (2010/C329/7) of 01/01/2011, on the application from 1st January 2011 of State aid rules to support measures in favour of banks in the context of the financial crisis, [2010] OJ C329/7 at para.12 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010XC1207(04)&from=EN [last accessed on 07/11/2018].
[124] *Ibid.*
[125] *Ibid*.
[126] *Ibid* at para.14.

ascertaining which financial institutions are fundamentally sound or not. Quigley states that the reason behind this development was mainly due to the fact that the wider EU banking sector had stabilised to some degree so that viable banks could now meet their obligations without the need for State aid.[127] Yet instead of the 2011 Communication equating "significant… reliance on State aid" with the need for a liquidation plan, an in-depth restructuring was the preferred response.[128] During the Irish financial crisis two banks in particular became overly reliant on State support, namely Anglo Irish Bank and Irish Nationwide Building Society. The initial Commission decisions assessing the State aid advanced to Anglo Irish Bank endorsed continued support in exchange for an intensive restructuring plan which was considered sufficient to restore viability. But the initial perception of the Irish authorities that Anglo Irish Bank could be resurrected and generate a return for the Irish taxpayer is a costly example of how what qualifies as a "fundamentally sound" or "distressed bank" may alter over time and how Member States can fail to anticipate these developments. In retrospect, no matter how intensive the restructuring plan was for Anglo Irish Bank fundamentally the bank did not have a viable business model in a post crisis environment. This then illustrates a key problem when Member States and the Commission respond to a banking crisis where a financial institution may be systemically important but not a long-term viable bank. A future State Aid Crisis Framework will have to establish new criteria so that the difference between systemically important but a non—long-term viable financial institution can be applied by both the Commission and Member States. Only then will policymakers be better able to ensure short-term stability but not at any costs to the taxpayer.

3.7.1. Communication on Pricing

In January 2012 the Commission issued a new Communication on Pricing, setting out how any shares issued to a State in exchange for State aid should

[127] C. Quigley, "Review of the Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis", (2012) Vol.3(3) Journal of European Competition Law and Practice pp.237-247 at p.246.
[128] N.123 at para.15.

have a reduced price as a form of *quid pro quo* between the parties.[129] Where the shares in question are non-listed then a "market-based evaluation approach" should be applied for valuing these shares.[130] The 2012 Communication also established a new pricing level based on a financial institution's credit default swap over a longer timeframe rather than over the initial years of the financial crisis.[131] One of the reasons behind this particular development was the fact that current market instability at the time of a State guarantee support could potentially penalise prudent financial institutions and the related current credit default spread may then represent wider market concerns rather than underlying problems with the financial institution in question.[132] Although this Communication was primarily focused on pricing there was no effort to link pricing of guarantee schemes with the actual systemic threat a financial institution may have posed. This will be further examined in Chapter 4 as a new State Aid Crisis Framework should be designed so that financial institutions that pose the most risk to Member State resources and indeed the wider banking sector discharges a fee that represents this risk.

3.8.1. Banking Communication 2013

The 2013 Banking Communication restates the importance of imposing restructuring costs on creditors and shareholders via burden-sharing before State aid may be provided.[133] Following developments in the EU bank resolution domain, the Banking Communication also exempts "other senior creditors", including uninsured depositors from burden-sharing.[134] An

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[129] Commission Communication (2011/C356/02) of 06/12/2011 on the application from the 1st January 2012, of State aid support measures to banks in favour of banks in the context of the financial crisis, [2011] O.J. C 356/02 at para.8 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011XC1206%2802%29&from=EN [last accessed on 07/11/2018].
[130] *Ibid* at paras.9 and 10.
[131] *Ibid* at para.17.
[132] *Ibid* para.at 14
[133] Commission Communication (2013/C216/01) of 30/07/2012 on the application from the 1st of August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication") [2013] OJ C216/1 at para.15 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013XC0730%2801%29&from=EN [last accessed on 07/11/2018].
[134] *Ibid* at para.42.

intriguing facet though to this provision is the reference to both insured and uninsured deposits as "senior debt". Under Irish law deposits rank as unsecured debt rather than senior debt thus the Commission appears to be re-classifying deposits at least at a supranational level as senior debt.[135] Yet this extension to uninsured depositors was not followed during the Cypriot banking crisis where uninsured depositors of Bank of Cyprus were "bailed in" via a "deposit-for-equity conversion".[136] This again shows how the steps Member States will take in response to a bank failure will vary depending on the wider context that is prevailing at the time. In some cases, imposing losses on depositors may trigger instability but in times of greater market calm the imposition of losses on depositors may not trigger a contagion effect. What this also indicates is the need for a future State Aid Crisis Framework to have some flexibility so that State support may extend to a wider range of creditors.

Under the Banking Communication, burden-sharing will occur where a financial institution is unable to raise fresh capital via a new plan and if this bank has already fallen below "minimum regulatory capital requirements" then "subordinated debt must be converted to equity".[137] Only after these circumstances have occurred may State aid then be provided. A Member State may avoid imposing bail-ins on creditors in cases where it may "endanger financial stability or lead to disproportionate results".[138] Alternatively a bail-in may not be required where the requested level of State aid remains low and other capital raising measures have reduced the financial institution's capital shortfall.[139] Presumably these measures involve the disposal of business units, halting dividend payments and other steps that do not require some form of contribution on the part of creditors. The 2013 Communication also prohibits a recipient financial institution from engaging in share dividend or share buy-back schemes, undertaking aggressive commercial practices or

[135] B. Devine, "NCB Fixed Income", 14th February 2011th, at p.1 available at https://www.socialjustice.ie/sites/default/files/file/Policy%20Issues/2011-02-14%20-%20NCB%20on%20Senior%20Bond%20Issue.pdf [last accessed on 07/11/2018].
[136] Bank of Cyprus Group Annual Report 2013 at p.5 available at http://www.bankofcyprus.com/globalassets/investor-relations/annual-reports/english/annual-financial-report-eng-not-signed.pdf [last accessed on 07/11/2018].
[137] N.133 at paras.36 and 43.
[138] *Ibid* at para.45.
[139] *Ibid*.

repurchasing hybrid capital instruments where these actions would undermine the financial position of the recipient financial institution in question.[140] Acquiring a stake in another undertaking should also be refrained from unless this transaction relates to the management of existing claims, meets a *de minis* criterion, or the acquisition has received authorised from the Commission.[141]

The 2013 Communication places considerable emphasis on the need for burden-sharing to adhere to the "no creditor worse off principle".[142] Thus the 2013 Communication aims to re-position the State aid regime in line with market realties where there is no State aid cushion. An effective policy in ensuring that subordinated creditors are not excessively compensated from State aid resources. In certain cases, there may be no scope for imposing losses on subordinated creditors, and so shareholders may have to carry the financial burden of restructuring. For instance, when assessing the State aid provided to the Cypriot bank, Cooperative Central Bank, the Commission noted that as there was no outstanding junior or subordinated creditors only existing shareholders could be subject to burden-sharing.[143]

3.8.2. Guarantees under Banking Communication

Under the Banking Communication a distinction has been introduced for guarantee supports which may cover financial institutions with or without a capital shortfall. In the case of the latter an individual notification must be submitted to the Commission rather than this institution availing of a general scheme designed primarily for more viable undertakings.[144] Under this procedure Anglo Irish Bank would not have been subject to the general Irish banking sector guarantee scheme but instead a separate specific scheme applicable to just this institution. The Banking Communication follows the

[140] *Ibid* at para.47.
[141] *Ibid*.
[142] *Ibid* at para.46.
[143] Commission Decision SA.43367 (2015/N) of 18/12/2015 Cyprus 2015 *Additional restructuring aid to the Cooperative Bank of Cyprus Ltd*., OJ C(2015)9681 at para.102 available at http://ec.europa.eu/competition/state_aid/cases/261742/261742_1719392_72_2.pdf [last accessed on 07/11/2018].
[144] N.133 at para.58.

same restrictions as applied to guarantee schemes under previous Communications. Guarantee schemes should only cover newly issued debt, not have a retroactive effect and also preclude subordinated liabilities.[145] An explicit limit applies to the level of long-term debt a financial institution may issue under a guarantee scheme, namely only one-third of guarantee maturities in excess of three years may be authorised.[146] Where a financial institution issues guaranteed debt of more than "a ratio of 5% of total liabilities and a total amount of €500 million" then a restructuring plan must be submitted.[147]If a guarantee scheme is triggered then a restructuring or wind-down plan "must be submitted within two months" to the Commission.[148]

3.8.4. Liquidation aid under the Banking Communication

Under the Banking Communication orderly liquidation is referred to as a way to facilitate the exit of a non-viable institution from the wider banking sector without triggering further instability.[149] The disposal process or any business the financial institution undertakes while subject to liquidation should also contribute to the costs of liquidation.[150] When developing a liquidation plan for the financial institution in question, a Member State must be cognisant of the fact that the same conditions that apply to restructuring aid as set out under the Restructuring Communication will also apply to any provision of liquidation aid.[151]

Therefore any liquidation aid provided must be limited to the "minimum necessary" but sufficient to maintain the operations of the financial institution before final closure.[152] During the liquidation process the relevant financial institution should not engage in any competitive behaviour and instead focus on gradually reducing its market presence and its customer base.[153] Parties

[145] *Ibid* at para.59.
[146] *Ibid* at (b).
[147] *Ibid* at (d).
[148] *Ibid* at (e).
[149] *Ibid* at para.65
[150] *Ibid* at para.67.
[151] *Ibid* at para.70.
[152] *Ibid* at para.72.
[153] *Ibid* at paras.74-75.

such as shareholders and subordinated creditors should not have any legal claims against any new institution arising post the liquidation.[154] Any sale process of the financial institution's subsidiaries or businesses should be "open, unconditional and non-discriminatory", "takes place on market terms", and the sale price should be the "maximum" sale price for the "assets and liabilities involved".[155] For example, during the liquidation of the non-core part of MKB Bank in Hungary, the Commission considered the sale of the bank's car fleet business and leasing division as sufficient to reduce the required level of State aid.[156] It appears that the Commission also favours a sale process where different bidders acquire different parts of the liquidated financial institution.[157] These conditions are similar to those set out under the Restructuring Communication.[158] Normal competition and State aid rules apply in cases where the purchasing financial institution may need State support to acquire the business unit or subsidiary in question or this business unit or subsidiary has received State aid. [159] Assessing the viability of the acquiring financial institution may also be necessary depending on its "size and strength" vis-a-vee the business acquired.[160]

Most of the above conditions set out under the Banking Communication are in many ways simply restating the practical implications for when a financial institution enters liquidation. There may also be circumstances where an open and transparent sales process may not be possible especially if the selling financial institution is in the process of being liquidated which may entail an accelerated disposal to protect customers and other market participants. Another example of possible divergence between the Commission's preferred position during the disposal process, namely that there be multiple purchasing financial institutions, may not be possible if the market in which these assets

[154] *Ibid* at para.77.
[155] *Ibid* at para.80.
[156] Commission Decision SA.40441 (2015/N) of 16/12/2015 *Hungary Restructuring of Magyar Kereskedelmi Bank Zrt*., OJ C(2015)9349 at para.119 available at http://ec.europa.eu/competition/state_aid/cases/261437/261437_1721348_166_2.pdf [last accessed on 07/11/2018].
[157] N.133 at para.79.
[158] N.88.
[159] N.133 at paras.81-82.
[160] *Ibid*.

are located remains unattractive for most financial institutions. Thus a domestic rival may remain the only viable option during the sales process. As noted above, new market entrants should be considered by the Member State and Commission as a preferred option yet if this is not possible then perhaps dividing the relevant institution designated for disposal among a number of domestic financial institutions may constitute a better response rather than one existing market operator increasing their market share further. Therefore, a new State Aid Crisis Framework will need to introduce a number of different disposal options tailored to reflect the relevant internal dynamics within different Member State's banking sector. This will be further discussed in both Chapters 5 and 6.

3.8.5. Orderly Liquidation Schemes

To facilitate the liquidation of a financial institution, "liquidation aid schemes for institutions of a limited size" may be authorised by the Commission provided that there are safeguards in place to prevent any "negative spillovers" for the wider economy and both shareholders and creditors are subject to burden-sharing.[161] For financial institutions of a certain size, "with total assets of more than €3000 million" an individual notification may be required due to the possible competition distortions that may arise if liquidation aid is provided.[162]

It appears that the Commission may be introducing some form a *de minims* exception for liquidation aid under the Banking Communication. The problem with authorising general schemes is that individual factors for different beneficiary financial institutions may require a response which diverges from the provision of the scheme in question. Therefore, the level of liquidation aid may vary from one financial institution to another. To resolve this problem, the Commission should require Member States to categorise the financial institution designated for liquidation either as (1) systemically important but not long-term viable, (2) systemically important and long-term

[161] *Ibid* at paras.83-84.
[162] *Ibid* at para.86.

viable (3) not systemically important or viable and so can be liquidated immediately without wider market consequences. In this way a Member State would have to ascertain how much aid may need to be provided for financial institutions under these different categories. For instance, a systemically important but non long-term viable bank may need to be liquidated over a longer timeframe to minimise market instability. This in turn would require substantially more liquidation aid than a financial institution with a relatively small market profile and few if any inter-bank relationships that could trigger instability. A new State Aid Crisis Framework will need to encompass the above proposals so that in a future crisis State resources are utilised in a more effective and efficient manner to support actual systemically important financial institutions.

Conclusion

Although the Commission did seek to establish some specific controls for the banking sector, in most cases the reality of market pressures ensured that these controls were simply not-viable (divestment programmes for financial institutions with an already limited balance sheet being a key example). Another obvious problem with this crisis framework has been the lack of critical assessment into how to differentiate effectively between a systemically important bank and a bank that actually has a long-term market future. The parameters in place for determining the remit of guarantee schemes while flexible, failed to provide sufficient grounds for when a Member State may be able to introduce a blanket guarantee scheme. It is noticeable as the framework evolved over the crisis period that there was more of an emphasis on burden-sharing and liquidation. Yet if these twin concerns were adopted as a central plank of the framework at an earlier date then both Member States and taxpayers would have been spared further expense. If bank creditors realise that Member States are restricted in the level of support they can provide to a failing institution then arguably these parties, even during a systemic crisis, may be more willing to accept limited compensation rather than risk further loss. In conclusion, the problems raised in this Chapter in respect of the Commission's State Aid Crisis Framework for the banking sector highlights the need for a new approach, one where the complex questions such as systemic importance and long-term viability amongst others, are properly resolved. These are issues which will now be discussed in the following Chapters.

Chapter Four: The Scope of Bank Guarantee Schemes under Article 107(3)(b) TFEU in times of financial crises

Introduction

The central research question of this Chapter is to tease out what exactly constitutes "appropriate" and "necessary" aid in respect of bank guarantee schemes. One way of addressing the complexities of establishing an "appropriate" response and "necessary" level of State aid in respect of bank guarantee schemes is to develop a new State Aid Crisis Framework for bank guarantee. This proposed framework should in turn seek to resolve the adverse consequences arising from the sovereign-bank link that can occur when a Member State seeks to introduce a sector wider guarantee scheme for their domestic banks. In order to provide a coherent overview of State aid law in this area the Commission practice pre-crisis will be examined. This includes an examination of both the guarantee schemes falling under the Rescue and Restructuring Guidelines and more specific public guarantees provided to State owned banks such as the Landesbanken in Germany. The decisional practice of the Commission is then assessed under Article 107(3)(b) TFEU and the crisis framework. Throughout the Chapter a distinction is drawn between "blanket" guarantee schemes and those schemes that did not entail all-encompassing creditor protection.

However, the "appropriate" and "necessary" strands of State aid do not exist in isolation from related competition factors. Therefore, the "proportionate" strand of State aid criteria applied by the Commission will also be critically assessed and new a "proportionate" criterion proposed for bank guarantee schemes. This new proposed criterion will aim to strike a balance between the need for State intervention via a guarantee scheme and the need to limit possible adverse competition distortions arising from this intervention within a Member State and the wider Union banking sector. Competition distortions also arising from bank guarantee schemes are examined and proposed safeguards set out.

4.1.1. Background to guarantees as State aid: German Landesbanken and State Guarantees

The response by Member States during the 2008 financial crisis to introduce banking sector guarantee schemes was not a new departure for State-bank State aid engagement. Prior to the financial crisis of 2008 guarantees had already been provided by certain Member States to financial institutions. In the case of the German Landesbanken, each Federal State within Germany provided a guarantee for the local Landesbank. This "State guarantee" was established for German Landesbanken due to the role such banks perform in providing lending to local businesses and consumers within each individual German State. Certain commentators have suggested that this guarantee was in fact an equivalent form of intervention that a private market investor would have made as an alternative for providing capital.[1]

To resolve the State aid concerns related to these public guarantees for Landesbanken a compromise position was agreed between the Commission and the German authorities whereby the Landesbanken could continue to avail of this State support until 2005.[2] Up to that time the Landesbanken could still issue bank debt subject to the pre-existing guarantee.[3] In effect these institutions did not have to operate in similar manner to private market operators in the German banking sector. Ilako does question though whether one can really compare the business operations of the Landesbanken with say private Germany banking groups such as Deutsche Bank.[4] The former operates in different market segments than the latter.[5]

Although Ilako does raise an interesting point about whether there was any actual practical competition between public and private banks in Germany, it seems both arms of the German banking sector invested in US subprime

[1] A. Winckler, "State Guarantees for Financial Institutions: State Aid and Moral Hazard", in Claus Dieter-Ehlermann and Michelle Everson, ed., *Competition Law Annual 1999: Selected Issues in the Field of State Aids* (Oxford: Hart Publishing, 2001) p.433 at p.447.
[2] T. Döring," German Public Banks under Pressure of the EU Subsidy Proceedings", Intereconomics March/April 2003 pp.94-101 at p.95 and p.99.
[3] *Ibid* at p.100.
[4] C. Ilako, "State Aids and the Banking Sector", in Claus Dieter-Ehlermann and Michelle Everson, ed., *Competition Law Annual 1999: Selected Issues in the Field of State Aids* (Oxford: Hart Publishing, 2001) p. 231 at p.236.
[5] *Ibid*.

mortgages.[6] The total value of impaired securities held by German financial institutions in 2008 was estimated to be €230 billion a figure which included the security portfolios of eight different Landesbanken.[7] Prior to the phasing-out of the Government guarantee scheme Landesbanken increased their capital reserves and "used these funds to invest abroad with the amount of assets in foreign securities doubling in size from mid-2005 to mid-2008" (from an excess of €50 billion to over €150 billion).[8] Hence the legacy effect of the Landesbanken guarantee was to undermine prudent management within this market segment of the German banking sector. Other Member States also supported public sector banks via State guarantees, in Austria, Landeshypothekenbanks were subject to a sovereign guarantee applicable to all liabilities in the event of an insolvency.[9] This State support was also subject to a phasing-out period agreed between Austria and the Commission.[10] Yet the adverse consequences of such a guarantee became clear when the regional bank, Austrian Bank Burgenland, was subject to an internal fraud which threatened the long-term viability of the bank.[11] To ensure that the public guarantee was not invoked the regional authority had to introduce a new guarantee to specifically cover the losses arising from this fraud.[12] An illustration how when regional or State authorities establish

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[6] K. W. Dam, "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives", Vol.10 (2) 2010 Chicago Journal of International Law at pp.20-21 available at http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1573&context=law_and_economics [last accessed on 07/11/2018].

[7] F. Hüffner, "The German Banking System: Lessons From the Financial Crisis", OECD Economic Department Working Papers No. 788 at p.4 available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=eco/wkp(2010)44 [last accessed on 07/11/2018].

[8] *Ibid* at p.11.

[9] Commission Decision-*Authorisation of State aid pursuant to Articles 87 and 88 of the EC Treaty-Cases where the Commission raises no objections*, C (2003) 1329 final [2003] OJ C175 available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2003.175.01.0008.01.ENG&toc=OJ:C:2003:175:TOC [last accessed on 07/11/2018].

[10] Commission decision (2005/691/EC) of 07/05/2004 *on State C44/03) (ex NN158/01) aid which Austria is planning to implement for Bank Burgenland AG* [2005] OJ L 263/8 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005D0691&from=EN [last accessed on 07/11/2018].

[11] *Ibid* at L263/18.

[12] *Ibid*.

guarantee schemes other steps are then to ensure that these schemes are not triggered.

In France, Caisse des Depots et Consignations were established to provide State support to French businesses but were also active in commercial banking activities.[13] However, the State guarantee in the 1990s supporting the operations of the Caisse des Depots et Consignations also included commercial banking liabilities.[14] This clearly constituted an unnecessary extension of the State support provided to this institution.[15] The Commission was willing to accept that Caisse des Deports et Consignations was "a very important borrower on financial markets" function which may have warranted some level of State support.[16] But the unlimited nature of the proposed guarantee was considered "disproportionate".[17] One can thus see how in the past Member States had intervened in their domestic banking sectors via the provision of guarantee schemes. However, in the above cases the guarantee schemes introduced were not to resolve a financial crisis but rather to meet certain economic goals. During the 2009 financial crisis, guarantee schemes would be introduced with the economic goal of maintaining economic stability.

4.1.2. Rescue and Restructuring Guidelines and Bank Guarantees

The Landesbanken guarantee scheme did not fall under the State aid exemption as set out in Article 107(3)(c)TFEU. For this provision to be applicable the institutions in question would have to have fallen under the "failing firm" defence.[18] Instead the State support provided to Landesbanken

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[13] Commission Notice *pursuant to Article 93 (2) of the EC Treaty to other Member States and interested parties concerning aid which France has decided to grant to Credit Foncier de France C 30/96 (NN 44/96)* [1996] O.J. C275/2 at 8 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:C1996/275/02&from=EN [last accessed on 07/11/2018].

[14] *Ibid*

[15] *Ibid*.

[16] *Ibid.*

[17] *Ibid*.

[18] Commission Communication (2004/C244/02) of 01/10/2004 on Community Guidelines on State for Rescuing and Restructuring Firms in Difficulty [2004] OJ C244/2 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52004XC1001(01)&from=EN [last accessed on 07/11/2018].

fell under a more complex sphere of competency conflict between Member State and the Commission. The central issue revolved around the level of discretion available to a Member State in providing State support to public financial institutions and the distinction between a bank's "commercial business and *activities in the public interests* from a State aid point of view".[19]

However, other Member States did invoke the Rescue and Restructuring framework to stabilise and restructure banks with precarious financial positions. In most cases this support entailed not just State recapitalisations but also State guarantees. For example, in the case of Credit Lyonnais the French authorities sought to guarantee the financial institution's liabilities in order to prevent its exit from the market place.[20] In this case the French State agreed to underwrite certain losses on the financial institution's balance sheet in order to facilitate the transfer of assets from the bank to a "hive-off" vehicle.[21] According to the Commission this support, in conjunction with the other rescue measures provided to Credit Lyonnais satisfied the then Rescue and Restructuring Guidelines.[22] Therefore, the aid in question was deemed to not only restore the institution to long-term viability but was also proportionate to the restructuring costs and contained sufficient competition safeguards. Interestingly, the Commission expressly stated in its Credit Lyonnais decision that the principles of the Rescue and Restructuring Guidelines could be applied to the financial services sector provided that "any undesirable negative effects of applying them" are considered in light of the central role of the banking sector.[23] A precursor perhaps of what was to come with the onset of the 2008 crisis where the Commission realised that the

[19] S. Moser and N. Pesaresi, "State guarantees to German public banks: a new step in the enforcement of State aid discipline to financial services in the Community", Competition Policy Newsletter June 2002 (2) pp.1-11 at p.4 available at http://ec.europa.eu/competition/publications/cpn/2002_2_1.pdf [last accessed on 07/11/2018].
[20] Commission Decision (95/547/EC) of 26/07/1995 *giving conditional approval to the aid granted by France to the Credit Lyonnais group* [1995] OJ L308/92 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31995D0547&from=EN[last accessed on 07/11/2018].
[21] *Ibid* at L308/106.
[22] *Ibid* at L308/117.
[23] *Ibid* at L308/95.

existing Rescue and Restructuring Guidelines were not adequate to address the problems facing the Union banking sector.

A bank guarantee has a dual effect and purpose, firstly, to ensure that the recipient financial institution continued to operate and secondly to contain wider financial instability. This approach obviously has advantages in cases where the underlying problem rests in just one financial institution. However, during the 2008 financial crisis more than one financial institution may require State support or the inter-linkages between domestic financial institutions is such that even an insolvent bank must be subject to a guarantee scheme in order to prevent contagion. The nature of the 2008 financial crisis was such that industry wide guarantee schemes were introduced in a number of Member States. Thus the scope of banking guarantees developed overtime from an individual form of State aid tailored for one specific financial institution to that of wider industry support. The question must then be asked how the Commission responded to this development.

4.2.1. Crisis Framework and Bank Guarantees

Prior to the financial crisis of 2008 if a financial institution required State support the applicable criteria was set out under the Rescue and Restructuring Guidelines. Under these Guidelines guarantees could be provided to failing firms so long as the rate of return charged was sufficient to incentivise early exit from the guarantee in question.[24] The new crisis framework also included specific references to the level of remuneration a financial institution should pay for availing of a State guarantee. Under the Guarantee Communication guarantee fees were to, if possible, reflect market prices and distinguish between the different financial profiles of each participating financial institution.[25] Similarly, a DG Staff Competition Working Paper from 2010 proposed that guarantee fees should be gradually increased to ensure that the

[24] N.18 at para.25.

[25] Commission Communication (2008/C270/02) of 25/10/2008 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 at para 11 available at http://ec.europa.eu/competition/state_aid/legislation/banking_crisis_paper.pdf [last accessed on 07/11/2018].

beneficiary institutions were charged in line with normal market conditions.[26] While pricing should be in line with European Central Bank recommendations, thus for "a bond with maturity over one year, the fee comprises a flat charge of 50 basis points augmented by each bank's median five-year senior debt CDS spread observed in the period 1 January 2007 to 31 August 2008".[27] Yet again the Commission's parameters were based on trying to establish an adequate fee for beneficiary institutions to discharge. But the underlying question of what scope a guarantee scheme should encompass was not examined in detail.

The DG Staff Competition Working Paper also notes that "while access to market financing has generally improved, banks which have been downgraded are still benefiting from their pre-Lehman credit rating and perceived creditworthiness".[28] In effect, guarantee schemes may distort capital markets as even banks with low-credit ratings are able to access funds at a reduced rate by virtue of a government-backed guarantee.[29] Another step the 2010 Working Document proposed was placing an obligation on Member States to submit a viability plan for any beneficiary financial institution where this bank had become overly reliant on guaranteed debt.[30] The threshold set by the 2010 Working Document was "a ratio of 5% of outstanding guaranteed liabilities over total liabilities and at a total amount of guaranteed debt of €500 million".[31] While the Commission was correct to link the use of bank guarantee schemes to possible viability plans for participating financial institutions, the actual question of whether a guarantee scheme was a proper crisis measure was not addressed.

Therefore, both the 2010 Working Document and the Commission's Communications sought to establish a fee for State guarantees and also link

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[26] DG Competition Working Paper on the Application of State Aid Rules to Government Guarantee Schemes Covering Bank Debt to be issued after 30th June 2010, 30th April at p.2 available at http://ec.europa.eu/competition/state_aid/studies_reports/phase_out_bank_guarantees.pdf]last accessed on 07/11/2018].
[27] *Ibid* at p.5.
[28] *Ibid*.
[29] *Ibid*.
[30] *Ibid* at p.6.
[31] *Ibid* at p.7.

an institution's reliance on a guarantee with further restructuring and viability plans. However, from the onset the key problem with adopting a framework for bank guarantee schemes during a crisis scenario is how to strike a balance between immediate financial stability and longer-term costs for the Member State providing the guarantee. Setting guarantee fees for banks based on a market that was not actually functioning due to the crisis and then attempting to address the complex question of viability, show in many ways how the Commission had adopted a default position that guarantee schemes were an appropriate response. But the question remains how the Commission got this position. Examining the Commission's decisional practice should provide some answers to this question.

4.2.2. From Communication to Decisional Practice

Under Article 107(3)(b) TFEU the Commission applies three conditions for examining whether or not aid is compatible or not with the EU Treaty. These conditions include whether the aid is "appropriate", "necessary" and "proportionate". The first condition refers to the State aid is required to meet the objectives in question, the second condition to the amount of aid provided and the final strand relates to the competition distortion effect the aid may have on the wider market place.[32] If one examines the Commission's decisional practice in respect of guarantee schemes during the 2008 financial crisis a picture is quickly drawn which shows a failure on the part of both the Commission and Member States in appreciating the adverse consequences associated with State-backed guarantee schemes for the financial standing of a sovereign. This will be further examined below.

[32] Common Principles of an Economic Assessment for the Compatibility of State Aid under Article 87.3, at p.3 available at http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf [last accessed on 07/11/2018].

4.2.3. "Appropriateness"

An obvious example of where the Commission failed to apply a more rigorous assessment is the initial decision approving the Irish blanket guarantee scheme. According to the Commission the response by the Irish authorities met the "appropriateness" standard as the context prevailing at the time required an immediate form of intervention. "Thus, the Commission considers that the guarantee is an appropriate measure to remedy a serious disturbance of the Irish economy".[33] In this regard the Commission appeared to have conceded that, "systemic banking difficulties demand a systemic solution through industry-wide schemes".[34]

A similar position was also adopted in respect of the guarantee schemes introduced by other Member States such as the United Kingdom and Italy. In respect of the United Kingdom the Commission considered the introduction of a Wholesale Guarantee Scheme an appropriate measure to ensure that credit constraints in the inter-bank markets were alleviated.[35] For the Italian guarantee scheme the Commission also had no difficulty in finding a similar intervention to be an "appropriate" measure. Although all three measures satisfied the "appropriate benchmark", all three schemes had distinctive features. The Irish scheme was a wide-ranging measure, as nearly all banking liabilities were included, in contrast the United Kingdom scheme only applied to wholesale funding. Under the Italian scheme a number of conditions applied to the eligible financial institutions, as indeed were such conditions applied to Irish institutions, but the Italian scheme was limited to solvent financial institutions.[36] The initial Irish decision failed to specifically

[33] Commission Decision NN 48/2008 of 13/10/2008 *Guarantee scheme for banks in Ireland*, OJ C(2008)6059 at para. 59, available at http://ec.europa.eu/competition/state_aid/cases/227694/227694_884719_59_2.pdf [last accessed on 07/11/2018].
[34] R. M. D'sa, ""Instant" State Aid Law in a Financial Crisis- A U-turn?" (2009) Vol.8 (2) EStAL pp.139-144 at p.142.
[35] Commission Decision N507/2008 of 13/10/2008 –*Financial Support Measures to the Banking Industry in the UK*, OJ C(2008)6058 at para.56, available at http://ec.europa.eu/competition/state_aid/cases/227824/227824_881394_17_2.pdf [last accessed on 07/11/2018].
[36] Commission Decision N520a/2008 of 13/11/2008 *Urgent measures to guarantee the stability of the Italian banking system*, OJ C(2008)6989 at para 66, available at http://ec.europa.eu/competition/state_aid/cases/227940/227940_899544_36_1.pdf [last accessed on 07/11/2018].

establish an eligibility framework based on whether or not the participating financial institutions in question were solvent as a presumption or mistaken diagnosis had found these financial institutions to be solvent but illiquid. Thus even though each of the three schemes contained key differences and, in the case of both the UK and Italian scheme more limited than the Irish response, the Commission nonetheless considered all three schemes "appropriate". In time the Commission's Communications would apply additional limitations to guarantee schemes introduced by Member States.[37] However, a retrospective examination of the Commission's initial decision-making when determining State guarantee schemes does indicate a rather broad interpretation of the "appropriate criterion". This will now be illustrated in the below section.

4.2.3.1. "Appropriateness" in other contexts

The Commission's role as a State aid gatekeeper should extend beyond merely endorsing a "State aid" solution to systemic banking crisis. Prior to the financial crisis, State aid law revolved mainly around the Rescue and Restructuring Guidelines for firms in difficulty and industry-specific State aid exemptions for public services or infrastructure projects. In these cases, the equivalent "appropriate" provision may be more easily ascertained by both policymakers and the Commission. Under these Guidelines, aid may be authorised so long as the intended recipient is a "firm in difficulty".[38] For Public Service Obligation Contracts, the central basis for the financial support provided to the undertaking performing the service in question depends on whether or not there is a public service to satisfy.[39] In both of these State aid domains the focus of the State support remains limited to just a single

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[37] Commission Communication (2013/C216/01) of 30/07/2013 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 ('Banking Communication') [2013] OJ C216/1 available at http://ec.europa.eu/competition/state_aid/cases/227940/227940_899544_36_1.pdf [last accessed on 07/11/2018].

[38] N.18 at para. 20.

[39] Commission Communication (2012/C 8/02) of 11/01/2012 on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest [2012] OJ C 8/4 at 11 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012XC0111(02)&from=EN [last accessed on 07/11/2018].

recipient or a particular service. But the Commission has an underlying benchmark for assessing whether the aid in question is "appropriate" or not. During the financial crisis no such benchmark existed for determining the "appropriateness" of bank guarantee schemes. As noted above different Member States introduced different schemes all of which were considered "appropriate" by the Commission. Instead of the Commission adopting a uniform set of principles to ascertain what constitutes an "appropriate" guarantee scheme in times of crisis, the crisis itself was the sole qualifying criterion. "Appropriateness" largely depended on the wider economic context at the particular time of the State aid application in question.

In one study undertaken to assess whether or not aid should be provided to firms in difficulty, the wider macro-economic effects of a firm's collapse were examined. When addressing this complex question, three key factors were considered. Firstly, the firm's characteristics, secondly the sector's characteristics and thirdly the workforce and labour market's characteristics.[40] The first category relates to whether or not the demise of the firm in question will trigger wider externalities.[41] This in turn relates to whether or not the sector the firm operates in will itself undermine wider regional growth in cases of internal market disruption. The final category addresses the adverse effect on regional employment should the firm or sector in question become vulnerable to market pressures.[42] If one was to apply this approach to bank guarantee schemes then arguably the "appropriateness" benchmark would easily be met. As discussed in Chapter 1 the potential contagion effect of one financial institution entering bankruptcy required Member States to adopt preventive measures during the financial crisis. One can also see how the above criteria are similar to the proposed systemic

[40] London School of Economics, "Study on the Methodology for Identifying Sectors with Serious Structural Problems" Report to European Commission Competition DG, December 2002 at vii available at http://ec.europa.eu/competition/state_aid/studies_reports/report_en.pdf [last accessed on 07/11/2018].
[41] *Ibid*.
[42] *Ibid*.

importance test for financial institutions.[43] This will be discussed later in Chapter 5.

Bolsa Ferruz and Nicolaides when examining the economic factors affecting State aid applications under the Rescue and Restructuring Guidelines, suggest that Member States should advance a "credible counterfactual" indicating the likely outcomes should no aid be provided.[44] Although the authors confine their studies to non-banking institutions, arguably during the initial phases of the financial crisis Member States could provide the Commission with sufficiently adverse counterfactuals to warrant the application of wide-ranging guarantee schemes. This in turn laid the ground for extending the scope of the "appropriate" criterion. However, a new State Aid Crisis Framework will have to establish new qualifications for what the "appropriateness" encompasses in respect of bank guarantee schemes. Closely related to the question of what is an "appropriate guarantee" scheme for the banking sector is what constitutes the minimum necessary level of aid. A matter now examined next.

4.2.3.2. Necessity provision: guarantee schemes and the minimum amount of state aid possible

The second strand of the Article 107(3)(b) TFEU test is the necessity provision, namely whether the intended State aid constitutes a value which is the "minimum necessary" to meet the objective in question. An overview of the guarantee schemes introduced during the financial crisis provides an insight into how the Commission applied this test. Different Member States adopted different policies in respect of guarantee schemes with some, such as Ireland, introducing a wide-ranging guarantee scheme while others relied on a more nuanced approach.

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[43] See Chapter 5 at p.128.

[44] M. A. Bolsa Ferruz and P. Nicolaides, "An Economic Assessment of State Aid for Restructuring Firms in Difficulty: Theoretical Considerations, Empirical Analysis and Proposals for Reform", (2014) Vol. 37(2) World Competition Paper pp.207-234 at p.232.

For example, the Danish guarantee scheme was targeted specifically at depositors and senior debt holders, this position struck the correct balance between countering a potential bank run but also facilitating some level of access for Danish banks to tap inter-bank markets.[45] However, another key feature of the Danish guarantee scheme was the involvement of Danish banking sector in financing a proportion of the guarantee costs. A substantial contribution up to a maximum of DKK 35 billion could be levied under the guarantee scheme from the Danish banks.[46] This sum had been paid into the Danish bank resolution fund prior to the outbreak of the 2008 crisis. Further, the Danish scheme was part of dual-fold package also containing a specific framework for resolving insolvent banks.[47] When assessing the potential State aid element of this bank insolvency process the Commission again placed particular focus on the “minimum necessary” principle. Applying this to any efforts to resolve an insolvent bank would entail the Danish authorities firstly examining whether a private solution could be implemented.[48] If not, then Danish policymakers would have to pursue the “least costly solution” and this may have precluded the winding-up of a bank if selling it to the private sector remained more advantageous.[49]

A number of points may be extrapolated from the Commission’s oversight of the Danish guarantee scheme. Firstly, unlike the Irish response the Danish one was grounded in a wider banking reform agenda. The Danish guarantee scheme was not a measure aimed at reinforcing the *status quo* in the Danish banking sector but designed to align stabilisation with bank restructuring. Although it must be pointed out that Irish policymakers did seek to restructure the Irish banking sector in time as will be discussed in Chapter 8 with the passage of the *Credit Institutions (Stabilisation) Act 2010* and associated policy efforts such as the merger between Educational Building Society and Allied Irish Banks, and the establishment of the National Asset Management

[45] Commission Decision NN 51/2008 of 10/10/2008 *Guarantee Scheme for banks in Denmark,* OJ C(2008)6034 at para 50 available at http://ec.europa.eu/competition/state_aid/cases/227716/227716_876335_14_2.pdf [last accessed on 07/11/2018]
[46] *Ibid* at para.10.
[47] *Ibid* at para.37.
[48] *Ibid* at para.57.
[49] *Ibid*.

Agency.[50] Secondly, unlike the absence of any bank resolution or banking insurance fund in the case of Ireland, Denmark could leverage the utilisation of a pre-existing industry fund. These two distinguishing features perhaps underline the main difficulties facing the Commission as a State aid supervisor when different Member States have distinct bank resolution policies in place. Thus one could submit that in the Danish case the "minimum necessity" principle does appear to have been met. However, in the case of the Irish scheme one could in hindsight conclude the opposite. The contrast between the Danish and Irish guarantee schemes also illustrates the overlap between bank resolution schemes and State aid. Instead of the Commission having to determine the Danish guarantee scheme application in isolation, the pre-existing bank resolution architecture could be used as benchmark when applying the "necessity criterion".

In the case of the United Kingdom, the Commission again endorsed European Central Bank guidance on the matter of subordinated debt which the UK guarantee scheme excluded.[51] But the Commission considered the prospective nature of the guarantee, only covering future debt and not pre-exiting liabilities, as another factor in line with the "minimum necessary" principle.[52] The UK scheme also only applied initially for a six-month period, a short-time frame in which potential recipients could avail of the State guarantee.[53] Thus in different Member States different forms of guarantee schemes were enacted and in most cases unlike the all-encompassing nature of the Irish scheme, these measures had more restrictive limits in relation to value of the guarantees. For instance, under the German scheme the then newly established Financial Market Stabilisation Fund would guarantee up to €400 billion of future liabilities for German financial institutions.[54] But this scheme was part of a wider financial support package introduced by the German State. Similar to the Danish scheme, the Commission again

[50] See Chapters 7 and 8.
[51] N.35 at para.59.
[52] *Ibid*.
[53] *Ibid*.
[54] Commission Decision N 17/2009 of 21/01/2009, *Rescue Packages for Credit Institutions in Germany*, OJ C(2008)6422 at para.19 available at http://ec.europa.eu/competition/state_aid/cases/227880/227880_882424_41_1.pdf [last accessed on 07/11/2018].

considered the German scheme to satisfy the "minimum necessary" criterion due to the restrictions applicable to this State intervention.[55] Although Pleister correctly predicted that this guarantee would not be triggered in its entirety one could still question how the Commission could find such a contingent liability for a Member State to fall within the range of "minimum necessary" State aid intervention.[56]

Thus an obvious problem does remain when comparing the Commission's decisional practice for different guarantee schemes. Even though a Communication on this matter provided some guidance for Member States, the different levels of instability throughout the Union made it difficult to adopt a uniform standard. What may have constituted the "minimum amount of aid necessary" in respect of the Irish scheme may have been excessive in the context of the Danish financial crisis. Under the Rescue and Restructuring framework, the central consideration for both the Member State and the Commission prior to the financial crisis was whether or not this form of support was the "strict minimum necessary" to restructure the beneficiary in question.[57] Aid limited to the minimum necessary entails the recipient firm providing at least 50% of the restructuring costs.[58] In past cases though the Commission adopted a more flexible approach when ascertaining what constitutes the minimum level of aid necessary. For instance, in the case of Bankgesellschaft the Commission authorised a "risk-shield", in effect a tiered form of State support whereby losses up to a certain threshold are met by the financial institution with the rest then met by the Member State in question, for the recipient institution even though a competitor raised concerns over the scope of this intervention.[59] According to a submission from Berliner Volksbank this risk shield "constitutes an unlimited additional funding

[55] N.54 at para.63.
[56] C. Pleister, "The Federal Agency for Financial Market Stabilisation In Germany: From Rescue to Restructuring", (2011) Vol. 2011(2) OECD Journal: Financial Market Trends pp.1-10 at p.4 available at https://www.oecd.org/finance/financial-markets/48989210.pdf [last accessed on 07/11/2018].
[57] N.18 at para.60.
[58] *Ibid* at para.44.
[59] Commission decision (2005/345/EC) of 18/02/2004 *on restructuring aid implemented by Germany for Bankgesellschaft Berlin AG* [2005] OJ L116/1 at 17, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005D0345&from=EN [last accessed on 07/11/2018].

commitment since the Land of Berlin's associated liability cannot be estimated at present and is therefore a 'blank cheque' for future losses".[60]

The Commission though placed significant weight on the fact that this "risk shield" was only designed to resolve losses from a pre-existing asset pool rather than aid Bankgesellschaft to expand its business lines and market presence.[61] In contrast, the Commission adopted a far more restrictive stance when assessing the State guarantee implemented by the French State for Credit Foncier de France.[62] Although, the Commission conceded that the decision of the French State to introduce an institutional guarantee was "understandable-to prevent the bankruptcy of CFF (a very important borrower on international financial markets) and a general crisis — its intervention would seem to be disproportionate".[63] The "disproportionate" nature of this guarantee was mainly due to the unlimited scope both in time and level of debt covered.[64] Thus, in both the Bankgesellschaft and Credit de Foncier de France State aid applications the "minimum criterion" was applied an inconsistent manner. Despite the market dominance of Bankgesellschaft in the regional banking sector, the Commission deemed the substantial guarantees granted by the German authorities as falling with the "minimum necessary" criterion. Yet the possible systemic threat posed by the collapse of Credit Foncier de France was considered insufficient to warrant a *de facto* "unlimited" guarantee.[65]

This in turn though raises issues as how the Commission can apply a more balanced and critical overview of national guarantee schemes in times of financial crisis. If in times of financial crisis, the Commission ultimately applies varying standards dependent on the circumstances of each Member State then this poses problems in respect of the internal market and competition policy. Perhaps comparing the responses of the Irish and Danish authorities fails to address the different economic issues facing both Member

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[60] *Ibid* at para.307.
[61] *Ibid*.
[62] N.13 at para. 8.
[63] *Ibid*.
[64] *Ibid*.
[65] *Ibid*.

States. But even in other Member States that were later subject to IMF/EU Memorandums of Support, the guarantee schemes introduced by these sovereigns did not encompass blanket support. The Greek authorities placed a number of limitations on the initial guarantee scheme, including the central allocation of debt guaranteed under the scheme, the level of guaranteed debt each institution could issue and the class of liabilities covered.[66] Similarly, the Spanish authorities also introduced a guarantee scheme which precluded inter-bank deposits, subordinated debt and "other instruments for which the amount of risk might be difficult to assess for the guarantor".[67] What the above cases illustrate is the need for a more detailed and coherent set of criteria for both determining the appropriateness of a guarantee scheme but also for applying the minimum necessary criterion for guarantee schemes.

4.3.1. Appropriate and Necessity Criterion: A new standard for bank guarantee schemes

Under the Commission's Communication for Guarantee Schemes certain specific limitations were set out such as the duration of these schemes and the exclusion of subordinated liabilities.[68] However, a more nuanced approach may need to be developed by the Commission when applying the Article 107(3)(b)TFEU exemption when assessing bank guarantee schemes during financial crises. The threshold for the "appropriateness" and "minimum necessary" criteria for guarantee schemes were applied in a flexible manner but with this flexibility may come at the expense of addressing the possible adverse consequences that may impact a Member State. Therefore, a new test needs to be established that strikes the correct balance between the short-term needs of stability and the longer-term needs of the Member State in question.

[66] Commission Decision N 560/2008 of 19/11/2008, *Support Measures for the Credit Institutions in Greece*, OJ C(2008)7382 at paras.67-69 available at http://ec.europa.eu/competition/state_aid/cases/228293/228293_959050_18_2.pdf [last accessed on 07/11/2018].

[67] Commission Decision NN 54/B/2008 (ex-CP 277/2008) of 23/12/2008, *Corrigendum to the Guarantee scheme for credit institutions in Spain*, OJ(2008)8960 at para.62 available at http://ec.europa.eu/competition/state_aid/cases/228183/228183_1001195_47_1.pdf [last accessed on 01/09/2017].

[68] N.25 at paras.23-24.

From an Irish perspective stability trumped any concerns over the underlying financial position of the domestic Irish financial institutions. However, this short-term focus resulted in longer-term costs. Determining what constitutes an "appropriate" guarantee scheme depends on the individual factors present in each Member State. One way to address these factors in each Member State is to establish a series of conditions which the Commission could then apply to determine whether the guarantee invoked by domestic authorities qualifies as "appropriate". In State aid law certain commentators discuss the need for competition authorities to apply a counterfactual scenario when assessing a State aid application.[69] A counterfactual test entails the Commission considering the consequences for the proposed recipient undertaking if no aid is forthcoming.

In a systemic crisis applying a counterfactual test may encompass considerable risks due to time restrictions. But as was evident during the financial crisis not all domestic banking sectors were equally affected. Therefore, some differentiating benchmark must be developed by the Commission when ascertaining whether or not a banking sector guarantee scheme falls within the exemption under Article 107(3)(b) TFEU. A counterfactual test should provide this benchmark and not only address State aid concerns but also economic and social considerations within a Member State. In general, such a counterfactual test should be based on the following three tests;

(1) Is there a viable alternative option to the guarantee scheme in place?
(2) Is the aim of the guarantee scheme regulatory forbearance or to restructure the domestic banking sector?
(3) Is there an effective exit strategy for institutions subject to the guarantee scheme?

[69] B. Lyons and M. Zhu, "Compensating Competitors of Restoring Competition? EU Regulation of State during the Financial Crisis" (2013) Vol.13 J. Ind Compet Trade pp.39-66 at p.51.

4.3.2. Alternatives to guarantee schemes

During a systemic crisis assessing whether there is an effective alternative in place to introducing a guarantee scheme may appear an obvious starting point for any future "appropriateness" test. This relates to the wider question of how Member States may then further proceed in recapitalisation or purchasing assets from financial institutions as will be further discussed in Chapters 5, 6 and 7. It also addresses the question of whether the wider context prevailing at the time of a proposed bank guarantee scheme is such that an alternative to a guarantee scheme may or may not be a viable option. As noted in Chapter 1 the Irish authorities considered a number of different options rather than a blanket guarantee scheme but these options were not considered conducive to financial stability at that particular point in time.[70] During the 2008 financial crisis the Commission placed considerable weight on the submissions from various Member States on what State aid measure should be adopted. Ultimately, this reliance on Member State input will not be diminished in the event of a future banking crisis. However, instead of the Commission applying a rather open-ended "appropriate" criterion a more substantial qualification framework should be applied. When considering whether a banking sector guarantee scheme constitutes an "appropriate" response the Commission should examine possible alternatives that the Member State could pursue. Therefore, the Commission should consider whether the applicant Member State could avail of alternative solutions such as bank resolution, recapitalisation or disposal to a viable competing financial institution. The Member State should then consider each of these alternatives and set out why these alternative measures do not suffice. When assessing different policy responses the Commission could then adopt a tailored set of principles which apply to operating aid under Article 107(3)(a)TFEU for undertakings located in certain disadvantaged regions within the EU.[71] For a firm to qualify successfully for operating aid under this particular State aid

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[70] Chapter 1 at pp.9-10.

[71] Commission, *Vademecum on Community Law on State Aid* 30th September 2008 at p.37 available at http://ec.europa.eu/competition/state_aid/studies_reports/vademecum_on_rules_09_2008_en.pdf [last accessed on 07/11/2018].

exemption three steps must be met (1) the aid must contribute to regional development, (2) the aid must be proportionate to any handicaps sought to alleviate and (3) the aid in question must be reduced over time.[72]

A similar test could be developed by the Commission when assessing whether or not there are viable alternatives to a proposed banking sector guarantee scheme. Each of the possible alternative options could be viewed through a similar prism as the "operating aid" criteria above. The three conditions for operating aid could be tailored to reflect the wider economic rationales for State aid intervention in a Member State's banking sector. For instance, the intervention in question should: (1) contribute to regional or economic development, that is in effect maintain a functioning economy, (2) the intervention in question should be proportionate to resolve the relevant instability or market failing in question and (3) the intervention must be withdrawn overtime.

Both the proposed intervention, the bank guarantee scheme, and the possible alternative options should then be considered in light of these three tests by both the applicant Member State and the Commission. For instance, if liquidating a bank triggers further instability then this option would fail to meet the first test. Nicolaides examines the application of a "counterfactual test" in the context of environmental State aid, where the Commission must in effect determine whether the provision of this aid will result in the beneficiary undertaking adopting a more environmentally friendly form of production.[73] However, counterfactual tests may not be a reliable form of criterion to apply in certain circumstances. For instance, the counterfactual may if actually applied in a given context trigger an internal failing within an undertaking not considered in a theoretical argument. In the example of supporting environmentally sustainable production it may be that new production techniques will undermine the profitability of the recipient undertaking. From a banking stability perspective, the absence of a guarantee may trigger an adverse "incentive" on the part of depositors and other

[72] *Ibid*.
[73] P. Nicolaides, "The Incentive Effect of State Aid: Its Meaning, Measurement, Pitfalls and Application", (2009) Vol.32(4) World Competition pp.579-591 at p.582.

creditors to withdraw their funds from the Member State banking sector in question.

In contrast, a State recapitalisation scheme may satisfy the first test but fail to qualify as a sufficient response in isolation to resolve the instability or market failure in question. Waiving merger controls, which was allowed for under the Irish *Credit Institutions (Financial Support) Act 2008* s.7(2), to enable a viable financial institution to acquire a failing bank or banks may also satisfy tests one and two but the requirement for possible further State aid would fall foul of test three.[74] However, depending on the wider economic environment pertaining at the time of the State aid application, a guarantee scheme may also fail to meet these three tests. A Member State may fail to sufficiently prove that the proposed scheme will actually promote economic development or that this support will be withdrawn within a set timeframe. Conversely, the circumstances within a Member State may be such that individual recapitalisation schemes for individual financial institutions may prove a more viable alternative than a sector wide bank guarantee scheme. For example, in the case of Banesto in Spain, a sector wide guarantee scheme was not required for this financial institution to be restructured and then sold to Banco Santander.[75]

4.3.3. Blanket Guarantee Schemes and Appropriateness

In certain circumstances though a Member State may seek to introduce a blanket guarantee scheme to contain instability in their domestic banking sector. However, from a State aid perspective should all "crisis containment" steps automatically qualify as an "appropriate" remedy? The "post-Lehman syndrome", where the demise of Lehman Bros. triggered such a negative reaction across financial markets that any subsequent financial institution that

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[74] *Credit Institutions (Financial Support) Act 2008*, at s.7(2) available at http://www.irishstatutebook.ie/eli/2008/act/18/enacted/en/html [last accessed on 07/11/2018].

[75] A. Altuzarra, J. Ferreriro, C. Gálvez, C. Gómez, A. Gonález, P. Peinado, C. Rodrígues and F. Serrano, "Report on the Spanish Financial System", Financialisation, Economy, Society and Sustainable Development, FESSUD, Studies in Financial System No.6, at p.22 available at *fessud.eu/wp-content/uploads/2012/08/the-spain-financial-system..pdf* [last accessed on 07/11/2018].

had financial difficulties was now considered too-big-to-fail, and the banking collapse in Iceland would provide substantial negative counterfactuals for both domestic and EU authorities when assessing whether a Member State should introduce a blanket guarantee scheme.[76] Therefore, an additional criterion may need to be developed to support both Member States and the Commission in determining whether a blanket guarantee is the correct response rather than a guarantee scheme with a more limited scope. If one considers the *raison d'être* for a bank guarantee scheme is to stabilise the funding base for financial institutions, then it stands to reason for the Commission to question whether this necessitates a Member State introducing a blanket scheme covering all bank liabilities.

The introduction of the Bank Resolution and Recovery Directive should to some degree reduce the need for a Member State to invoke a blanket guarantee scheme.[77] However, if in a particular circumstance a bail-in policy for creditors or depositors may offset further instability then the Commission may authorise a blanket guarantee scheme provided certain measures are met.[78] According to a report by the London School of Economics, industrial sectors in decline can be identified by a number of factors.[79] These include, a decrease in the volume of production over a certain timeframe, an increase in production value that remains "lower than the general price increase over the reference period", and decline in production represents a continuing trend rather than a one-off occurrence.[80] Although there are obvious problems when seeking to apply industrial benchmarks to the banking sector, one could extrapolate from the above characteristics a specific set of provisions for determining whether the banking sector in a Member State has entered into a

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[76] T. Beck, D. Gros and D. Schoenmaker, "On the Design of a Single Resolution Mechanism" in *Banking Union: Single Resolution Mechanism Monetary Dialogue* (European Parliament, February 2013), p.29 at p.35, available at http://www.europarl.europa.eu/document/activities/cont/201304/20130422ATT64861/20130422ATT64861EN.pdf [last accessed on 09/012017].
[77] European Parliament and Council Directive No.2014/59/EU of 14/05/2014 [2014] OJ L173/190 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:3201514L0059&from=EN [last accessed on 07/11/2018].
[78] *Ibid* at art.44(2)(a)-(g) and art.44(3)(a)-(d).
[79] N.40 at p.102.
[80] *Ibid.*

sharp structural decline. A decline which may warrant State intervention in the form of a blanket guarantee scheme.

For instance, if a Member State's domestic banking sector experiences a substantial outflow of funding over a sustained period of time this results in a sharp contraction in the provision of credit thereby reducing the potential profitability of the banking sector. This outflow in turn results in a sharp reduction in the provision of credit in the wider economy thereby decreasing the sector's profitability. Hence the value of the sector is subject to a share depreciation. These three factor combined will then arguably constitute an industry in decline or a sector under temporary distress and mirror the criteria for categorising industries in decline. A decline in the volume of production ultimately triggers an associated decrease in the value a sector can generate further entrenching the market *status quo*. Similarly, if the capital base of a Member State's banking sector in effect collapses then both value and market share will further decline necessitating some form of exceptional support by the State in question.

One could also compare a systemic crisis within the banking sector as a similar form of destabilisation that arises in the oil market. Whenever there is a sharp increase or decrease on the international price of crude oil market participants, investors, buyers and sellers, in effect have to reconsider their long-term market price forecasts.[81] The "anchor point" for price determination has been lost and as such some form of intervention is required to stabilise the oil market.[82] This intervention may take the form of better information provision for market actors, better flexibility in supply and demand to offset market spikes or falls and market innovation and diversification.[83] However, if one was to set out equivalent intervention measures to re-establish an "anchor point" in the banking sector, such as market innovation and restructuring, these measures may take time to

[81] Y. Kobayashi, "Destabilisation of the Crude Oil Market and Efforts Toward Price Stabilisation", The Institute of Energy Economics Japan, October 2010, at p.5 available at http://www.eaber.org/system/tdf/documents/IEE_Kobayashi_2010.pdf?file=1&type=node&id=22794&force= [last accessed on 07/11/2018].
[82] *Ibid*.
[83] *Ibid* at p.10.

implement. Immediate intervention requires some form of "insurance" or backstop that realistically only a State may be able to provide. In these cases, a blanket guarantee scheme may be required as the only option to restore some form of market equilibrium where possible.

4.3.4. Objective of the guarantee scheme: regulatory forbearance or resolving a market failure

From examining the State aid applications for bank guarantee schemes it becomes evident that policymakers at Member State level presumed that the crisis would quickly abate and that the guarantee could then be revoked in an orderly manner. However, revocation may need to be delayed due to wider economic factors, for example the Irish authorities renewed the Irish scheme after the initial two years lapsed.[84] In cases where this arises the Member State in question may still adopt a default policy of regulatory forbearance rather than implement an in-depth restructuring of the "guaranteed" financial institutions. Honohan and Klingebiel discuss how there are three degrees of regulatory forbearance, the first entails "banks that are generally known to be insolvent are allowed to remain opened".[85] Alternatively, an intermediate form of forbearance may be evident where banks with an "undercapitalised" base are allowed to remain open for a limited timeframe.[86] A "less-accommodating" form of forbearance is where policymakers allow for a financial institution to circumvent certain market regulations and allow for the possibility that this bank may open new business lines.[87] Lumpkin also cites these three degrees of forbearance when examining regulatory responses. In cases where "macroeconomic misalignments or shocks" arise, then "forbearance can be used under such circumstances to buy time until

[84] SI. No.471/2010-*Credit Institutions (Financial Support) (Financial Support Date) Order 2010*, available at http://www.irishstatutebook.ie/eli/2010/si/471/made/en/print[last accessed on 07/11/2018].
[85] P. Honohan and D. Klingebiel, "Controlling fiscal costs of banking crises", (2000) Policy Research Working Paper 2441, World Bank Development Research Group Finance and Financial Sector Strategy and Policy Department September 2000 at p.6, available at http://documents.worldbank.org/curated/en/109971468741329122/pdf/multi-page.pdf [last accessed on 07/11/20180].
[86] *Ibid*.
[87] *Ibid*.

conditions normalise”.[88] Thus fundamentally sound banks may then be able to return to profitability.[89]

The pre-existing State aid framework does encompass a requirement for financial institutions to undergo a restructuring program as a condition of this support.[90] However, when assessing an application for a sector wide guarantee scheme the Commission should seek further clarification from the Member State in respect of the short and long-term aims of this scheme. The short-term aim of the scheme will obviously include stability grounds but the longer-term objectives should include a set of coherent steps to restructure not just the financial institutions subject to the guarantee but the wider banking sector. If the underlying pretext of the guarantee scheme rests on regulatory forbearance, then the Commission may by default endorse the pre-crisis market environment. Where the provision of State aid equates to regulatory forbearance then this in turn may accentuate the “market failure” necessitating the initial State intervention. Where State intervention results in “capital misallocation” within a particular industry this may result in the continued presence of inefficient undertakings and also trigger wider inefficiency in the sector in question.[91] From a banking sector perspective a parallel argument can be drawn whereby a bank guarantee scheme may represent a misallocation of capital whereby the participating banks continue to operate in an imprudent manner and fail to restructure their business models.

The initial effect of any proposed guarantee scheme is to “rescue” the domestic banking sector from collapse. Yet once this is achieved the Member State in question should be required to submit macro reforms. This may include a cap on certain types of lending, ensuring financial institutions place additional capital aside over and above pre-existing regulatory levels, and

[88] S. Lumpkin, “Resolution of Weak Institutions: Lessons learned From Previous Crisis” Financial Market Trends OECD 2008 at p.13 available at http://www.oecd.org/finance/financial-markets/41942943.pdf [last accessed on 07/11/2018].

[89] *Ibid*.

[90] N.37 at para.23.

[91] Organisation for Economic Co-operation and Development, “Competition, State aids and Subsidies” Policy Roundtables 2010 at p.10, available at http://www.oecd.org/competition/sectors/48070736.pdf [last accessed on 07/11/2018].

establishing limitations on these financial institutions' reliance on wholesale funding. If a new crisis framework includes a "macro-reform" strand as part of the "appropriate" criterion, then this in turn should act as sufficient counter to the market *status quo* under the guise of regulatory forbearance. This could also align with bank resolution objectives to ensure that financial institutions do not remain too-big-to-fail and also further curtailing where possible the interconnectedness between financial institutions and also act as safeguard against the need for possible future State aid intervention.

4.3.5. Exit Strategy: Revoking the guarantee scheme

A future State Aid Crisis Framework should have specific provisions in place to ensure the gradual revocation of a State guarantee so that the sovereign-bank link can be easily disentangled. An effective exit strategy should aim to restore the financial institutions covered under the guarantee to long-term viability or if necessary facilitate a controlled exit from the banking sector. Establishing whether a financial institution may fall under the classification as a long-term viable bank is discussed further in Chapter 7. In any case even if a bank fails to meet the long-term viability benchmark a systemic threat may still apply. Teasing out the nuances on what may constitute a systemically important financial institution falls within the confines of Chapter 6. However, in respect of guarantee schemes a parallel question also arises.

To ensure that State resources are targeted effectively and efficiently the scope of a guarantee scheme should be tailored where possible to reflect the market position of each financial institution in a Member State's banking sector post the crisis. Efficiency in State aid law mainly relates to the need to ensure that any aid that is provided to an undertaking remains well-targeted for the objective in question. Verouden and Werner discuss this efficiency concept in respect of services of a general economic interest and how a tendering process for these services should counter overcompensating the contracted undertaking.[92] Other commentators, such as Friederiszick et al., have discussed how efficiency and equity may overlap with one another. For example, they note how Besley and Seabright see an interdependency between equity and efficiency where the relocation of a company to an economically disadvantaged region may trigger wider economic benefits.[93] The regions that would have the greatest spill-over benefits should, from a pure efficiency perspective, then be able to provide the largest financial support to entice this firm.[94] But this may preclude poorer regions from the bidding process thereby requiring some form of "redistribution" so that not all the development becomes clustered in already well-developed areas.[95]

One may question how the efficiency and equity aspects of State aid law may relate to formulating a bank guarantee scheme. However, there are a number of key issues that a future crisis framework will need to address that relate to the question of "efficiency". In particular, in the context of a bank guarantee scheme, not all participating financial institutions will have similar business lines or models. Therefore, in order to ensure that State resources are not utilised in an inefficient manner the coverage of a guarantee scheme should reflect the viability of each financial institution. The level of assessment may need to be compromised in particularly severe circumstances even necessitating the inclusion of financial institutions close to insolvency if this means wider stability being safeguarded A limited timeframe may impede this assessment but at least ensure that some form of demarcation between financial institutions is implemented by Member States during a crisis scenario so that the sovereign-bank link does not become all- encompassing like that of the Irish banking sector and the Irish State. In this way, imprudent and inefficient financial institutions would not in effect be "overcompensated" if the scheme were to be applied in a blanket manner.

[92] V. Veroduen and P. Werner, "Introduction-The Law and Economics of EU State aid Control", in Philip Werner and Vincent Verouden, ed., *EU State aid Control, Law and Economics*, (The Hague: Kluwer Law International, 2016) p.7 at p.58.

[93] H. W. Friederiszick, L.H. Röller and V. Verouden, "EC State Aid Control: An Economic Perspective", in Michael Sánchez Rydelski, ed., *The EC State Aid Regime: Distortive Effects of State Aid on Competition and Trade*, (London: Cameron May, 2006) p.145 at 158.

[94] Besley and P. Seabright, "The effects and policy implications of state aids to industry", (1999) Vol.14(28) Economic Policy pp.13-53 at p.23 cited at *Ibid*.

[95] *Ibid*.

Similarly, one could view this tailored approach as a form of "redistributing" State resources based on the viability of a financial institution rather than the weakest financial institutions in effect availing of this support the most to the detriment of more prudent competing banks.

The new criteria envisaged in both Chapters 5 and 6 mainly refer to specific State aid applications for individual financial institutions rather than sector wide schemes. However, a similar exercise could also be applied by domestic authorities when submitting a State aid application to the Commission. These factors should include whether the financial institutions in question remains active in more than one business line, the funding balance of each institution in respect of retail or wholesale funding and the maturity of the financial institution's debt profile.

In effect, "[s]ome kind of selectivity is almost always necessary as there are no market failures from which all firms suffer to the same degree".[96] Therefore the incentive measures applicable to financial institutions that fall within the long-term viable criteria will differ from those for insolvent financial institutions. For instance, in order to incentivise long-term viable financial institutions to exit the guarantee scheme the pre-existing measures such as penal guarantee fees and narrow timeframes for issuing guaranteed debt should be complemented by additional behavioural incentives to ensure a prompt exit from the guarantee scheme.[97] These additional incentives should be primarily designed to promote private investment but also structural reforms. Divestment plans should be in place whereby if a financial institution does not exit the scheme within a given timeframe then certain business lines should be disposed to either a domestic rival or a new market entrant.[98]

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[96] C. Buelens, Gaelle Garnier, Roderick Meiklejohn, DG for Economic and Financial Affairs, and Matthew Johnson UK Office of Fair Trading, "The economic analysis of State aid: Some open questions" European Economy Economic Papers No.287, September 2007 at p.14 available at http://ec.europa.eu/economy_finance/publications/publication9549_en.pdf [last accessed on 07/11/2018].

[97] See Chapter 3 at Table 1..

[98] Commission Decision n° SA.34539(2012/N) of 30/03/2012-*Germany Amendment to the restructuring plan of Commerzbank*, OJ C(2012)2227 at paras.14-15 available at http://ec.europa.eu/competition/state_aid/cases/244147/244147_1326390_39_5.pdf [last accessed on 07/11/2018].

Alternatively, the financial institution may be liable to re-purchase shares at a penal rate held by the State in order to re-issue these to private investors.[99] These incentives may need to be curtailed somewhat if such measures actually pose further problems for the underlying financial position of the financial institution in question.

Including an insolvent financial institution in a guarantee scheme with limits on the level of support may strike the correct balance between financial stability and countering moral hazard concerns. It also addresses the possible time constraints Member States may be under when introducing a guarantee scheme while also having to determine the solvency or insolvency of financial institutions with limited information available and the threat of a bank collapse imminent. This delineation between solvent and insolvent financial institutions would provide sufficient grounds for Member States to adopt effective exit plans for each of the covered financial institutions subject to the guarantee scheme. For solvent financial institutions, an extended maturity timeframe for newly issued guaranteed debt would apply, thereby providing a timeframe for both management and policymakers to adopt a restructuring plan. In contrast, an insolvent financial institution would not be able to issue new debt subject to the guarantee. Instead this financial institution would remain reliant on debt retrospectively guaranteed under the scheme while a liquidation plan be put in place.

There are obvious limitations to this proposal not least the fact that retrospectively guaranteeing bondholders in an insolvent financial institution raises both competition and moral hazard concerns. The recently enacted Bank Resolution and Recovery Directive should now ensure that certain *ex-ante* measures are in place to impose losses on creditors.[100] However, any new Commission Communication for Bank Guarantees may still need to address the problem posed by an insolvent but systemically important financial institution. In exceptional circumstances such financial institutions may need

[99] Commission Decision N9.2009 OF 14/01/2009 *Recapitalisation of Anglo Irish Bank by the Irish State*, OJ C(2009)134 at para.20 available at http://ec.europa.eu/competition/state_aid/cases/230289/230289_978754_31_2.pdf [last accessed on 07/11/2018].
[100] N. 77 at art.44.

to be subject to a guarantee scheme. However, the above proposals should ensure that even within the confines of a guarantee scheme there is a degree of differentiation between the level and scope of support provided to long-term viable and insolvent financial institutions.

4.3.6. Counterfactual test

The above three tests should provide some level of guidance for both Member States and the Commission when assessing whether a guarantee scheme, including in some cases a blanket guarantee scheme, falls under the Article 107(3)(b) TFEU exception. During the 2008 financial crisis the prevailing environment at the time meant that undertaking an in-depth investigation into each State aid application was not possible. In future financial crises, this time constraint will still remain present. The limited conditions applied by the Commission as the EU State aid regulator, when authorising guarantee schemes, it is submitted failed to balance short-term objectives of stability with longer-term implications. The proposed counterfactual test for guarantee schemes, will at the very least entail the Commission examining in greater detail the grounds behind the application, while also ensuring guarantee schemes do not become a default response in times of financial crisis.

While this “counterfactual” test may raise the threshold for Member States seeking to introduce sector wide support for financial institutions, in practice such a test only remains effective if wider steps are implemented within the applicant Member State’s banking sector. For instance, the first test may only be deemed relevant if the Member State in question has a robust bank resolution and deposit protection regime in place. If this is not the case then the “alternative” test is easily overcome.

The third test may also appear somewhat contradictory when viewed in conjunction with the proposed second test, as in effect guaranteeing an insolvent financial institution does constitute a form of regulatory forbearance. However, in practice the contagion threat posed by the liquidation of an insolvent financial institution may still require some form of temporary guarantee until market conditions are more conducive to liquidation. This position follows the same reasoning as the “failing firm” defence in merger control law, where allowing the acquisition of a failing firm by a rival may raise competition issues but these are outweighed by the benefits of this firm's business remaining present in the relevant market place.[101] In effect allowing an insolvent financial institution access a guarantee scheme may trigger competition concerns but any exclusion from this scheme may offset further instability which negatively affects long-term viable financial institutions.

If the proposed three step counterfactual test is satisfied, then a Member State may invoke a guarantee scheme. In order to satisfy this proposed test, the Commission would have to agree with the Member State's position that there is no viable alternative to the introduction of a bank guarantee scheme, that the objective of the scheme is for restructuring the covered financial institutions not for regulatory forbearance purposes and finally that there is an effective exit plan in place so that the covered financial institutions are able to access non-guaranteed funding. But this proposed test must be applied in a restricted manner, for instance an all-encompassing guarantee scheme such as the one adopted by Ireland would presumably fail the "viable alternative" test.[102] Even if the Commission in times of systemic crises did lower the threshold for the "viable alternative" strand, a more stringent application of the "necessity" principle should act as an additional safeguard in insulating sovereign resources from the needs of domestic financial institutions.

4.4.1. Necessity proviso: A new minimum criterion for bank guarantee schemes

Establishing a new "minimum necessary" criterion may prove somewhat difficult where the Member State in question seeks to introduce a blanket guarantee scheme. But as noted above even in these cases a new test to determine where such a course of action is indeed "appropriate" should

[101] *Roundtable on Failing Firm Defence*, OECD Competition Committee, Note by the Services of the European Commission, Directorate-General of Competition, at pp.2-3 available at http://ec.europa.eu/competition/international/multilateral/ec_submission.pdf [last accessed on 07/11/2018].
[102] Although such a scheme is possible if the proposed test in this Chapter is met.

encompass certain safeguards to counter the adverse effects of the sovereign-bank link. As noted above time constraints may pose a threat to a Member State applying a proper demarcation between solvent and insolvent financial institutions. An additional safeguard may include a parallel "minimum necessary" test whereby the level of support under a guarantee scheme is subject to specific caps related to the value of the guarantee. Therefore, any efforts to develop an "appropriate" standard for bank guarantee schemes should also align with any new "minimum necessary" criterion.

4.4.2. Deposit Protection and State Aid

It may seem that deposit protection and State aid are divergent strands of policy however, in times of crisis a Member State may seek to guarantee bank deposits. When this occurs, the exact parameters of the term "minimum necessary" and how it applies to bank deposits then becomes a pertinent issue for policymakers. Currently under the Deposit Protection Directive Member States introduced deposit protection schemes for their domestic banking sectors.[103] During the initial phases of the crisis certain Member States unilaterally extended depositor protection under the pre-existing Deposit Protection Directive. For instance, the blanket guarantee introduced by the Irish government extended a sovereign guarantee to all deposits even those above the new limit set by the updated EU directive.[104] Both the United Kingdom and the German governments also introduced blanket deposit protection, the former in the case of Northern Rock and the latter for all deposits held in German financial institutions.[105] The possible competition distortion effects of Member States introducing different levels of deposit

[103] European Parliament and Council Directive 2014/49/EU of 16/04/ 2014 [2014] OJ L173/149 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0049&from=EN last accessed on 07/11/2018]

[104] L. Laeven and F. Valencia, "The Use of Blanket Guarantee Schemes in Banking Crisis" (2008) IMF Working Paper WP/08/250 at p.9 at available at https://www.imf.org/external/pubs/ft/wp/2008/wp08250.pdf [last accessed on 07/11/2018].

[105] R. Winnet and N. Allen, "Financial Crisis: Germany announces savings guarantee", *The Telegraph*, (5th October 2008) available at http://www.telegraph.co.uk/finance/personalfinance/savings/3141286/Financial-crisis-Germany-announces-savings-guarantee.html [last accessed on 07/11/2018]; Northern Rock deposits guaranteed, BBC News, 17th September 2007, available at http://news.bbc.co.uk/2/hi/business/6999615.stm [last accessed on 07/11/2018].

protection will be discussed further below. For present purposes the key issue examined here addresses the application of the "minimum necessary" criterion in respect of deposit protection schemes. Yet even in a non-crisis context the minimum necessary may apply differently in different jurisdictions.

If one examines surveys of different Member State deposit protection schemes before the 2008 crisis it becomes evident that despite the drive towards of "harmonisation" key differences remained between the actual coverage levels under different schemes.[106]For example, one study found that imposing a set deposit guarantee at €20,000 across all EU Member States would result in a sharp decrease across the EU of covered deposits.[107] Similarly, if an inflation-based approach was applied to deposit protection levels then this would only increase the scope of the deposit threshold in countries with an already high coverage ratio.[108] From these examples one can posit that even applying a set deposit protection threshold across the EU may have varying affects in each Member State as ultimately the pre-existing level of protection may be lowered in some cases. Therefore, a depositor may seek to transfer funds from a Member State where any new harmonised threshold actually reduces the existing coverage level. This in turn suggests that setting a uniform standard based on deposit value remains the best safeguard against a capital flight from one Member State to another. However, in a financial crisis this uniform threshold may not be sufficient for some Member States trying to prevent capital flight. A uniform standard may act as a pull incentive for depositors in Member States with vulnerable financial institutions to another Member State's financial system perceived as more stable. In these cases, a Member State, such as Ireland, may seek to

[106] Report from the Commission to European Parliament and to the Council, Review of Directive 1994/19/EC on Deposit Guarantee Schemes, COM(2010)369 of 12/07/2010 at p.2 available at [last accessed on 07/11/2018].
[107] Report on the minimum guarantee level of Deposit Guarantee Schemes Directive 94/19/EC, at p.29 available at http://ec.europa.eu/internal_market/bank/docs/guarantee/report_en.pdf [last accessed on 07/11/2018].
[108] *Ibid* at p.33.

extend their domestic scheme further for financial stability reasons. But this response may then constitute State aid.

When assessing the Irish *Credit Institutions Financial Support Scheme (CIFS)*, the Commission found that the "appropriate", "minimum necessary" and "proportionately" conditions under Article 107(3)(b)TFEU were met.[109] The Commission placed considerable emphasis on the stability grounds advanced by the Irish authorities as any measure taken to reduce the level of deposit outflows from the Irish financial system would obviously stabilise the funding position of Irish financial institutions. But the one underlying adverse effect of increasing the level of deposits placed with Irish financial institutions would be increasing the contingent liability the Irish State would have to meet in the event of a bank collapse. While such a scenario also arises in other State deposit insurance schemes the problem with such an outcome during a financial crisis within an EU Member State is that this may result in a State aid race among Member States and possibly trigger a distortion of deposit flows within the Union banking sector.

As Article 107(3)(b) TFEU provides for an exception to the State aid bar under the EU Treaties, it must like all exceptions be applied in a narrow manner.[110] If one examines the Commission's role in assessing the guarantee schemes introduced by Member States the only substantial restriction applied was the timeframe a guarantee scheme could be in place. But an obvious difference arises if one compares the "one-time-last-time" doctrine under the Rescue and Restructuring Guidelines and the timeframe limits placed on bank guarantee schemes. Instead of the Commission adopting a restrictive prolongation policy, guarantee schemes were continually approved for prolongation. There is a difference between simply extending pre-existing aid and authorising repetitive aid. However, one could posit that once the Commission authorised a bank guarantee scheme incorporating additional protection for depositors, that in effect there arose an "implied" form of future

[109] N.33 at para.74 (although the Commission refers directly to the Rescue and Restructuring Guidelines despite applying Article 107(3)(b)TFEU.)
[110] Case 2/74 *Jean Reyners v Belgian State*, [1974] ECR. 631 at para.43 available at http://www.cvce.eu/content/publication/1999/1/1/c5431ce6-7199-419f-b80f-a1580438bb88/publishable_en.pdf [last accessed on 07/11/2018].

protection. In other words, prolongation could be presumed on the part of creditors and depositors especially if one Member State were to revoke their scheme without other Member States also doing so at the same time thereby resulting in a possible capital drain from the latter's banking sector. Whether a guarantee scheme should be removed or extended ultimately depends on a number of factors ranging from banking sector reform, wider economic stability and a new robust financial regulatory environment.[111] In summary a guarantee should be revoked if "removal is a non-event".[112] Yet for the Commission and Member States the process of removing an expanded guarantee scheme, be it for depositors or bondholders, remains a complex one.

This is particular evident if one examines recent decisions by the Commission to authorise the continuation of the Polish bank guarantee scheme.[113] Initially introduced in 2009, this scheme has been prolonged in total thirteen times.[114] Although the scheme remains limited to just solvent financial institutions and only applies to newly issued senior debt, the underlying fact remains that despite the relevant stability of the wider banking sector within the Union, Polish banks were still dependent on a State guarantee up to June 2016.[115] In a similar vein, the Commission authorised the prolongation of the Cypriot guarantee scheme for a seventh time in 2016.[116] Yet again the focus on this prolongation remained on senior bank debt rather than depositors or subordinated creditors.[117] Therefore while one response to the Cypriot

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[111] G. Garcia, "Deposit Insurance and Crisis Management" (2000) IMF Working Paper WP/00/57 at p.66 available https://www.imf.org/external/pubs/ft/wp/2000/wp0057.pdf at [last accessed on 07/11/2018].
[112] *Ibid*.
[113] Commission Decision SA.43924 (2015/N) of 01/02/2016-*Poland Thirteenth Prolongation of the Polish Bank Guarantee Scheme-H1 2016*, OJ C(2016)534 available at http://ec.europa.eu/competition/state_aid/cases/261879/261879_1742367_107_2.pdf [last accessed on 07/11/2018].
[114] *Ibid* at paras.2-4.
[115] *Ibid* at paras.26 and 30.
[116] Commission Decision SA.43874(2015/N) of 11/01/2016-*Cyprus Seventh Prolongation of Cypriot guarantee scheme for banks-H1 2016*, OJ C(2016)52 available at http://ec.europa.eu/competition/state_aid/cases/261802/261802_1726892_83_2.pdf [last accessed on 07/11/2018].
[117] *Ibid* at para.27.

banking crisis was to impose losses on uninsured depositors, another response was to provide a State guarantee for other senior creditors.[118]

What the above examples of prolongation highlight is that each Member State's banking sector has specific challenges and obstacles that may require the continuing presence of some form of State guarantee. In this way the concept of "minimum necessary" may not necessarily be uniformly applied when determining how many times a guarantee scheme should be extended. A new State Aid Crisis Framework for the banking sector will need to address the exact parameters of the term "minimum necessary" both in respect of deposit protection and wholesale funding. Both of which will now be discussed below.

4.4.3. Statutory deposit protection versus blanket coverage

One could argue that extending the scope of deposit protection reduces the problems associated with inadequate *ex ante* or *ex post* deposit protection funds. According to research undertaken by Cariboni et al. in respect of deposit protection schemes, "in the great majority of cases, funds are sufficient to face intervention of small size".[119] Whereas during systemic events funds would struggle to "protect consumers".[120] As noted by Campbell et al., "[i]t is necessary to consider the proportion of depositors and the proportion of deposits that need to be protected" to prevent a bank collapse and protect small depositors.[121] But the fact remains that during the financial crisis the Commission failed to adequately tease out the actual boundaries of what falls within or outside of the "necessity" proviso. Neven and Verouden discuss the concept of "public goods" in respect of EU State aid law. According to the authors, "public goods represent an extreme case of

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[118] Bank of Cyprus Press Release: deposit to equity conversion, 8th April, 2013, available at http://www.bankofcyprus.com.cy/en-GB/Cyprus/News-Archive/deposit-to-equity_conversion/ [last accessed on 07/11/2018].

[119] J. Cariboni, E. Joosens and A. Uboldi, "The Promptness of European Deposit Protection Schemes to face bank failings", (2010) Vol.11(3) Journal of Banking Regulation pp.191-209 at p.208 available at http://www.palgrave-journals.com/jbr/journal/v11/n3/pdf/jbr201013a.pdf [last accessed on 07/11/2018].

[120] *Ibid*.

[121] A. Campbell, J. R. LaBrosse, D. G. Mayes, D. Singh, "A new standard for deposit insurance and government guarantees after the financial crisis" (2009) 17(3) Journal of Financial Regulation and Compliance pp.210-239 at p. 222.

externalities, as suppliers of these goods cannot appropriate the benefits that people derive from it".[122] This dichotomy between the demand for the product or service in question and the level of remuneration expected from the provision of this "public good" ultimately results in the State stepping in as an alternative provider.[123] Although financial institutions provide retail services such as deposit taking on a commercial basis, there is an obvious "public good" element in this relationship between bank and depositor, and indeed the wider payment system. Therefore, in cases where the normal functioning of this relationship between bank and depositor fails, the State may need to step in and provide additional protection. But the question then arises as to how one can accurately ascertain the "minimum" amount of aid sufficient to maintain this particular "public good".

A new crisis framework for guarantee schemes should dovetail with any pre-existing deposit protection scheme in a Member State. If a Member State seeks to extend the scope of a deposit protection scheme, then the Commission should ensure that this increase in scope remains limited to certain depositors. A principle of co-insurance should be applied to the extended deposit protection so that depositors remain liable for some degree of loss if this extended guarantee is triggered. Applying a co-insurance strand to any extended deposit protection scheme would not only ensure that depositors are not provided with a blanket State subsidy, it should also act as a limitation on the level of State support provided under a deposit protection scheme.

This approach aligns with the BRRD, where a number of liabilities are subject to a bail-in.[124] In exceptional circumstances these categories can be exempted but from a State aid perspective the number of creditor classes subject to such a proposal should remain limited.[125] One way of ensuring that the "bail-in" of

[122] D. Neven and V. Verouden, "Towards a More Refined Economic Approach in State Aid Control", Chapter 4 Part 1 of EU Competition Law-Volume 4: State aid" in W. Mederer, N. Pesaresi and M. Van Hoof, eds., Claeys & Casteels (2008), at 1.39 available at http://ec.europa.eu/dgs/competition/economist/economic_approach_sa_control.pdf [last accessed on 07/11/2018].
[123] *Ibid*.
[124] N.77 at art.44.
[125] *Ibid* at art.44(3).

certain liabilities is not circumvented in times of systemic crisis is by the Commission applying an additional criterion whereby the covered financial institutions must impose losses on subordinated and other junior creditors before availing of the guarantee scheme. Such a step would not only lower the contingent liabilities of the sovereign, it should ensure that both financial institutions and creditors are not subject to a systemic crisis subsidy as was particular evident in the case of the Irish banking sector. The same challenges facing deposit protection and guarantee schemes however also arise in respect of wholesale funding.

4.4.4. Wholesale funding

If one casts the actions of certain Member States in extending the scope of domestic deposit protection schemes during the 2008 crisis as in effect maintaining the provision of a "public good" then one could also examine the introduction of State support for the inter-bank funding market through an "essential facilities" prism. Under competition law, the "essential facilities doctrine" precludes one undertaking from barring a competitor from some product or service in a related market thereby undermining the latter's position vis-a-vee the former. For example, in one European case a shipping line could not preclude a competing undertaking from using its port infrastructure.[126] There are obvious limitations with invoking the "essential facilities doctrine" which falls within the market abuse domain of competition law rather than EU State aid law. However, one could posit that for certain Member States' domestic banking sectors the inter-bank funding market constitutes a parallel form of an "essential facility". An obvious benchmark may be extrapolated for determining the "minimum" amount of aid by applying a similar set of conditions as those used to determine whether the "essential facility doctrine" applies in certain cases or not. Particular focus here is on the following three "essential facility" conditions. First, can the "buyer obtain the goods and services elsewhere", second are "there other

[126] Commission Decision of 11th June 1992, relating to a proceeding under Article 86 of the EEC Treaty (IV34.174-Sealink/B and I-Holyhead-interim measures) available at http://ec.europa.eu/competition/antitrust/cases/dec_docs/34174/34174_2_2.pdf [last accessed on 07/11/2018].

downstream competitors" and third how important are "the goods and services to the buyer's business".[127] All three of these conditions could be tailored to apply in a State aid context when exceptional State support is required to resolve a market externality. This proposal ensures that State resources are provided to the financial institutions that require this support the most from the perspective of maintaining a competitive banking sector while also ensuring that the wider economy of a Member State does not experience a credit crunch. Another key advantage of this proposal is the fact that policymakers at both EU and national level would have to examine in greater detail the exact inter-bank funding needs of applicant banking sectors. This would then provide them with the information needed to apply more complex qualifications such as those proposed in this Thesis.

For instance, in the case of a guarantee scheme designed to alleviate the liquidity strain on financial institutions, the level of this support could be determined by applying a tailored form of the above three criteria. Thus adhering to the above three principles for the "essential facilities doctrine", the scope of a guarantee scheme for inter-bank liabilities should depend on the following three principles. First, can the relevant financial institutions access funding from an alternative source or without the need of a guarantee scheme? Second, if these financial institutions are unable to access inter-bank funding will this undermine their position vis-a-vee competitors? Third, how important is it for these financial institutions to access inter-bank funding? Even in cases where the Commission finds that a Member State's financial institutions do not have a viable alternative to inter-bank funding, and so require State support in doing so for competition and business purposes, certain restrictions should still apply. These will now be discussed below.

[127] J. Temple Lang, "Defining Legitimate Competition: Companies' Duties to Supply Competitors and Access to Essential Facilities" (1994) Vol.18(2) Fordham InT'l L. J. pp.437-524 at p. 476 available at http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1411&context=ilj [last accessed on 07/11/2018].

4.4.5. Contribution from banking sector and breaking the Sovereign-Bank Link

As noted in Chapter 3, Voszka discusses how the Commission failed to apply an effective limitation on the level of support Member States could provide to their domestic banking systems.[128] Focus on competition distortion safeguards meant that the Commission failed to successfully "stem the tide of aid" and "contributed to the accumulation and growth of state deficits".[129] However, one way in which this "tide of aid" may be successfully curtailed in respect of State guarantees is by placing a structural measure in place under the "minimum necessary" criterion. One possible structural measure may include a banking sector guarantor. For example the French guarantee fell under the remit of a banking fund.[130] Similarly in the case of Germany the bank guarantee was placed within SoFFin.[131] In both cases these funds were extensions of the State apparatus, both vehicles were State emanations and had recourse to State resources.

Developments at EU level have seen the establishment of the Single Resolution Mechanism and the introduction of the Banking Recovery and Resolution Directive. How these particular initiatives overlap with guarantee schemes will be discussed in Chapter 9. But one salient feature of this effort to harmonise bank resolution regimes within the common market is the focus on *ex-ante* resolution funding. Establishing domestic resolution funds which will over time merge to form one pan-EU fund should break the sovereign-bank link. Yet this model may also provide a useful benchmark for how to fund future bank guarantee schemes. In conjunction with establishing a bank resolution fund, Member States would, in order to satisfy the Article 107(3)(b) TFEU exemption for a future crisis, create a new guarantee fund

[128] E. Voszka, "Competition Policy in Europe-Temporary or Long-lasting Changes?" (2012) Vol.75(1) Public Finance Quarterly, pp.71-90 at p.82 available at https://www.asz.hu/storage/files/files/public-finance-quarterly-articles/2012/a_71_90_voszkaeva.pdf [last accessed on 07/11/2018].
[129] *Ibid*.
[130] Commission Decision State Aid N548/2008 of 30/10/2008, *Scheme for Refinancing Financial Institutions*, OJ C(2008) 6617 at para.5 available at http://ec.europa.eu/competition/state_aid/cases/228173/228173_1018733_33_1.pdf [last access on 07/11/2018].
[131] N.59.

which would be primarily based on the contribution of the participating financial institutions. This condition should not only address the issue of ring-fencing both the credit rating and financial resources of the Member State; it should also ensure that domestic financial institutions contribute to the cost of stabilising the wider banking sector. Another advantage of establishing a guarantee fund is that the scope of the guarantee would remain subject to a pre-defined limit. The contributions of the participating financial institutions would form the baseline of any guarantee provided with the Member State agreeing to advance an additional backstop. In effect this proposal would closely mirror that of the bank guarantee enacted by German policymakers.[132] This will be further discussed in Chapter 8.

4.4.6. Guarantee Funds and Financial Institutions' Contribution

The above proposals have obvious limitations as, ultimately, such funding depends on the structural form of a Member State's banking resolution architecture. In some cases, a Member State may not have the guarantee scheme fund in place although a bank resolution fund may be able to provide some form of guarantee support in times of financial crisis. Therefore, establishing a test to determine the level of contribution via a guarantee fee, financial institutions within a Member State should provide to a guarantee fund will be necessary. Chan-Lau et al. have examined the inter-linkages between banks and how this may spread contagion from one banking sector to another. The authors found that for banks based in London competitive strengths such as "accessibility, innovation and integration" also expose these banks to contagion risks.[133] Market integration and financial innovation may result in a confluence of risks where the financial position of one bank adversely affects another. From the perspective of a bank guarantee scheme, the participating fee should reflect not just the contagion risks a bank may

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[132] Commission Decision Nn17/2009 of 21/01/2009, *SoFFIN guarantee for Sicherungseinrichtungsgesellschaft deutscher Banker-Germany*, OJ C(2009) 440 final at para.13 available at http://ec.europa.eu/competition/state_aid/cases/229209/229209_1016043_31_1.pdf [last accessed on 07/11/2018].

[133] J.A. Chan-Lau, S. Mitre and L. Lian-Ong, "Contagion Risk in the International Banking System and Implications for London as a Global Financial Centre", (2007) IMF Working Paper 07/74 at p.23 available at https://www.imf.org/external/pubs/ft/wp/2007/wp0774.pdf [last accessed on 07/11/2018].

pose to other domestic financial institutions but also the wider banking system. A two pronged test should be developed to determine the level of contribution a guaranteed financial institution should pay. The following two questions may perhaps provide the best way to determine the level of contribution an individual financial institution should provide in exchange for availing of this State support. First, what market-share does the financial institution in question have in respect of lending and banking services? Second, what level of interconnectedness does the financial institution in question have with other institutions both domestically and throughout the Union via wholesale funding markets?

Depending on the answers of the first two questions, the level of contribution a bank may be liable for could be increased to reflect the contagion risk posed. Market share should determine the possible systemic footprint of the financial institution in question. Thus in the case of Irish financial institutions, both Allied Irish Banks and Bank of Ireland would have to discharge a higher guarantee fee than a financial institution such as Irish Nationwide Building Society, if an equivalent financial institution is active in a future Irish banking market.

To examine further how one would answer the second question, an overview of how the Commission enforces the concept of market dominance in EU competition law will need to be discussed. In this field, the Commission has established a definition for a relevant market in respect of "dominance" when determining whether or not an undertaking has "abused" their market position.[134] In the case of *Hoffman-La Roche*, the then European Court of Justice set out a detailed definition of market dominance.[135] Thus market dominance was based on the capacity of a market operator to utilise its market

[134] Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty OJ L1/1[2003] available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003R0001&from=EN [last accessed on 07/11/2018].

[135] Case 85/76, *Hoffman La Roche and Co v. Commission of the European Communities*, [1979] E.C.R 461 at para.91 available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61976CJ0085&from=EN[last accessed on 07/11/2018].

strength so as to impede possible competition from other market operators.[136] If one examines the Commission's decisional practice in the abuse of dominance arena, then it becomes clear that market share and dominance depends on the fragmentation of the market in question. For example, in its General Electric/Honeywell decision, the Commission found that a market share of 51% in the manufacturing of narrow-body commercial aircraft was sufficient to exercise a dominant position.[137]In general the Commission is unlikely to deem a market share of 40% as a dominant market share.[138] However, the relationship between market share and market dominance will clearly remain dependent on the specific characteristics of the market under examination. For example, in the BA/Virgin case the dominant market actor had a market share of 39.7%.[139] There are limited cases of the Commission examining abuse of a dominant position in the banking sector. In the case of Clearstream Bank, the Court of First Instance upheld the findings of the Commission that the bank "held a de facto monopoly" and was an "unavoidable trading partner" on the clearing and settlement of German securities.[140]

Related to market share is the question of relevant geographic market.[141] For the purposes of this proposed test, the geographical market would reflect not just the actual physical market setting of the financial institution in question but also the inter-Union footprint in other Member States via inter-bank funding markets. In this example, a financial institution such as Allied Irish Banks would meet this strand of the test due to its reliance on inter-bank

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[136] *Ibid*.
[137] G. Monti, "The Concept of Dominance in Article 82" (2006) Vol.2 ECJ pp.31-52 at p.40.
[138] "Competition: Anti-trust procedures in abuse of dominance", at p.1 available at http://ec.europa.eu/competition/publications/factsheets/antitrust_procedures_102_en.pdf [last accessed on 07/11/2018].
[139] Commission Decision (2000/74/EC) *relating to a proceeding under Article 82 of the EC Treaty* (IV/D-2/34. 780 ó Virgin/British Airways) (notified under document number C(1999) 1973) O.J. L 30/1 at paras.88 and 91 available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32000D0074&from=EN [last accessed on 07/11/2018].
[140] Case T-301/04 *Clearstream Banking AG and Clearstream International SA. v. Commission of the European Communities*, at para.146 available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62004TJ0301[last accessed on 07/11/2018].
[141] N.134.

funding prior to the financial crisis. However, while Anglo Irish Bank would also have met this second strand of the test it would not have met the first due to its relatively limited market share in the Irish banking sector. Therefore, at first glance this test may seem fallible as an imprudent bank such as Anglo Irish Bank would not have to discharge a higher contribution level than that of Allied Irish Banks and Bank of Ireland, actual long-term viable financial institutions. Yet, as will be further discussed in Chapter 5, a third strand could be applied to the contribution test so that even though a financial institution may not meet the first criterion, but does satisfy the second strand, then the Member State in question must determine whether the financial institution falls within a position of "dominant failure". If this is the case, then the additional contribution level will also apply.

By assessing these two factors, market share and geographical footprint, the Commission should be able to calculate the level of contribution each covered financial institution should be liable for. If one financial institution benefits more from a State guarantee scheme due to over-reliance on wholesale funding than other covered financial institutions, then the applicable fee should represent this fact. In certain cases, a financial institution may only meet the second strand but not the first and so an additional third criterion could then be applied based on the question of whether the bank is in a position of dominant failure.

4.4.7. Blanket Coverage and Minimum Necessary: Entry and Exit Fees

The above section discusses what level of contribution fees financial institutions may have to discharge under a new State Aid Crisis Framework. However, the need for a Member State to introduce a blanket guarantee scheme means that a different contribution criterion may need to apply to financial institutions availing of this support. In previous financial crises, a guarantee scheme was sufficient to allay depositor concerns, for instance after announcement of the Japanese blanket guarantee scheme deposit withdrawals decreased.[142] But holders of foreign liabilities may still decide to exit from a distressed financial sector even post the introduction of a blanket guarantee.

[142] N.104 at p.9.

As noted succinctly by Laeven and Valencia, "[i]n virtually all cases examined, an interesting pattern that arises is that foreign liabilities seem largely insensitive to the announcement of guarantees".[143] Therefore whether the "minimum necessary" criterion in the context of guarantee schemes should extend to wholesale funding, depends on the reliance a financial institution may have on this market for its operations. For example as Shin comments, Northern Rock's over-reliance on wholesale funding posed a central threat to the bank's long-term viability once international bank funding markets became constricted.[144] As wholesale debt began to mature Northern Rock was unable to issue new short-term debt.[145] One could also posit that long-term viable financial institutions, such as Allied Irish Banks and Royal Bank of Scotland, required wholesale funding during the crisis to maintain their market position against other competing banks.[146] There are certain positives for banks and the wider the banking sector for accessing wholesale funding, such as the role wholesale investors play in monitoring the financial performance of banks.[147] Equally there are a number of adverse consequences that arise from wholesale funding as these same investors have the capacity to withdraw their funding and may have an incentive to liquidate a financial institution to recover their funds ahead of normal retail depositors.[148] Despite these negative aspects of wholesale funding, in order to prevent the disorderly collapse of a bank, a sovereign guarantee may be required to cover these liabilities.

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[143] *Ibid*.

[144] H.S. Shin, "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis", (2009) Vol.23(1) Journal of Economic Perspective pp.101-109 at p.109 available at http://risk.econ.queensu.ca/wp-content/uploads/2013/10/Shin-Northern-RockJEP-2009.pdf [last accessed on 07/11/2018].

[145] *Ibid*.

[146] C. Pérignon, D. Thesmar and G. Vuillemay, "Wholesale funding dry-ups" Working Paper Series, N.49/July 2017, European Systemic Risk Board, at p.17 available at https://www.esrb.europa.eu/pub/pdf/wp/esrbwp49.en.pdf?f9afad129a57a3300547216f7d44dda7 [last accessed on 01/09/2017]: House of Commons Treasury Committee, The FSA's Report into the failure of RBS, Fifth Report of Session 2012-2013, at pp.7 and 16 available at https://publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/640/640.pdf [last accessed on 07/11/2018].

[147] R. Huang and L. Ratnovski, "The Dark Side of Bank Wholesale Funding" (2010) IMF Working Paper 10/170 at p.3 available at http://www.imf.org/external/pubs/ft/wp/2010/wp10170.pdf [last accessed on 07/11/2018].

[148] *Ibid* at p.4.

Although Member States intervened in the wholesale bank funding market by introducing State guarantees, this intervention did not necessarily result in an increase in wholesale debt issuance in the long-term.[149] This was mainly due to an increase in the "uncertainty and fears regarding the solvency sovereigns increased".[150] Therefore while a State guarantee for inter-bank funding may not actually prove to be a long-term solution the question remains whether such guarantees can meet the "minimum necessary" criterion where the Member State in question has introduced a blanket scheme for all bank liabilities.

One possible approach to curtailing the scope of the "minimum necessary" criterion in respect of blanket guarantee schemes is by applying tailored entry and exit fees. Such fees should only be repaid by the relevant financial institutions once normal market conditions have returned. Furthermore, the level of these fees should correspond to the total liabilities each financial institution had at the time the blanket guarantee was introduced. In this way the financial institutions which posed the greatest burden under the blanket scheme would pay the largest entry and exit fee once in a position to do so. This would constitute a form of claw-back mechanism so that the costs of providing a bank guarantee to the sovereign can in time be compensated in the longer-term. There are though limitations to imposing additional charges on participating financial institutions. Wehinger notes how any market-driven exit from State aid should not entail any "undue risk" and that any State support should be replaced by high-quality capital. This too would align with Basel III requirements that financial institutions have increased buffers of capital in case of a future financial crisis.[151] But attracting private market investors may proof difficult if such additional charges and fees apply to State supported financial institutions.

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[149] Recent developments in the composition and cost in bank funding in the euro area, ECB Economic Bulletin, Issue 1 2016 at p.30 available at https://www.ecb.europa.eu/pub/pdf/other/eb201601_article01.en.pdf [last accessed on 07/11/2018].

[150] *Ibid*.

[151] G. Wehinger, "The Financial Industry and Challenges Related to Post-Crisis Exit Strategies", (2009) Vol.9(2) OECD Journal: Financial Market Trends at p.10 available at https://www.oecd.org/finance/financial-markets/44563803.pdf [last accessed on 07/11/2018].

4.4.8. Minimum Necessary Criterion for Wholesale Funding and "Essential Facilities Doctrine"

The current basis for the essential facilities test in EU competition law is to determine whether a market operator is preventing access to an essential facility it controls in another market to impede competing undertakings. Although, the financial crisis of 2008 was a market failing from a macro perspective rather than one market operator attempting to distort the market itself, the impact of this failing on inter-bank markets was such as to undermine the market position of European financial institutions. The "essential" nature of inter-bank funding to certain financial institutions, meant that some new test needed to be established as how best to allow for these institutions avail of funding via State support.

Applying a tailored version of the "essential facilities doctrine" as a way of assessing the "minimum necessary" criterion in the case of bank guarantee schemes, should align with the above contribution and entry-exit fees conditions. For instance, in the first strand of the above counterfactual test for determining the "appropriateness" of a State guarantee scheme, the Commission should assess whether the Member States' financial institutions have access to alternative funding other than wholesale funding. However, if there are no alternative funding options in place there should still be some form of bank fund in place that can perform the role of guarantor before the State then has to step in. In this way the initial risk of default is to some degree internalised within a Member State's domestic banking sector before the State itself is called on to commit contingent or actual funds.

Any State guarantee scheme that extends to wholesale funding and indeed may cover all liabilities should realistically only be invoked if the remaining strands of the tailored "essential facilities doctrine" test are met. For example, if a Member State's domestic financial institutions are placed in a competitive disadvantage vis-a-vee other European financial institutions then blanket coverage may be a necessary response. Further, access to inter-bank funding may remain "essential" for certain Member States' financial institutions. However, if these last two strands are met then a claw-back entry and exit fee should be charged on the participating financial institutions. This fee should in turn reflect the level of liabilities each financial institution has guaranteed under the blanket guarantee scheme. Although this may be based on the actual liabilities falling under the State aspect of the dual bank-State guarantee fund as set out above.

These proposals will ensure that at a macro level the Commission applies a more detailed investigation as to whether or not a State bank guarantee should extend to inter-bank funding. However, even where this three step test is satisfied there should remain structural measures in place to constrain the possible exposure a Member State may face from providing an inter-bank guarantee scheme. Applying a delayed entry-exit fee should strike the correct balance between ensuring that a Member State is reimbursed adequately for the support provided to domestic financial institutions and allowing these same institutions to compete with other European financial institutions as per the tailored "essential facilities doctrine".

4.5.1. Bank Guarantees and Competition Distortion Safeguards

A future State Aid Crisis Framework will also have to tackle the possible competition distortion effects that may arise when a Member State introduces a blanket guarantee scheme for its domestic financial institutions. The final test the Commission applies when assessing State aid applications is whether or not the proposed measures are "proportionate" in respect of the possible competition distortions which may arise. A new State Aid Crisis Framework will have to also include new proportionately measures to ensure that competition distortions are minimised within the Union banking sector. During the financial crisis most Member States, including Ireland, failed to distinguish between insolvent and long-term viable financial institutions. Therefore imprudent market operators were allowed a "continued presence" in the market place and possibly undermined other firms in the market to the "detriment of consumer welfare".[152] This may engender a scenario where

[152] L. M. Perpiñà "Rescuing Icarus: the European Commission's approach to dealing with failing firms and sectors in distress", (2015) Vol.11(1) European Competition Journal pp.101-134 at p.107.

both prudent and imprudent operators have an adverse incentive to engage in high risk trading as there is no sanction for such conduct. A "moral hazard" that is not just confined to one sector or industry but to others as well. For example, in the context of regional aid programmes, Friederiszick et al. note how in regional aid, poorer regions may fail to take corrective fiscal measures if this reduces their access to State aid support.[153] One could also argue that a sector wide guarantee scheme causes an equivalent problem in that an imprudent bank has no incentive to restructure its business where this restructuring may result in exiting a State guarantee scheme.

Yet the problem with applying the ordinary tenets of competition distortion to the banking sector in times of systemic crises is the level of inter-connectedness between both insolvent and solvent financial institutions. The continued presence of an insolvent competitor may actually engender wider benefits for a prudent market operator as the adverse consequences of a banking collapse are circumvented.[154] This argument has particular cognisance when one examines the relationships between individual financial institutions within a Member State. However, from a wider pan-EU perspective competition concerns still remain evident where a guarantee scheme either distorts the flow of deposits or reduces the rate of interest for guaranteed bank bonds.

4.5.2. Proportionality safeguards and Guaranteed Bonds

A common safeguard imposed by the Commission on financial institutions under a guarantee scheme was a ban on these banks from publishing this very scheme.[155] But such a ban remains limited in effect as in most cases Member States made public announcements about the introduction of bank guarantee schemes. Furthermore, in respect of insolvent financial institutions the level of remuneration imposed for access may not act as sufficient counter against

[153] H.W. Friederiszick, L.H. Röller and V. Verouden, "European State Aid Control: An Economic Framework" in Paolo Buccirossi, ed., *Handbook of Anti-trust Economics* (Cambridge Massachusetts and London England: MIT Press, 2006) p.625 at p.635.
[154] B. Lyons and M. Zhu, "Compensating Competitors of Restoring Competition? EU Regulation of State during the Financial Crisis" (2013) Vol.13 J. Ind. Compet. Trade pp.39-66 at p.62.
[155] See Chapter 3 at p.29.

the distortion posed by these same institutions' continued market presence. Another failing of the competition distortion safeguards applied by the Commission is the absence of any prior examination as to how a sovereign guarantee would impact on the functioning of the bond market for guaranteed financial institutions.

According to Schich, research has indicated that the value of a sovereign guarantee for a financial institution ultimately depends on the financial position of the sovereign itself rather than the underlying financial position of the relevant financial institution.[156] For example, Grande et al. note how in one case a Spanish bank with a higher credit rating than a German competitor was still required to pay an increased interest rate as the value of the Spanish sovereign guarantee was viewed as inferior to that of the German one.[157] The authors came to the conclusion that in some cases, "the spreads at launch were not monotonically related to bank ratings: better rated banks in some countries paid larger spreads than banks in weaker countries". More succinctly, "the spreads seemed to reflect the nationality of the banks rather than their underlying soundness".[158] This in turn relates to the wider question of whether some form of pan-EU guarantee scheme may need to be implemented to alleviate these price differentials between financial institutions operating within the single monetary Union which will be examined in Chapter 8.[159]The reflection of nationality rather than soundness in spread prices also aligns with the findings of Estrella and Schich that the financial strength of the guarantor ultimately remains the most important determinant when credit rating agencies set credit default swap prices for guaranteed bank debt.[160] The better the financial position of the sovereign the

[156] S. Schich, "Expanded Guarantees for Banks: Benefits, Costs and Exit Issues" (2010) Vol.2009(2) OECD Journal: Financial Market Trends at p.15, available at http://www.oecd.org/finance/financial-markets/44260489.pdf [last accessed on 07/11/2018].
[157] G. Grande, A. Levy, F. Panetta, A. Zaghini, "Public Guarantees on Bank Bonds Effectiveness and Distortions" (2011) Vol.(2) OECD Journal: Financial Market Trends at p.11, available at http://www.oecd.org/finance/financial-markets/49200208.pdf [last accessed on the 07/11/2018].
[158] *Ibid* at p.12.
[159] Chapter 8 at p.254.
[160] A. Estrella and S. Schich, "Sovereign and Banking Sector Debt: Interconnectedness through Guarantees", (2012) Vol.2011(2) OECD Journal: Financial Market Trends at p.37

higher the value of the bank guarantee.[161] In Chapter 3 we also saw how Latvian banks were liable for a higher guarantee fee than larger German banks.[162]

Therefore, in certain cases a situation developed whereby different guarantee schemes in different Member States ultimately distorted the price of inter-bank debt to the benefit of more vulnerable financial institutions but at the expense of more prudent competitors. Both Estrella and Schich propose a number of possible solutions to this particular problem of sovereign-support distortion.[163] These include ensuring that "strong sovereigns" charge a higher guarantee fee to their domestic banks for availing of this indirect subsidy. As will be further discussed in Chapter 8, establishing a centralised guarantee fund may resolve a number of these problems at pan-Union level.[164] Other options include ensuring that sovereigns extend their scheme to international banks, which was actually a policy adopted by the Commission, or the establishment of an international body that could issue guarantees for banks across multiple sovereigns.[165] Yet each of these proposals have their flaws, as a "strong sovereign" may undermine its own banking system with excessive charges while other sovereigns may not be in a financial position to extend a guarantee to non-domestic financial institutions.[166] While politically there remains an unwillingness from certain stronger sovereigns to share banking liabilities with weaker sovereigns such as Greece.[167]

One possible option to counter this competition distortion is to impose a claw-back mechanism whereby the Commission re-examines the price of debt issued by financial institutions and then determines the level of discrepancy between the market price for the guarantee debt and the parallel price for non-guaranteed debt. The difference in pricing could then provide the basis for a penalty payment by the relevant financial institution to the Member State post

available at http://www.oecd.org/finance/financial-markets/48963986.pdf [last accessed on 07/11/2018].

161 *Ibid*.

162 See Chapter 3 at pp.2-5.

163 N.160.

164 *Ibid*.

165 *Ibid* at p.38.

166 *Ibid*

167 *Ibid*.

the financial crisis. Schich also suggests that guarantee fees should be altered where possible to reflect market prices while a penalty charge could then also apply to incentivise a bank to exit the State guarantee scheme in question.[168] The above proposal is similar to Schich's position except that it would apply retrospectively.

This retrospective penalty payment should serve two purposes. Firstly, it would remove the additional subsidy the financial institution in question availed of during the crisis and ensure that such a subsidy is not used to extend business lines or market share at the expense of less subsidised rivals. Secondly, this payment should ensure that the Member State in question receives adequate recompense for providing the guarantee scheme once the crisis abates in line with the repayment condition established under the proposed new "minimum necessary" criterion above.

4.5.3. Competition Distortion and Deposit Protection

Guarantee schemes that affect the normal market flow of deposits between different banks and different Member States during financial crises also trigger competition concerns. In other jurisdictions there have been examples of certain banks leveraging deposit guarantee schemes to improve their credit rating and thus expand their deposit base. Mayes cites the example of South Canterbury Finance which, after joining the New Zealand deposit protection scheme, "raise[d] considerable new finance from depositors and was able to increase its loan portfolio by a third".[169] Although if one examines the sharp decrease in deposits within Anglo Irish Bank between 2008 and 2009 post the introduction of the Irish guarantee scheme then it may that depositors will not always accept a guarantee scheme at face value if the guarantor in question is perceived as financially weak.[170] In order to liquidate South Canterbury

[168] N.156 at p.29.
[169] D.G. Mayes, "Government guarantees and contingent capital: Choosing good shock absorbers" in John Raymond LaBrosse, Rodrgio Olivares-Caminal and Dalvinder Singh ed., *Financial Crisis Containment and Government Guarantees* (Cheltenham: Edward Elgar Publishing, 2013) p.125 at pp.131-134.
[170] As of September 2008 total customer deposit in Anglo were €51.5 billion whereas on 31st December 2009 post the introduction of the Irish guarantee scheme customer deposits stood at €27.2 billion albeit retail deposits in Ireland grew within this period international deposits in the UK and Isle of Man did not. See Anglo Irish Bank Annual Report 2008 at p.8 available at https://assets.documentcloud.org/documents/284225/index.pdf [last

Finance the New Zealand authorities had to step in and pay out to depositors in full.[171]Even in cases where a deposit protection scheme is primarily designed to remain defensive, that is to retain deposits, rather than offensive and used to entice depositors from other jurisdictions, increasing the threshold for deposit protection may still give cause to competition distortions.

Although a financial institution availing of a blanket deposit guarantee remains liable for participating fees under the crisis framework an additional competition safeguard should apply. This may take the form of an *ex post* penalty applied to all financial institutions availing of a blanket guarantee for deposits once the crisis has abated so that any increase in deposits is not used to expand growth at the expense of competing banks within the Union. This charge should be based on the increase of deposit levels in financial institutions after the introduction of the blanket guarantee scheme for deposits. Each of the domestic Irish banks would be liable for such a charge but if foreign banks also availed of the Irish guarantee scheme they would remain exempt in cases where their domestic sovereign did not provide an equivalent guarantee scheme. In this way a longer-term competition equilibrium may develop between domestic financial institutions and foreign financial institutions. If the latter are not subject to an additional penalty charge this should in theory, ensure their continued market presence in the Member State in question and ensure that the domestic deposit market does not become subject to oligopolistic behaviour. Rosenberg and O'Halloran describe an oligopolistic market as one "where market power is concentrated among a small number of firms".[172] In these markets there are usually high barriers to market entry due to the "scale" of the incumbent market operators.[173] In some Member States, such as Ireland, a small number of

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accessed on 07/11/2018]; Anglo Irish Bank Annual Report 2009 at p. available at https://www.yumpu.com/en/document/view/3989058/annual-report-accounts-2009-anglo-irish-bank [last accessed on 07/11/2018].

[171] *Ibid*.

[172] S. Rosenberg and P. O'Halloran, "Firm Behaviour In Oligopolistic Markets: Evidence from a Business Simulation Game",Vol.10(3) Journal of Business Case Studies, pp.239-254 at p.240 available at http://webcache.googleusercontent.com/search?q=cache:YGMzhtgcYwUJ:www.cluteinstitute.com/ojs/index.php/JBCS/article/download/8714/8695+&cd=19&hl=en&ct=clnk&gl=ie&client=firefox-b [last accessed on 09/10/2017].

[173] *Ibid*.

banks may in effect determine the pricing of products and the interest rates to charge in a non-collusive but oligopolistic manner. Therefore, imposing these financial institutions to some form of penalty charge may fetter this market discretion if a foreign financial institution remains unencumbered by the same penalty charge. Alternatively, financial institutions subject to a blanket guarantee scheme for deposits could provide an undertaking to retrench from certain retail markets in order to allow non-guaranteed financial institutions, be they domestic or foreign, a market entry or expansion opportunity.

Table 1: Guarantee Communication and Future Proposed Guarantee

Guarantee Communication provisions related to guarantee schemes	**Appropriate Measure**
-may include deposits under guarantee scheme -should exclude subordinated liabilities but if included certain restrictions must then apply -general schemes should be limited in scope beyond the initial six month timeframe and may extend to 2 years -guarantee fees should reflect the market price where possible -guarantee triggered contribution should be provided by financial institution including via possible clawback mechanism -restriction on promoting guarantee scheme and balance sheet growth	-Is there an alternative to the guarantee? -Is the aim of the guarantee scheme regulatory forbearance or to restructure the domestic banking sector? -Is there an effective exit strategy in place for banks subject to this guarantee scheme? Blanket Guarantee Scheme Proposal - there is a sector wide downturn then a blanket guarantee may be introduced by a Member State rather than falling under the above three tests for a non-blanket guarantee scheme **Minimum Necessary** -Deposit Protection Perspective-apply a form of co-insurance Wholesale Perspective-Three test step-alternative funding/unable to access undermine competitive position vis-a-vee international competitors/ how important is the access to wholesale funding for these financial institutions

	Proportionate Wholesale-Financial institutions need to discharge sovereign premium Deposit-Offensive penalty applied so that financial institutions are subject to competition constraints to allow greater competition within a Member State's market

Conclusion

The effectiveness of the pre-existing State aid architecture, whereby the Commission determines whether the aid in question meets the "appropriate", "necessity" and "proportionate" criteria by reference to the applicable Crisis Communications remains questionable. A divergence has evolved between the actual guidelines established under the Crisis Framework and precisely what constitutes "appropriate", "minimum necessary" and "proportionate" aid. This Chapter has teased out the complexities evident in each of these State aid conditions and proposes new sub-criteria for determining the parameter of these terms in respect of bank guarantee schemes. For instance, when determining whether or not a guarantee scheme is an "appropriate" aid measure, the Commission should consider whether viable alternatives exist. Where a Member State wishes to introduce a blanket guarantee scheme, the Commission should adopt an additional test to ascertain whether this response is required depending on the underlying financial position of the Member State's banking sector. The actual scope of this guarantee scheme should also be subject to additional qualifications. In respect of deposit guarantees the Commission should invoke financial regulation and ensure that some form of co-insurance is introduced to counter moral hazard concerns. For wholesale funding, the Commission should examine how reliant a Member State's banking sector is on inter-bank funding in order to determine the coverage of a bank guarantee scheme. Where appropriate additional penalty fees should be applied either via claw-back mechanisms or a retrospective entry-exit fee based on the level of liabilities held by the financial institution when entering the guarantee scheme.

In respect of competition distortions, the Commission should apply additional safeguards that aim to establish some semblance of competitive balance between financial institutions subject to different State guarantee schemes. Most of these measures may be applied *ex-post* but at the very least these would ensure that recipient financial institutions could not use what in effect constitutes legacy aid to further distort future market practices. Imposing penalty charges on financial institutions' for availing of a blanket guarantee on deposits may appear at first glance as yet another drain on the future revenue of such banks. But by basing this charge on the level of deposit increase post the introduction of a blanket guarantee scheme ensures that there is a direct link between possible market distortion and the applicable competition distortion safeguards. Where no such deposit increase has arisen then this charge will not apply as by extension there has been no competitive distortion effect arising from the Member State's blanket guarantee for deposits.

A proposed new framework for guarantee schemes should not necessarily prohibit the introduction of blanket guarantee schemes. In future, a Member State may need to invoke an all-encompassing guarantee due to a systemic banking crisis. But any new crisis framework should have measures in place to better counter the toxicity of the sovereign-bank link which arises under such guarantee schemes. One must also be cognisant of developments at EU level in respect of bank resolution and depositor protection. These developments will be further discussed in Chapter 8, but for now suffice to say *ex-ante* resolution schemes, bail-in of certain creditors, and more substantial deposit protection funds should reduce the need for Member States to rely on blanket guarantee schemes in future crisis. The above proposals should though provide an effective benchmark for both Commission and Member States when applying more limited guarantee schemes. Furthermore, by establishing a coherent guarantee crisis framework for Member States to adhere to in times of crisis, a better balance should be struck between maintaining economic and financial stability within a short-timeframe while also ensuring that Member States such as Ireland do not become tethered to their domestic banking sector at the expense of their wider economy and society. The same problems though the Commission had to overcome in respect of guarantee schemes were also evident when trying to determine what was or was not a systemically important financial institution. This will now be examined in the next Chapter.

Chapter Five: State aid support to financial institutions and the question of systemic importance

Introduction

The central research question in this Chapter revolves around what should constitute a systemically important bank for the purposes of applying EU State aid law in a future financial crisis by using the past as a guide to future practice. This question requires examining the Commission and Member States' responses to the financial crisis during its initial phases and teasing out the exact parameters of what banks may fall under the systemically important category. Hence the application of EU State aid rules prior to the crisis will be assessed and then compared with the application of Article 107(3)(b) TFEU.

The key question of what constitutes or does not constitute a systemically important bank is mainly assessed via the example of Anglo Irish Bank. Other European examples are also assessed such as Hypo Real Estate and the Fortis Banking Group. While objective benchmarks from the banking industry may provide an indication as to what is or is not a systemically important financial institution, in times of a systemic crisis these benchmarks may not suffice. Therefore, what is required as part of any future State Aid Crisis Framework is a specific 'systemic importance' test that addresses the contagion threat a financial institution may pose. Furthermore, the question of systemic importance is not necessarily related to the question of long-term viability as an insolvent financial institution may also pose a systemic threat were it to enter liquidation during a systemic crisis.

Once the question of systemic importance has been addressed the next question is to determine what level of State aid such a financial institution should then receive. This particular challenge is addressed by proposing a new "minimum necessary" requirement for systemically important financial institutions. Thus this Chapter follows the same structure of that of the previous Chapter but tailored to reflect the specific complexities of assessing what constitutes a systemically important financial institution and what level of aid such an institution should then receive. Following this structure, the final section of the Chapter examines the possible competition distortion effects that may arise from any support provided to an insolvent but systemically important financial institution. This again aligns with the Commission's own assessment process where aid is considered first via an appropriate framework then a minimum necessary one followed finally by an examination of the possible competition distortion problems that may arise from the State aid in question.

5.1.1. Commission and Member State's State aid responses in the crisis: from guarantee to recapitalisation

The Commission performed a key role during the initial stages of the financial crisis as Member States sought authorisation for bailing-out domestic financial institutions. When the financial crisis arose Member States sought to apply the Rescue and Restructuring Guidelines when providing State aid to failing financial institutions. However, these guidelines were not designed for a systemic crisis in one particular economic sector let alone a pan-EU banking crisis. Furthermore the Commission was not designed to act as a crisis resolution authority.[1] Yet due to the wider economic challenges facing Member States, the Commission could no longer assess bank State aid applications in isolation from these very same challenges. Although commenting from an anti-trust perspective Jenny states that a competition authority, such as the Commission, has three options in times of economic crisis. These include applying competition rules as normal, no longer applying these competition rules for the duration of the crisis, or striking a balance between ensuring economic stability while also imposing some form of tailored controls on any anti-competitive conduct.[2]

[1] T.J. Doley, "Managing State Aid in Times of Crisis: The Role of the European Commission", (ECPR Fifth Pan-European Conference on EU Politics, University of Oporto and University of Fernando Pessoa, Porto, June 22nd-23rd) at p.12 available at http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf [last accessed on 07/11/2018].
[2] F. Jenny, "The Economic and Financial Crisis, Regulation and Competition" (2009) Vol.32(4) World Competition pp.449-469 at pp.459-460.

From a wider State aid perspective, which encompasses competition concerns but also questions of appropriate intervention and the level of support provided, the Commission's practices fell under the final option. State aid rules were still applied during the financial crisis, initially these encompassed the Rescue and Restructuring Guidelines, but later included specific Communications as discussed in Chapter 3. In many ways the Commission's 2008 response followed the same course of action as that post the September 11th terrorist attacks.[3]

For example, post September 11th, the Commission was willing to authorise two categories of State aid for the airline industry. Under Art.107(3)(b) TFEU, due to the exceptional nature of the attacks, the Commission allowed Member States to compensate airlines for the costs directly related to the closure of US airspace.[4] Yet the Commission's sole focus remained on the airline sector rather than how this event may have impacted on the wider economy. Therefore, in this case the "serious disturbance" in question remained rooted in one isolated sector rather than pose a systemic threat to the wider Union economy.

As discussed in Chapter 3, Member States sought to provide State aid to financial institutions during the 1990s, while the example of Credit Lyonnais will be discussed further below, a number of other banks also availed of State assistance. In most of these cases the level of support was sufficient to fund the restructuring of the bank until a private sector solution could be implemented. Thus in the case of Banco di Napoli, the final outcome saw the beneficiary being acquired by an insurance group and a banking competitor.[5] Similarly, post the support provided to the French institution Societe Marselliaise de Credit, Banque Chaix purchased this bank.[6] In both cases the Member State in question could in effect act as a stop-gate investor until a

[3] Commission Communication, The repercussions of the terrorists attacks in the United States on the air transport industry, of 10/10/2001, COM(2001) 574, available at http://ec.europa.eu/transparency/regdoc/rep/1/2001/EN/1-2001-574-EN-F1-1.Pdf [last accessed on 07/11/2018].
[4] *Ibid* at pp.8-9.
[5] A. Petersen, "State aid in Banking" in Claus Dieter Ehlermann and Michelle Everson, ed., *European Competition Law Annual, 1999, Selected Issues in the Field of State Aids* (Oxford-Portland Oregon: Hart Publishing, 2001) p.255 at p.259.
[6] *Ibid* at p.261.

private party could step in and continue the operations of the recipient financial institutions. However, the systemic nature of the 2008 financial crisis meant that even financial institutions unaffected by the wider instability were unwilling to acquire other banks in the absence of State aid support.

In cases where a systemic threat may arise if one market participant fails then "there is a clear and significant social benefit to the grant of aid".[7] However there is also a related cost when aid is granted in these cases, as Beck et al. note, when financial institutions avail of State aid this may trigger an associated increase in fees and lower interest rates.[8] A result which adversely impacts not only taxpayers but consumers namely, "borrowers and depositors".[9] Another adverse consequence of providing State aid to the banking sector is the fact that the level of aid provided may undermine the position of sovereign. Therefore, the Commission had a difficult balance to strike when assessing State aid applications as the 2008 crisis began, between engendering short-term stability and ensuring that short-stability did not trigger longer-term consequences for taxpayers.

There was a previous case of State aid intervention in the French banking sector that did provide a pointer for the Commission when assessing State aid applications in 2008. In the case of Credit Lyonnais, the French State sought to in effect bail-out this financial institution as liquidating the bank would trigger wider economic instability. Yet the Commission's position was that despite this threat of economic instability normal State aid rules should continue to apply.[10] In addition, the Commission also refused to consider the support provided to Credit Lyonnais under Article 87(3)(b)EC as the aid in

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[7] C. Ahlborn and D. Piccinin, "The Application of Restructuring Aid to Banks" (September 21, 2009) at p. 12 available at **http://ssrn.com/abstract=1476298** [last accessed on 07/11/2018].

[8] T. Beck, D. Coyle, M. Dewatraipont, X. Freixas and P. Seabright, "Bailing out the Banks: Reconciling Stability and Competition" (2010) Centre for Economic Policy Research at p.44 available at http://dev3.cepr.org/pubs/other/Bailing_out_the_banks.pdf [last accessed on 07/11/2018].

[9] *Ibid*.

[10] Commission Decision (98/490/EC) of 20/05/1998 *Credit Lyonnais* C(1998) 1494 [1998] OJ L221/98 at 64 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998D0490&from=EN [last accessed on 07/11/2018].

question was designed "to resolve the problems of a single recipient, CL [Credit Lyonnais], as opposed to the acute problems facing all operators in the industry".[11] Therefore, even though the demise of Credit Lyonnais would have potentially impacted on the wider French economy and by extension other French banks, the Commission was unwilling to apply the "serious disturbance" State aid exemption.

As will be discussed further below, in some of the earlier State aid applications in 2007 the Commission would also refuse to apply Article 107(3)(b)TFEU on the same grounds in Credit Lyonnais. However, as the crisis developed Article 107(3)(b)TFEU became the only practical provision to authorise State aid under. But this in turn raises other questions as to whether the Commission lowered the threshold raised high in Credit Lyonnais, to include financial institutions that did not even pose a systemic threat. To answer this question, the business models of these financial institutions before the crisis will now be examined and whether these models posed a systemic threat to the wider pan-EU banking sector. This relates in turn to the question of systemic importance and whether the concept of systemic importance may be defined in a broader manner in times of financial crises.

5.2.1. Business models of certain European Financial Institutions and Systemic Importance: From Ireland to Germany

As examined in Chapter 1, Irish financial institutions sought to increase their market share by accessing wholesale bank funding rather than relying on their domestic deposit base.[12] Therefore instead of Irish financial institutions only having domestic creditors, such as Irish depositors, they increasingly became reliant on European based funding from other financial institutions. According to the Central Bank of Ireland the United Kingdom represented the primary source of this wholesale funding, "[t]hroughout the 2000s the UK remained the predominant source of funding for the Irish banking system,

[11] *Ibid* at 65.
[12] See Chapter 1 at p.6.

representing 77 per cent of foreign funding by mid-2008".[13] Financial institutions from other EU Member States also invested in Irish bank bonds. For example, German financial institutions alone had inter-bank investments in Irish banks of €135 billion in September 2008.[14]

Post the demise of Lehman Brothers this source of funding for Irish banks became increasingly difficult to access as the "credit crunch" took hold. Three months prior to the introduction of the Irish blanket guarantee "foreign funding withdrawals amounted to €8 billion".[15] Certain Irish banks were more reliant on wholesale funding than others, both Anglo and Irish Nationwide Building Society had a limited deposit base on which to base further business growth.[16] Both financial institutions had over exposure to the property development sector.[17] Unlike the practice of securitisation in the United States Irish financial institutions such as Anglo Irish Bank and Irish Nationwide Building Society retained loans on their balance sheet. Thus the increase in non-performing property related loans would directly impact on the repayment capacity of these banks to finance inter-bank funding as it matured. To further examine the question of systemic importance the business models of other European banks will now be considered.

5.2.2. Other European Banks

Although Irish financial institutions had become vulnerable due to the increasing reliance on wholesale funding, in other jurisdictions financial institutions had also made similar market missteps. For example the Benelux

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[13] D. Coates and M. Everett, "Profiling the Cross-border Funding of the Irish Banking System" Vol. 2013 Economic Letter Series Central Bank of Ireland p.3 available at https://centralbank.ie/docs/default-source/publications/economic-letters/economic-letter---vol-2013-no-4.pdf?sfvrsn=10 [last accessed on 07/11/2018].

[14] D. Scally, "How much European money, particular German, was in the Irish economy when the music stopped", The Irish Times, (27th March 2013) available at https://www.irishtimes.com/news/politics/how-much-european-particularly-german-money-was-in-the-irish-economy-when-the-music-stopped-1.1339877 [last accessed on 07/11/2018].

[15] N.13.

[16] Merrill Lynch, "Presentation to National Treasury Management Agency 28th of September 2008" at p.2 available at http://opac.oireachtas.ie/AWData/Library3/Banking/BINTMACoreBook44.pdf [last accessed on 07/11/2018].

[17] *Ibid* at pp.20-22.

lender Dexia, via its US subsidiary FSA, had considerable exposures to the US subprime market.[18] Similarly, in Belgium the Fortis Group had direct exposure to the US subprime market and had further over-extended its financial position by purchasing a stake in ABN AMRO.[19] German banks had also become active in the subprime market while other more specialised lenders, such as IKB Deutsche IndustrieBank, were adversely affected by the wider economic downturn.[20]

In the United Kingdom financial institutions such as Northern Rock and Bradford and Bingley had placed excessive reliance on wholesale funding in order to sustain mortgage lending rates. For Northern Rock "by the end of 2006 75 per cent of funds came from sources other than retail deposits, primarily wholesale funding".[21] This corresponded with an erosion in the retail deposit base of the bank which decreased from €19.2 billion in December 2006 to just €9.39 billion in December 2007.[22] Financial institutions such as Royal Bank of Scotland and Halifax Bank of Scotland also had difficulty accessing funding. The former had failed to foresee the financial problems facing ABN AMRO, which it had purchased as part of a wider banking consortium.[23] While the latter become overly reliant on

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[18] Commission Decision NN49/2008, NN50/2008 and NN45/2008 of 19/11/2008 *Emergency aid to Dexia in the form of a guarantee for bonds and liquidity assistance*, OJ C(2008)7388 at para.61 available at http://ec.europa.eu/competition/state_aid/cases/227670/227670_944151_76_1.pdf]last accessed on 07/11/2018].

[19] Commission Decision N574/2008 of 19/11/2008 *State Guarantees for Fortis Bank* OJ C(2008) 7387 at para. 26 available at http://ec.europa.eu/competition/state_aid/cases/228379/228379_1018353_32_1.pdf [last accessed on 07/11/2018].

[20] Commission Decision N 639/2008 of 22/12/2208 *Germany Guarantee to IKB*, OJ C(2008) 8987 at para. 4 available at http://ec.europa.eu/competition/state_aid/cases/228885/228885_1034463_25_1.pdf [last accessed on 07/11/2018].

[21] "Northern Rock: The Impact of Public Support on Competition" (2009) The Office of Fair Trading p.9 available at http://s3.amazonaws.com/zanran_storage/www.oft.gov.uk/ContentPages/43533120.pdf [last accessed on 07/11/2018].

[22] *Ibid*.

[23] "High Level Expert Group on reforming the structure of the EU banking sector", Chaired by E. Liikanen, Final Report, October 2012, at p.60 available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf [last accessed on 07/11/2018].

wholesale funding to increase customer lending resulting in a total customer loan portfolio of some £456 billion.[24]

The above cases illustrate that prior to the 2008 crisis, financial institutions across the Europe Union had engaged in market expansion either via increasing credit provision or by acquiring other financial institutions. Yet both strategies reinforced the financial links between different financial institutions across different EU Member States. These links in turn raised additional complexities for policy makers in times of crisis as even a peripheral financial institution with a small market share may have had a financial relationship, via interbank lending, with a financial institution in either the same or different jurisdiction. A future State Aid Crisis Framework will have to address how exactly to identify these connections between financial institutions and whether these connections or overlaps then make a financial institution systemically important.

5.3.1. Bank Failure and the Question of Systemic Importance

Where financial links between financial institutions form and develop over time this in turn raises questions as to how the failure of one bank may impact on other financial institutions. Jenny notes that there are three types of bank failures, one where the failure of the financial institution may engender a systemic crisis such as AIG in the United States, two is when the failure of the financial institution is not related to mismanagement on the part of the executives but simply a result of another institution's failure, and three, the failure of the financial institution rests solely with the internal decisions by management.[25]

If one was to apply Jenny's three possible reasons for bank failure to the above financial institutions, it is not hard to come to the conclusion that most would fall under the last category. Management in a number of financial institutions such as Anglo Irish Bank, Royal Bank of Scotland and Dexia

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[24] Bank of Scotland plc. Annual Reports and Accounts, for the period ended 31st December 2007, at p.59 available at http://www.lloydsbankinggroup.com/globalassets/documents/investors/2007/2007_bos_ra.pdf [last accessed on 07/11/2018].

[25] N. 3 at p.454.

made strategic decisions which ultimately jeopardised the long-term viability of the bank. However, on closer inspection this may appear a somewhat simplistic argument as financial institutions such as Northern Rock and Anglo Irish Bank may have maintained their market presence had it not been for the sudden restriction in the inter-bank funding market. One could posit that management in both Anglo Irish Bank and Northern Rock adopted aggressive market growth strategies. These financial institutions were profitable before the crisis and both performed key roles in the provision of credit to the property development and residential mortgage sectors respectively.[26] Therefore in the market environment prevailing before the crisis a financial institution such as Anglo could easily have been considered systemically important. As Svvides and Antoniou comment "allowing a facilitator of the economy to fail" triggers further "concerns for dislocation of efficient credit allocation to firms and individuals".[27] In the pre-crisis banking sectors of both Ireland and the United Kingdom, both Anglo and Northern Rock were arguably key economic "facilitators". In effect this means that both financial institutions did play an important role in the wider economic landscapes of both Ireland and the United Kingdom prior to the crisis in property development and mortgage provision respectively. A "facilitator" in a banking sector context may not necessarily be confined to those banks that have wide market footprints via retail branch networks.

From a non-banking perspective, if a firm that plays a dominant economic role in a specific region then enters financial difficulty the adverse consequences will then spread to other firms.[28] Suppliers or customers of the failing undertaking may have to find new business partners while competing

[26] Anglo Irish Bank Annual Report and Accounts 2007 at p.40 available at http://www.passionforliberty.com/wp-content/uploads/2013/10/Annual_Report_2007.pdf [last accessed on 07/11/2018]; Northern Rock Annual Report 2007 at p.43 available http://www.n-ram.co.uk/~/media/Files/N/NRAM-PLC/documents/corporate-reports/res2006pr-annualreportandaccounts.pdf [last accessed on 07/11/2018].
[27] C. Savvides and D. Antoniou, "Ailing Financial Institutions: EC State Aid Policy Revised" (2009) Vol. 32(3) World Competition pp. 347-366 at p.358.
[28] European Commission Competition "Should aid be granted to firms in difficulty? Aa study on counterfactual scenarios to restructuring state aid" (2009) Oxera Report prepared for the European Commission p.110 available at http://www.oxera.com/Oxera/media/Oxera/Restructuring-state-aid.pdf?ext=.pdf [last accessed on 07/11/2018].

undertakings may be adversely affected by a possible contagion effect.[29] These wider consequences from the failure of an undertaking have arguably influenced the Commission's practice in assessing Rescue and Restructuring applications to non-bank undertakings. For example, Hancher et al. notes how in the 1990s the Commission authorised rescue and restructuring aid to Portuguese chemical producers.[30] The aid was used for a wide variety of productivity and modernisation improvement programmes but was considered "appropriate" due to the serious issues facing these undertakings.[31] Therefore, the Commission has recognised the possible systemic impact of a failing undertaking under the Rescue and Restructuring Guidelines. It is then not surprising that in a banking crisis that the Commission may not apply and develop a new crisis framework initially but adopt a rather broad interpretation of the systemically important concept.

Returning to Savvides and Antoniou's bank as a "facilitator" argument, if one considers that Anglo was a "facilitator of the economy", albeit a facilitator of one particular sector, then one can indeed argue that this financial institution qualifies as a systemically important undertaking. But there are counter-arguments to the proposition that both Anglo and Northern Rock were economic facilitators as neither financial institution exercised an exclusive monopoly position within their respective Member State's banking sector. Both Bank of Ireland and Allied Irish Banks could have performed Anglo Irish Bank's role in as "economic facilitator" were the latter to collapse as indeed could other financial institutions within the United Kingdom absorb the market position of Northern Rock.

However, from a wider perspective the main grounds for supporting Anglo and indeed other non-viable financial institutions was to maintain financial stability rather than whether the recipient in question was or was not an economic "facilitator". What illustrates this best is the first recapitalisation decision for Anglo Irish Bank where the Commission approved the Irish State

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[29] *Ibid*.

[30] L. Hancher, T. Ottervanger and P.J. Slot, *EU State Aids* (London: Sweet and Maxwell, 2012) at p.917.

[31] *Ibid*.

injecting some €1.5 billion into the bank in exchange for a "non-cumulative perpetual preference share".[32] But the underlying incentive for this intervention was to "ensure that Anglo is adequately capitalised to preserve financial stability".[33]

Beck et al. state that bank failure resolution has three primary *ex post* objectives: protect depositors and avoid bank runs; to maintain borrower-lender relationships; and to avoid any disruption of the payment and clearing system.[34] Goals one and three demand "rapid intervention".[35] If one considers the stability grounds for State aid intervention under Article 107(3)(b)TFEU then one can see a direct correlation between the bank resolution objectives as set out by Beck et al. and the State aid advanced to financial institutions such as Anglo and Northern Rock. In the case of Anglo periodic injections of State aid may to some degree invoke wider stability in the short-term and protect affected parties such as depositors, but in the longer-term, as evident in Ireland, this exacerbates the crisis. Gort and Galand note how "[i]nitially the Irish authorities expected that a limited recapitalisation and a guarantee covering, its (Anglo's) liabilities would be sufficient to save the bank and to keep it operating".[36]

In effect both Member States and the Commission utilised State aid as a means of preserving financial stability. However, it is submitted that the Commission failed to adequately address the question of whether financial institutions, such as Anglo, were or were not systemically important. Hence the threshold for invoking Article 107(3)(b)TFEU was lowered without resolving this particular question. This despite the fact that the Commission had initially proven reluctant to apply Article 107(3)(b)TEFU in the earlier stages of the crisis.

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[32] Commission Decision N/9/2009 of 14/01/2009 *Recapitalisation of Anglo Irish Bank by the Irish State*, OJ C (2009) 134 at para.17 available at http://ec.europa.eu/competition/state_aid/cases/230289/230289_978754_31_2.pdf [last accessed on 07/11/2018].

[33] *Ibid* at para. 28.

[34] N.8 at p.37.

[35] *Ibid*.

[36] C. Galand and M. Gort, "Massive State Aid to Anglo Irish Bank, Small Distortions of Competition", (2012) Vol.3(3) Journal of European Competition Law and Practice pp.263-265 at p.265.

5.3.2. State aid to banks under Article 107(3)(c)TFEU: Pre-Lehman Brothers response

The first European financial institutions to require State aid during the financial crisis were German banks such as WestLB and Hypo Real Estate. Both financial institutions had invested in complex financial instruments in order to generate better financial returns. As Hellwig comments certain German banks sought to increase their investment yields by investing in mortgage-backed securities from the United States.[37] But these investment decisions on the part of WestLB, while not unique to this financial institution meant that for the Commission the application of the Rescue and Restructuring Guidelines would suffice.

For example in the case of WestLB, the Commission rejected the German authorities stance that the aid provided to the recipient should fall under the Article 107(3)(b)TFEU exemption.[38] Instead the Commission, following its position in Credit Lyonnais, held that the problems facing WestLB were in many ways specific to the bank in question rather than as a result of wider market conditions prevailing at the time.[39] Similarly, in relation to Sachsen LB, the Commission considered the State aid application under Article 107(3)(c) TFEU and the Rescue and Restructuring Guidelines, rather than the wider "economic disturbance" exemption as set out in Article 107(3)(b)TFEU.[40] Other applications also were considered in this manner.

The initial Northern Rock State aid decision was also subject to the parameters set under the Rescue and Restructuring Guidelines. For the Commission, Northern Rock's "business model" with its "heavy dependence

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[37] M. Hellwig, "The Causes of the Financial Crisis", (2008) Vol.9(4) CESifo Forum pp12-21 at p.20 available at https://www.macroeconomics.tu-berlin.de/fileadmin/fg124/financial_crises/literature/Hellwig.pdf [last accessed on 07/11/2018].

[38] *Commission Decision* NN 25/2008 of 30/09/2008 (ex CP 15/08) *WestLB Risk Shield*, OJ C(2008)1628 at para.42 available at http://ec.europa.eu/competition/state_aid/cases/225266/225266_843256_6_1.pdf [last accessed on 07/11/2018].

[39] *Ibid*.

[40] Commission Decision C9/2008 (ex CP244/07 and ex NN 8/08) of 27/02/2008, *Germany Sachsen LB*, OJ C(2008)/711 def. at paras. 65-70 available at http://ec.europa.eu/competition/state_aid/cases/224576/224576_791168_24_1.pdf [last accessed on 07/11/2018].

on wholesale funding", pointed to an internal failing within this financial institution and so was best addressed under the Rescue and Restructuring Guidelines.[41] Interestingly, the Commission did not dispute the grounds put forward by the UK authorities that the demise of Northern Rock "would have affected other banks and created a systemic crisis".[42] Although the Commission conceded that the evidence of the UK authorities was sufficient to indicate a systemic crisis from Northern Rock's collapse such evidence did not necessarily extend to "constituting "a serious disturbance in the economy" of the UK within the meaning of Article 87(3)(b)".[43] Even though Northern Rock did pose a contagion threat for the wide UK banking sector the Commission was unwilling to apply the exemption under Article 107(3)(b)TFEU. Therefore, the Rescue and Restructuring Guidelines were considered more than adequate to resolve the problems facing both WestLB and Northern Rock. A wider systemic crisis had not yet developed, and so the long-term future of both WestLB and Northern Rock could be determined overtime under the 2004 Rescue and Restructuring Guidelines. If the initial rescue aid was successful than the recipient financial institutions could be restored to long-term viability, if not than both could be resolved in a controlled manner.[44] However, in time the Commission would asses further State aid applications for both banks under the Article 107(3)(b)TFEU exemption which illustrates the wider context of when an application for State is submitted remains a key external factor influencing the Commission's decision-making process.[45] The wider environment may have changed to such a degree that an "economic facilitator" with a limited business model, such as

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[41] Commission Decision NN 70/2007 (ex CP269/07) of 05/12/2007 *United Kingdom Rescue Aid to Northern Rock*, OJ C(2007) 6127 at para. 38 available at http://ec.europa.eu/competition/state_aid/cases/223064/223064_782466_33_2.pdf [last accessed on 07/11/2018].

[42] *Ibid* at para. 101

[43] *Ibid*.

[44] Commission Communication (2004/C244/02) Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty [2004] O.J. C244/02 at para.15 available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:244:0002:0017:EN:PDF [last accessed on 07/11/2018].

[45] Commission Decision C 14/2008 (ex NN1/2008) of 02/09/2008 *Restructuring aid to Northern Rock*, OJ C (2008) 1210 available at http://ec.europa.eu/competition/state_aid/cases/225083/225083_825918_2_1.pdf [last accessed on 07/11/2018].

Anglo Irish Bank, may have been a deemed viable undertaking in the absence of wider contagion fears. However, once the crisis hit the key consideration for policymakers at both national and EU level was to buttress the financial institutions on stability grounds rather than on actual viability grounds.

For example, by the time the Commission had to assess the restructuring plan for Northern Rock economic conditions had deteriorated further and a new crisis framework had been put in place specifically tailored for banks seeking State aid support. Lyons and Zhu argue that "[Northern Rock] was not a systemically important bank in the sense that even if it had collapsed, it would probably not have brought down other banks".[46] In effect the problems undermining Northern Rock were due to internal failings namely "a fragile funding model and risky loan portfolio".[47] While Lyons and Zhu's comments may have proven correct in the absence of a wider systemic crisis, the post-Lehman Bros. environment after September 2008 meant that even banks with internal mismanagement may have posed a systemic threat to rival prudent financial institutions. This becomes evident if one examines the Commission's subsequent decision-making in respect of WestLB. Despite WestLB having a history of repeated State aid support, the Commission now placed considerable emphasis on the role performed by the bank in "specific regional markets" as well as "its cross-border operations and its integration and co-operation with other public sector banks".[48] The diverse nature of the recipient's business model was, it seems, sufficient for the Commission to deem WestLB as "systemically relevant bank".[49]

Gebski suggests that the principle of non-discrimination may provide a reason as to why the Commission had in effect lowered the threshold for what constitutes a systemically important bank post the collapse of Lehman

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[46] B. Lyons and M. Zhu, "Compensating Competitors of Restoring Competition? EU Regulation of State during the Financial Crisis" (2013) Vol.13 J. Ind. Compet. Trade pp.39-66 at p.51.
[47] *Ibid*.
[48] Commission Decision N531/2009 of 07/10/2009 *Germany Assumption of risk for WestLB*, OJ C(2009) 7683 at para.22 available at http://ec.europa.eu/competition/state_aid/cases/233195/233195_1095432_60_2.pdf [last accessed on 07/11/2018].
[49] *Ibid*.

Bros..[50] "In consequence, all banks seem to qualify as "systemic"" due to the central role performed by the banking sector in the wider economy.[51] Policymakers too were in a difficult decision-making environment with limited knowledge as to the scope of bank interconnectedness across jurisdictions. If one was to apply one of the Hofstede cultural principles in this context, a form of "uncertainty avoidance" may have arisen whereby the key "uncertainty" to avoid in this case was the possible market response to the collapse of another financial institution.[52] Just as "a firm or a household" may have sought to retrench from spending until stability returned, policymakers sought to engender stability by stabilising financial markets rather than risk the uncertainty of non-intervention.[53]

For instance, Gebski notes the example of Kaupthing Bank which despite a balance sheet of just "€2.3 billion and 23,000 depositors" was still deemed systemic.[54] A similar point is also raised by Fossmark Pedersen who examines the Commission's response in the case of Max Bank AS of Denmark.[55] Despite the market profile of Max Bank, a financial institution only operating in the south and south-western regions of Denmark and with a deposit based of only €580 million, the Commission still found the bank to be of systemic importance.[56]The Commission found that the demise of even a small market operator in the Danish banking sector could have undermined consumer trust in other Danish banks.[57]

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[50] S. Gebski, "Competition First? Application of State Aid Rules in the Banking Sector" (2009) Vol. 6 CompLRev pp.89-115 at p.93 available at http://www.clasf.org/CompLRev/Issues/Vol6Issue1Article5Gebski.pdf [last accessed on 07/11/2018].

[51] *Ibid* at p.94.

[52] R. Inklaar and J. Yang, "The impact of financial crises and the tolerance of uncertainty",(2012) Vol.97(2) Journal of Economic Development pp.466-480 at p.478.

[53] *Ibid*.

[54] *Ibid*.

[55] K. Fossmark Pedersen, "State aid to Financial Institutions-the EU and EEA approach" (Master Thesis 2011, University of Bergen) at p.29 available at https://bora.uib.no/bitstream/handle/1956/5653/91858091.pdf?sequence=1 [last accessed on 07/11/2018].

[56] Commission Decision SA.33639 (2011/N) of 07/10/2011 *Rescue aid for Max Bank*, OJ C(2011) 7264 at para. 59 available at http://ec.europa.eu/competition/state_aid/cases/242130/242130_1266000_56_2.pdf [last accessed on 07/11/2018].

[57] *Ibid* at para. 59.

There are other examples of where the Commission altered its stance in respect of reassessing subsequent rescue aid decisions, such as BAWAG-PSK of Austria and Roskilde of Denmark, under Article 107(3)(b)TFEU.[58] According to Schiavo these cases illustrate "how necessary a broader interpretation of Art 107(3)(b) TFEU was".[59] But this again raises questions as to how exactly one can objectively determine what is or is not a systemically important bank. If pre-Lehman Bros a bank did not qualify as systemically important but post-Lehman Bros this qualification is met then this may indicate the Commission's capacity to change course in response to market developments. Yet this "flexibility" should not equate to an open-ended State aid policy where the interconnectedness of financial institutions trumps any other considerations. For instance, if an institution such as Anglo Irish Bank, with an imprudent lending policy, poses a wider threat to market stability then the actual underlying rationale for allowing this financial institution to fail is replaced by economic considerations. Therefore, in these cases the recipient financial institution is in effect is awarded aid not necessarily on the merits of a viable restructuring plan but on the basis of ensuring the viability of competing undertakings. While the wider economic considerations may have justified the aid in this case, the fact remains that some form of restriction should have applied to the level of aid provided. Anglo Irish Bank's systemic importance was in effect based not on whether it was an actual "economic facilitator" whose business lines could not be transferred to other financial institutions, but on the basis that its collapse would trigger further instability. But while maintaining stability remains a key consideration for policymakers, this should not mean the adoption of unrestricting and continuing State aid support from a Member State. Such a policy will simply reinforce the sovereign-bank link during times of financial crises.

[58] G. Lo Schiavo, "The Impact of Crisis-Related Framework on State aids to Financial Institutions: From Past Practices to Future Perspectives" (2013) Vol. 9 CompLRev pp.135-168 at p.143 available at http://new.clasf.org/CompLRev/Issues/Vol9Issue2Art3LoSchiavo.pdf [last accessed on 07/11/2018].

[59] *Ibid*.

In the first Anglo Irish Bank recapitalisation decision the Commission agreed that the intervention by the Irish authorities was rooted in public policy considerations rather than the State acting as a market investor.[60] The Commission then assessed the breakdown of Anglo's loan book, noting that the bank's loan portfolio "is approximately €72 billion and is heavily exposed to commercial investment property (c. €40 billion) and, more crucially, to the development sector (c. €20 billion)".[61] Applying the specific benchmarks laid down by the Recapitalisation Communication the Commission disagreed with the Irish authorities and concluded that Anglo Irish Bank was not a "fundamentally sound bank".[62] Therefore there was a penalty applicable to the level of remuneration Anglo Irish Bank had to repay to the Irish State.[63] But this point illustrates a key problem with both the crisis framework enacted by the Commission and the application of Article 107(3)(b)TFEU. Instead of adopting a similar set of principles to the Rescue and Restructuring Guidelines where the emphasis is on demarking long-term viable State aid recipients from non-viable undertakings, the crisis framework placed stability as a central policy consideration regardless of the underlying financial position of certain banks. While wider economic considerations may have justified the aid in this case, the fact remains that some form of restriction should have applied to the level of aid provided to Anglo Irish Bank. Anglo Irish Bank's systemic importance was in effect based on whether or not the bank could be a possible trigger for future market instability. But when seeking to maintain stability policymakers should be able to apply a framework that will not only maintain stability but also ensure that the sovereign-bank link is not reinforced undermining the wider economy of the Member State in question. If a bank is not "fundamentally sound" then realistically a liquidation plan should be implemented which may entail some level of recourse to State aid not a level of aid that may very well undermine the fiscal position of the Member State in question.

[60] N.32 at para.35.
[61] *Ibid* at para. 46.
[62] *Ibid* at para. 66.
[63] *Ibid*.

On the other hand if one examines the Commission's position in the initial pre-Lehman Bros decisions such as Northern Rock and Bradford and Bingley and then compare with the later decisions falling under Article 107(3)(b)TFEU the difference in approach is not perhaps as stark. For example, in the case of Bradford and Bingley, the first State aid application which was subject to the Rescue and Restructuring Guidelines, was focused on wider concerns as set out under point 25(b).[64] These concerns included protecting jobs at Bradford and Bingley and also protecting depositors.[65] Similarly in its WestLB decision the Commission authorised the implementation of a risk shield for the bank under Article 107(3)(c)TFEU as without this "the total capital ratio of WestLB would have fallen below the minimum quota required by the banking regulator".[66] This in turn would have presumably triggered resolution proceedings, therefore one could deduce from this decision that the Commission, even when applying the Rescue and Restructuring guidelines to banks, was still willing to authorise State aid intervention rather than allow for the possible liquidation of a bank. All this despite the fact that the Rescue and Restructuring Guidelines included grounds for an undertaking to be liquidated and any aid provided to be recovered as part of the liquidation process.[67]

5.4.1. State Aid in times of crisis: Appropriate, minimum necessary and proportionate

The crisis framework adopted to regulate State aid provision to financial institutions in distress contains three provisos which must be met in order for the aid to be deemed compatible under Article 107(3)(b)TFEU. In order to address any State aid concerns the aid must be appropriate for the objective

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[64]Commission Decision NN41/2008 of 01/10/2008 *Rescue aid to Bradford and Bingley*, OJ C(2008) 5673 available at http://ec.europa.eu/competition/state_aid/cases/227662/227662_884717_21_2.pdf [last accessed on 07/11/2018].

[65] *Ibid* at para. 47.

[66] N.48 at para. 45.

[67] Commission Communication (2014/C249/01) of 31/07/2014 Guidelines on State aid for rescuing and restructuring firms in difficulty [2014] OJ C249/1, at para.15 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0731%2801%29&from=EN [last accessed on 07/11/2018].

intended, the aid must be necessary so that the disturbance in the economy can be abated and the aid must also be proportional so that there are limited negative effects on competition.[68] During the peak of the financial crisis though what constitutes "appropriate", "necessary" and "proportionate" may become open to interpretation. These criteria are in effect the core principles the Commission applies in different State aid contexts as set out in Chapter 2.[69] In the previous Chapter each of these strands was examined in the context of bank guarantee schemes and now these strands will be examined and new interpretations proposed as to how these strands may apply in respect of systemically important financial institutions.

5.4.2. Appropriate aid for financial institutions in times of systemic crisis

When assessing the first State aid intervention for Anglo Irish Bank the Commission concluded that the aid advanced was indeed appropriate to "remedy a serious disturbance" in the Irish economy. The main factors which seem to have influenced the Commission's decision was the reliance of the bank on wholesale capital markets and the fact that Anglo Irish Bank was "one of the six core banks in the State".[70] But it was the threat Anglo posed to the wider Irish banking sector that appeared to be the central reason why the Commission ultimately concluded that the initial €1.5 billion was an appropriate remedy in these circumstances. "Therefore a loss of confidence in Anglo could undermine confidence in the Irish financial sector as a whole, thus entailing a serious risk of a systemic crisis in the Irish financial system".[71] However the problem with applying an "appropriate" benchmark in times of economic crisis is that in effect any level of aid may indeed qualify as an "appropriate" amount. Perhaps one commentator is correct when he states that "rescue aid is appropriate by its very nature" as "[i]t is targeted to

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[68] Commission Communication (2008/270/02) of 25/10/2008 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 C270/80 available at http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:270:0008:0014:EN:PDF [last accessed on 07/11/2018].
[69] See Chapter 3 at p15.
[70] N. 32 at para. 49.
[71] *Ibid* at para. 50.

remedy a serious systemic problem".[72] Yet this line of reasoning seems to suggest that rescue aid should be the default remedy in times of crisis regardless of the cost. While rescue aid may indeed be necessary in a crisis scenario this should not mean that stability is automatically linked with the continuous transfer of financial support from Member States to their domestic banking sector. If this occurs, then short-term stability trumps longer-term consequences such as a drain on Member State's resources and an implied reliance on the part of financial institutions that taxpayer funds will be available in a future crisis.

For example, the key aim in respect of the first and subsequent Anglo Irish Bank recapitalisations was to maintain wider financial stability. Therefore, one could argue that the Commission in effect based the "appropriateness" of an aid measure not necessarily on the grounds that the recipient may return to long-term viability but on stability grounds instead. In the case of HSH Nordbank the Commission also deemed a recapitalisation and risk shield as an "appropriate" measure in order not only "to eliminate the threat to the German economy" but also "to prevent an insolvency of HSH by moving the capital ratios of HSH above the required regulatory minimum".[73] Similarly for Dexia, the Commission accepted that the level of State support provided by Belgium was "appropriate" to maintain the bank as a going concern.[74] This support took the form of liquidity assistance so that Dexia could continue to redeem current funding for continued access to wholesale money markets.[75] Therefore it appears that the Commission adopted in most cases a presumption of systemic importance when it came to assessing the question of whether State aid should be authorised under Article 107(3)(b) TFEU.

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[72] E. Pentony, "Is the Commission's recent interpretation of Article 107(3)(b)TFEU a departure from established state aid policy in the financial sector?", (LLM Diploma Thesis, Dublin Institute of Technology, 2010) p. 49 available at http://arrow.dit.ie/cgi/viewcontent.cgi?article=1024&context=aaschssldis [last accessed on 07/11/2018].

[73] Commission Decision N264/2009 (ex-PN 59/2009) of 29/05/2009 *Rescue aid (recapitalisation and risk shield) to HSH Nordbank AG*, OJ C(2009) 4297 at para. 43 available at http://ec.europa.eu/competition/state_aid/cases/231161/231161_979302_94_2.pdf [last accessed on 07/11/2018].

[74] N.18 at para.61.

[75] *Ibid*.

Perhaps the Rescue and Restructuring Guidelines provide the best benchmark for determining whether State aid is "appropriate" in cases involving financial institutions during times of financial crisis. Yet in the case of Hypo Real Estate the Commission did apply the Rescue and Restructuring Framework in the initial decisions and this did not necessarily diverge substantially from the subsequent application of Article 107(3)(b) TFEU and the crisis framework. One of the conditions for rescue aid under the 2004 guidelines included that the aid in question was "warranted on the grounds of serious social difficulties and have no unduly spillover effects on other Member States".[76] There are a number of other qualifications such as the subsequent need for a Member State to submit a restructuring plan to the Commission within six months after the rescue aid is authorised.[77]

However, if one focuses on the "social difficulties" condition it is not hard to equate this to the "appropriate" benchmark under the crisis framework. In the case of Hypo Real Estate the Commission accepted that the insolvency of the bank would have resulted in multiple parties facing losses from employees to pension funds.[78] Thus in conjunction with the other applicable conditions for rescue aid under Article 107(3)(c) this "social difficulty" criterion was met and so rescue aid could be provided to the undertaking in question. If an undertaking in question does not receive rescue aid then it is highly likely, as a failing firm, to enter insolvency proceedings. In addition, this insolvency is likely to adversely affect related third parties. Yet the initial rescue aid provided to Hypo Real Estate remained substantial as did the subsequent restructuring support indicating that even the pre-existing Rescue and Restructuring Guidelines were not necessarily an adequate response for determining an "appropriate" level of State aid. An appropriate response for

[76] Commission Communication (2004/C244/02) of 01/10/2004 Community Guidelines on State aid for rescuing and restructuring firms in difficulty [2004] OJ C244/2 at para. 25(b) available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52004XC1001(01)&from=EN [last accessed on 07/11/2018].
[77] *Ibid* at para. 25(c).
[78] Commission Decision NN44/2008 of 02/10/2008 *Rescue aid for Hypo Real Estate* OJ C(2008) 5735 at para.28 available at http://ec.europa.eu/competition/state_aid/cases/227668/227668_1072011_33_1.pdf [last accessed on 07/11/2018].

a failing manufacturing undertaking such as a ship builder, may have at least a "default" value limit if internal restructuring has limited systemic consequences.[79] For instance, the exit of certain markets may benefit competing undertakings but in a banking context this exist may trigger short-term instability.[80] In contrast, a financial institution may have contingent liabilities such as deposits and inter-bank loans that if immediately withdrawn could trigger the "insolvency" of the financial institution. Therefore, an all-enveloping form of aid may be required to stabilise this undertaking whereas a lesser amount of aid may suffice for a manufacturing undertaking.

Clearly, both Member States and the Commission remain in a difficult position when ascertaining the level of State support that should be provided to a failing financial institution as the question of systemic importance remains unclear. Even where a financial institution remains insolvent, the threat this bank may pose to other banks means that question of whether State aid is an "appropriate" response or not becomes increasing difficult to answer. Appropriateness is no longer defined purely on the internal failings or successes of the relevant undertaking but on the possible interconnectedness of it to the wider banking system. This will mean that a future State Aid Crisis Framework will have to address how best to redefine appropriateness that not only examines interconnectedness but also different forms of interconnectedness.

5.4.3. State aid test for Systemic Importance

In times of financial crises, it is not hard to envisage both Member States and the Commission adopting a presumption of systemic importance in respect of almost all financial institutions. As noted above, the question of systemic importance remains complex and wider economic factors may further distort the answer to this question. The wider context such as the financial environment prevailing at the time and whether this simply amplifies existing

[79] Commission Decision SA.36143 (2013/HR) of 19/06/2013-*Pre-accession Croatia Restructuring of the shipbuilding company 3.Maj*, OJ C(2013)3556, at para.16 available at http://ec.europa.eu/competition/state_aid/cases/247552/247552_1457813_113_2.pdf [last accessed on 07/11/2018].
[80] *Ibid* at para.21(c).

failings within a financial institution or is an external shock undermining longer-term viability. In order to rebut this presumption of systemic importance two questions need to be addressed. First, what can be objectively defined as a systemically important financial institution? Second, even if a financial institution is deemed to be systemically important does this necessarily mean that the bank in question can return to long-term viability? According to the Basel Committee on Banking Supervision the five criteria to assess whether a financial institution is systemically important from a global perspective include, (1) cross-jurisdictional activity, (2) size (3) interconnectedness with the financial system (4) substitutability of the institution's activities and (5) complexity of this institution.[81] If one examines these conditions individually then arguably Anglo Irish Bank, with a limited market presence in other jurisdictions and a monoline business model, failed to meet both the cross-jurisdictional activity and the complexity criteria.[82] Furthermore, the substitutability criterion could arguably be said to be redundant in respect of Anglo Irish Bank as the financial institution's business model was primarily dependent upon an unsustainable property market. However, this bank did constitute a considerable presence within the Irish banking sector, and this presence in turn posed an interconnectedness threat to other Irish financial institutions. Thus while there are obvious benefits to the applying financial industry and regulatory benchmarks to EU State aid rules for the banking sector there are also limitations to applying the above criteria for determining systemic importance. Systemic importance remains rooted on two primary factors that the Basel tests do not address. These are firstly, the context in which a financial crisis may arise and secondly the actual market segment where this instability may occur. Further, in the post Bank Recovery and Resolution Directive and Single Resolution Mechanism regulatory landscape the test for systemic importance may require additional strands.[83] A new State Aid Crisis Framework must address these challenges and seek to establish a criterion for what constitutes systemic importance so

[81] Basel Committee on Banking Supervision, "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirements" July 2013, at p.5 available at http://www.bis.org/publ/bcbs255.pdf [last accessed on 07/11/2018].
[82] See Chapter 4 at p.112.
[83] This will be discussed in Chapter 8.

that not all financial institutions become by default, systemically important in times of crisis.

As noted above under the Rescue and Restructuring Guidelines the "social difficulty" exemption may provide an equivalent benchmark to possibly establishing a new systemically important test for the purposes of EU State aid control. This proposed test should in effect encompass three different strands of what constitutes a "social difficulty". In the context of the banking sector there are three primary stakeholders, these include the financial institution itself and the wider banking sector, the external parties reliant on this system, such as consumers, and finally the wider economy that may be affected by a failing financial institution. This in turn aligns with the position of Sjöberg that there are three different types of bank crisis.[84] On "level one" there are banks that are "individual non-systemic banks" whereby if they were to fail this would not "under almost any circumstance, be of systemic relevance".[85] "Level two" arises when a bank is systemically important but no wider systemic problems may arise so long as "the situation is handled promptly and correctly".[86] The final type of bank crisis is an actual "level three" systemic crisis whereby "substantial parts of the financial system in a country or, even worse, in the region or even the world are in deep distress".[87]

Sjöberg also examines what constitutes a systemically important financial institution. According to Sjöberg systemic importance may arise where a financial institution is "so large that its failure will create considerable disturbances to the functioning of the economy as a whole or where there is a risk of contagion".[88] Contagion may then occur where "difficulties in one bank lead to problems in other banks".[89] This contagion may spread due to the "direct links (through contractual relationships including credit exposures or the payment systems) between banks and indirect links such as via markets

[84] G. Sjöberg, "Banking Special Resolution Regimes as a Governance Tool", in Wolf-Georg Rinke and Peter M. Huber, ed., *Legal Challenges in the Global Financial Crisis,* (Oxford: Hart Publishing, 2014) pp.187 at p.190.
[85] *Ibid*.
[86] *Ibid* at p.191.
[87] *Ibid* at p.192.
[88] N.84.
[89] *Ibid*.

and/or rumours that the problems in one bank are also present in other banks".[90] Calomiris actually addresses this latter point when examining past US bank runs and finds that the failure of large banks was not the underlying cause but rather the response of depositors in withdrawing their funds from other financial institutions. In these cases the depositors were responding to the "temporary confusion about the incidences of shocks within the banking system".[91]

Yet the Financial Stability Board, has also defined a systemically important financial institution as one "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity".[92] A cursory glance at Sjöberg's three level model of financial crises and the Financial Stability Board's definition of systemic importance would suggest that large financial institutions and systemic importance are one and the same. However, this is not necessarily the case. As the example of US banking set out by Calomiris above shows, confusion among depositors or other market participants may trigger a systemic crisis regardless of the size of the originating financial institution. Some commentators have also stated that the "relationship between bank size and systemic risk is not always clear."[93] Previous banking crisis such as the Savings and Loan crisis in the United States "show that the failure of small banks can create systemic crisis".[94]Once perception forms among depositors that their funds may be threatened a herding mentality may arise which further precipitates other depositors withdrawing their funds from larger financial institutions.[95] The financial

[90] *Ibid*.
[91] C.W. Calomiris, "Bank Failures, the Great Depression and Other Contagious Events", in Allen N. Berger, Philip Molyneux and John O.S. Wilson, eds., the *Oxford Handbook of Banking* 2md ed. (Oxford: Oxford University Publishing, 2015) p.721 at p.732.
[92] "Policy Measures, to Address Systemically Important Financial Institutions" Financial Stability Board, 4th November 2011, available at http://www.fsb.org/wp-content/uploads/Policy-Measures-to-Address-Systemically-Important-Financial-Institutions.pdf [last accessed on 07/11/2018].
[93] "Assessing state support to the UK banking sector" Oxera Report Prepared at the request of Royal Bank of Scotland, March 2011, at p.4 available at https://www.oxera.com/Oxera/media/Oxera/downloads/reports/Assessing-state-support-to-the-UK-banking-sector.pdf?ext=.pdf [last accessed on 07/11/2018].
[94] *Ibid*.
[95] *Ibid* at p.12.

shock that may trigger the collapse of a large bank within a concentrated banking sector may have the same systemic consequences as in a fragmented market where multiple smaller banks face failure from the same shock in question.[96] Such a scenario follows Schwarz's definition of systemic risk as a risk that arises after an economic shock that triggers market or institutional failure via panic or other means causing a chain of failure thereby resulting in a funding crisis within the wider financial sector.[97] During the opening stages of the 2008 financial crisis, a similar panic had arisen whereby bank depositors and investors attempted to reduce their risk to financial institutions that may or may not have been failing. A new State Aid Crisis Framework will thus have to address how best to define the scope of this panic so that whether a financial institution is or is not systemically important can determined in more coherent manner.

If one again considers the three stakeholders set out above, then arguably examining these strands in isolation may not necessarily account for the threat of contagion. Even where a bank may not objectively have a systemic relevance, as per Sjöberg, and its demise should only impact on the financial institution itself, the second stakeholders, may interpret this collapse as a precursor to other bank failures. This is particularly true where these parties perceive there to be a link or connection between the failing financial institution and other banks. In this way, these stakeholders may then trigger an economic wide credit crunch thereby directly affecting the third stakeholder, namely the wider economy.

In past bank collapses as set out in Chapter 1, such as Herstatt Bank, Continental Illinois and Barings Bank, then arguably these failings only impacted the first strand of stakeholders, the banks themselves and possibly to some degree the wider banking sector. Depositors and other consumers may have been affected but not to the extent where a systemic crisis may have developed. But the question must then be asked whether financial institutions

[96] *Ibid* at p.4-5.
[97] S.L. Schwarz, "Systemic Risk", (2008) Vol.(97) Georgetown Law Journal pp.193-249 at p.198 available at http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2549&context=faculty_scholarship [last accessed on 09/10/2017].

such as Anglo Irish Bank, Fortis and Hypo Real Estate would meet this new three stakeholder strand test. Although, Anglo Irish Bank did not have a national retail network, according to the institution's 2007 annual accounts the bank did hold some €19.4 billion in retail deposits.[98] Similarly, Fortis had a considerable market presence within the Belgian retail banking sector, holding some 20-30% of all household deposits in Belgium as of the end of September 2008.[99] Thus while both Anglo Irish Bank and Fortis may have met all three stakeholder strand tests, Hypo Real Estate arguably would not have due to the absence of any retail presence.[100]

5.4.4. Indirect Effect of Market Exit: A new way of determining systemic importance

From the above three examples there remains an outlier in the market position of Anglo Irish Bank. As noted above this financial institution did not have a retail presence of any significance but its collapse would have resulted in undermining the market position of both Irish consumers and other market operators. Holding deposits of up to €19.4 billion meant that Anglo Irish Bank had shared a market presence in the same sector as both AIB and Bank of Ireland. In effect, the demise of Anglo Irish Bank may very well have triggered the same reaction from depositors as that discussed by Calomiris above. If one were to examine the developments in other industries that experienced market wide instability, then it becomes apparent that this "indirect effect" is not necessarily unique to the banking sector. For instance, the exit of a key supplier in a manufacturing chain could indirectly impact on consumers and other industry participants. Similarly, if the operator of an infrastructure facility was to collapse then this could also trigger wider market instability even though there is limited if any direct impact on the public at large.

98 N.26 at p.15.
99 N.19 at para.33.
100 Commission Decision NN44/2008 of 02/10/2008 *Rescue aid for Hypo Real Estate*, OJ C(2008) 5735 at para.2 available at http://ec.europa.eu/competition/state_aid/cases/227668/227668_1072011_33_1.pdf [last accessed on 07/11/2018].

As noted in Chapter 4, the banking sector falls under the term “essential facilities”, a term used to determine whether or not market operators can access certain infrastructure essential for their operations even though a rival (the owner of this facility) may seek to impede this access.[101] Although the term itself relates to a form of market abuse by a dominant market operator, the key consideration for present purposes remains the “essential” nature of the facility in question for other market participants. In a similar vein one could argue that a financial institution constitutes a systemic threat if it also performs some form of “essential” role for other financial institutions and consumers. Blair has examined the interventions pursued by the United States post the September 11th terrorist attacks in the domestic airline sector.[102] One rationale for this intervention discussed is the “network externalities argument” whereby if one link of a transport chain fails then this may have a negative effect for the wider transport network in question. As Blair states “[t]his line of argument suggests that there are positive externalities to each link in a smoothly functioning air transportation system that provides links to many locations” and any government intervention to maintain one link in this chain may be an “efficient” action to take.[103] This “network externalities argument” ties in with the notion of the indirect systemic effect a financial institution may have on the banking wider market.

For example, the indirect systemic effect of Anglo Irish Bank exiting the Irish banking sector would have resulted in undermining the market perception of other Irish financial institutions which did have retail branch networks. This market perception of the other Irish financial institutions, Allied Irish Banks and Bank of Ireland, may have been largely driven by overlapping “determinants” between Anglo and these two banks. For instance, if one considers the reasons a firm may enter or exit a market place then a number of different “determinants” may be developed that explain the actions of the exiting or entering undertaking in question. According to a study undertaken

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[101] Chapter 4 at p.89.
[102] M.M Blair, “The Economics of Post-September 11th Financial Aid to Airlines” (2003) Vol.37 Indiana Law Review pp.366-395 at p.377 available at https://mckinneylaw.iu.edu/ilr/pdf/vol36p367.pdf [last accessed 07/11/2018].
[103] *Ibid*.

by the Commission's Directorate General for Economic and Financial Affairs, in most cases firms exiting a market place primarily did so due to their small size both in respect of competitors and the average industry firm size.[104] New firms also struggled to maintain a market presence due to the deterioration of their funding position.[105] These were considered to be "firm specific determinants".[106] Other determinants include "industry specific" or "country specific". In respect of the former, there may be certain specific factors within an industry whereby new firms entering and incumbents exiting is a common occurrence.[107] As for the latter, country determinants could arise depending on how developed the economy of the jurisdiction in question is and whether macroeconomic shocks arise within a country or not.[108]

Lee et al. have examined whether a firm is more likely to exit a market place where the undertaking in question has simply entered this market due to the similarity with its pre-existing business lines.[109] According to their findings a firm may be more willing to "abandon" this new business line as the costs to the firm of "redeploying" its resources to existing business lines can be done so relatively cheaply without incurring additional losses.[110] Thus the level of "relatedness" between a firm's new business line and existing operations may have a dual entry and exit effect whereby expanding into a new market can be accommodated efficiently. Yet there is also an exit effect as withdrawing from this market can also be achieved without this necessarily jeopardising the entire viability of the firm in question unlike a firm that has spent considerable sunk costs.[111]

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[104] M. Cinera and O. Galgau, "Impact of Market Entry and Exit on EU Productivity and Growth Performance", Directorate General for Economic and Financial Affairs, Feb 2005, at p.14 available at http://ec.europa.eu/economy_finance/publications/pages/publication712_en.pdf [last accessed 07/11/2018].
[105] *Ibid*.
[106] *Ibid*.
[107] *Ibid* at p.15.
[108] *Ibid*.
[109] G. Lee, T.B. Folta and M. Liberman, "Relatedness and Market Exit", Working Paper January 2010, at p.3 available at http://www.anderson.ucla.edu/faculty/marvin.lieberman/docs/LiebermanLee_Relatedness.pdf [last accessed on 07/11/2018].
[110] *Ibid* at p.8.
[111] *Ibid*.

The above considerations, the three different market exit determinants and the possible link between "relatedness" and market exit on the part of a firm, provide an indication of how best to develop the "indirect" strand of a systemic importance test in the State aid sphere. For example, the three determinants of market exit align with the three possible similarities that may arise between the financial institution subject to a systemic importance assessment and other domestic market operators. In the case of Anglo Irish Bank, the similarities with both Allied Irish Banks and Bank of Ireland arose in two primary areas, first, they both operated within the same jurisdiction, and second, both operated within the same industry. Therefore, in this particular example two market determinants were met. Conversely, the firm determinant would not be met as the business model adopted by Anglo Irish Bank was predominantly related to one economic sector. In contrast, both Allied Irish Banks and Bank of Ireland had prior to the crisis, and still have post the crisis, relatively diversified business models.

5.4.5. "Relatedness" across firms

Despite these underlying divergences in business models there remained a common link between Anglo Irish Bank, Allied Irish Banks and Bank of Ireland not just in respect of country or industry determinants. This is where the question of "relatedness" becomes a key issue when assessing whether or not there is a possible threat posed by market connectedness. While Lee et al. focused on the question of "relatedness" from the perspective of an individual firm entering and exiting markets, this concept could be applied equally to certain sectors as a whole or across firms. For example, if one firm acts in a particular manner due to certain incentives or rationales that are common to other competing firms then an external party may surmise that these other firms will behave in the same manner and thus exit this market. Ulen comments how there are two circumstances in which the term "rational choice" can be used, one is where an individual may makes a choice that they have made on a "deliberative and consistent" basis.[112] In other words the

[112] T.S. Ulen, "Rational Choice Theory in law and Economics", 1999, pp.790-818 at p.791 available at http://encyclo.findlaw.com/0710book.pdf [last accessed on 07/11/2018].

individual in question considers the relevant facts that affect them and then make a final decision based on these considerations.[113] The second circumstance arises where a consumer has a particular preference and will seek to satisfy this preference to the maximum utility possible for their benefit.[114]

A third circumstance in which the term "rational choice" may apply is where an individual investor seeks to maintain their current financial position at all costs rather than to risk a possible loss on their investments. One way to ensure this is to excise any possible exposure to vulnerable shares and corporations including those that may have certain similarities with already known failing firms. This aligns with how market investors respond to financial crises or sudden sharp market downturns by participating in herding behaviour whereby the acts of one investor may trigger similar behaviour from others.[115] This herding behaviour may not just arise in respect of one single undertaking but also to other similar companies or at a macro level the sectors where the initial source of the herding behaviour operates in.[116] Therefore a rational bank investor or depositor may consider the key aspects of a failing financial institution, business model, industry in general and domestic jurisdiction, and conclude that other financial institutions with certain, if not all, of these similarities also pose a risk. In this way a contagion affect can develop even where there is no direct relationship between the initial source of market instability and other market operators. Clerc et al. assess this issue of indirect bank contagion and found that there are two primary "channels" in which this may arise.[117] For instance, where a financial institution has to liquidate all its assets this may result in a decline in asset value that directly affects other financial institutions with the same asset

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[113] *Ibid*.
[114] *Ibid* at p.791.
[115] S. Bikhchandani and S. Sharma, "Herd Behaviour in Financial Markets: A Review", March 2000 IMF Working Paper 00/48 available at https://www.imf.org/external/pubs/ft/wp/2000/wp0048.pdf [last accessed on 07/11/2018].
[116] *Ibid* at p.11-where how this may occur with different investment managers is discussed.
[117] L Clerc, A. Giovannini, S. Langfield, T. Peltonen, R. Portes and M. Schneider, "Indirect Contagion: the policy problem", Occasional Paper Series European Systemic Risk Board No.09 January 2016, at p.4 available at https://www.esrb.europa.eu/pub/pdf/occasional/20160126_occasional_paper_9.pdf?4e2c080fcc9a6f3af8f1e095fc62f3ff [last accessed on 07/11/2018].

base.[118] There may also be adverse rumours or information circulating about a financial institution that results in external parties, be these investors or other institutions, seeking to reduce their exposure to this firm and others.[119] A number of proposals are suggested by Clerc et al as to how the threat of indirect contagion can be mitigated against. These include more transparent bank balance sheets so that investors have a better appreciation of an institution's liabilities, greater capital buffers on the part of institutions and also increasing bank reliance on more stable funding models.[120]

But for present purposes the key point remains that systemic importance ultimately remains contingent on whether other market operators have a number of market exit determinants that align with those of the failing financial institution. Therefore, where these determinants remain key factors for bank creditors then this should provide key grounds for determining whether the financial institution falls under the systemically important criterion.

5.4.6. New Systemic Importance Test: Three Stakeholder Strands and Indirect Effect

Under a future State Aid Crisis Framework for the banking sector both Member States and the Commission will need a more robust test when determining whether or not a financial institution is systemically important. One possible way to answer this complex question is to apply the above three-stakeholder strand test and see whether the second strand of this test indicates that a wider economic disturbance is likely to be triggered. If the second strand of stakeholders, namely depositors and bank investors, consider that other financial institutions have the same, what could be termed, "failing determinants", then this should indicate that the bank in question does pose a systemic threat. As noted above in respect of herding behaviour, the drop of share value in one undertaking may trigger investors seeking to reduce their exposure to this undertaking as quickly as possible as uncertainty spreads

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118 *Ibid*.
119 *Ibid*.
120 *Ibid* at p.27.

among consumers or investors.[121]Therefore, preventing this financial institution's collapse should prevent a contagion effect from spreading. It must also be pointed out, that the first stakeholder strand may encompass financial institutions that will come to the same conclusion as those in the second stakeholder strand. In these circumstances, the perception of a failing financial institution may extend from the first strand to the second and thereby impact the third. For these reasons, the question of systemic importance will not just revolve around the size of a financial institution but also the wider market context prevailing at the time. In this way the Commission should be able to apply a test that addresses the immediate concern of financial stability. However, the related question of how much support a systemically important financial institution should receive will also need to be re-examined. An issue addressed next in this Chapter.

5.5.1. Minimum Necessary and Insolvent Financial Institutions

The second criterion under Article 107(3)(b)TFEU revolves around the "necessity" of the aid or more precisely that the level of aid provided must be the "minimum amount necessary" to meet the objectives of this intervention. A new State Aid Crisis Framework will have to include new parameters for what constitutes the "minimum necessary" in case where a financial institution may be systemically important but is not actually a long-term viable financial institution. At first glance this criterion appears to complement the "appropriate" benchmark. For example, the initial State aid recapitalisations provided to Anglo Irish Bank were deemed to meet this "necessity" standard. Yet the cumulative State aid costs for Anglo Irish Bank equated to €29.440 billion.[122] Over time repetitive applications for State aid would become common occurrence during the initial years of the financial

[121] L. Nowzohour and L. Stracca, "More than a feeling: confidence, uncertainty and macroeconomic fluctuations", ECB Working Paper Series, No.2100/September 2017, at pp.9-10 available at https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2100.en.pdf?da4d868b13bddcf282e0eafd962956eb[last accessed on 07/11/2018].

[122] Commission Decision SA.32057 (2010/NN) of 21/12/2010 *Temporary approval of the fourth recapitalisation and guarantee in respect of certain liabilities in favour Anglo Irish Bank*, OJ C(2010) 9503 at para.16 available at http://ec.europa.eu/competition/state_aid/cases/239758/239758_1187960_26_2.pdf [last accessed on the 07/11/2018].

crisis. If one considers the application of the "one-time last-time" principle under the Rescue and Restructuring Guidelines, then clearly a similar restriction was absent from the Commission's crisis framework particularly in a financial crisis where continued uncertainties make the concrete application of such a rule difficult to apply in practice. Yet applying this principle to the banking sector remains a complex task. For example, when assessing the Commission's application of this qualification in the case of Credit Lyonnais and the GAN Group, Schütte observes that "the higher amounts concerned are, the easier it is to overrule the principle".[123] Albeit the author does concede that the Commission may be able to consider "new circumstances" when assessing a new State aid application.[124] In the context of a failed restructuring plan what is a "new circumstance" and whether there is a failing on the part of the recipient financial institution to implement this plan may not always be clear.[125]

A closer look at the earlier Anglo Irish Bank recapitalisation decisions illustrates this point further. The first recapitalisation for Anglo Irish Bank was €1.5 billion, a sum the Commission considered more than sufficient to "remedy concerns about the Anglo Irish Bank and thus the Irish financial system".[126] However this support did not prevent the need for the bank to access a further recapitalisation of €4 billion.[127] In effect the Commission accepted the Irish authorities' stance that this second amount was required to ensure that wider banking sector measures could proceed namely the Irish banking guarantee schemes and the establishment of the National Asset Management Agency. Furthermore, the Commission accepted the absence of any specified return on this recapitalisation in line with the Recapitalisation Communication as this intervention was viewed "solely as a temporary urgent

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[123]M. Schütte, "The Rescue and Restructuring of Banks: Loans and Guarantees to Banks" in Claus Dieter Ehlermann and Michelle Everson, ed., *European Competition Law Annual, 1999, Selected Issues in the Field of State Aids* (Oxford-Portland Oregon: Hart Publishing, 2001) p.375 at p.383.

[124] *Ibid*.

[125] *Ibid*.

[126] N.32 at para. 55.

[127] Commission Decision N356/2009 of 26/05/2009 *Recapitalisation of Anglo-Irish Bank by the Irish State*, OJ C(2009) 5185 at para.23 available at http://ec.europa.eu/competition/state_aid/cases/231723/231723_970996_46_2.pdf [last accessed on 07/11/2018].

relief on the assumption and condition that in the longer term the costs of public intervention in Anglo Irish Bank's favour will be reflected in the in-depth restructuring plan which must be submitted".[128]

If one further traces the Commission's decision-making process in respect of Anglo Irish Bank this contradiction between "necessity" and actual long-term viability becomes more evident. For example, in one decision the Commission deemed an enhanced recapitalisation of €10.44 billion to be compatible with the crisis framework but questioned the restructuring plan for the bank.[129] Under this plan Anglo Irish Bank would be spilt into an Old and New Bank, the Old bank would be used as a resolution vehicle while the new bank would enter new markets such as the German bank deposit market.[130] For the Commission these proposals remained contingent on a number of variables mainly related to the funding and liquidity profile of the new bank.[131] However, when assessing the compatibility of the recapitalisation with Article 107(3)(b) TFEU the Commission examined this support via a regulatory prism. The recapitalisation was considered "necessary" in order to ensure the recipient financial institution could meet the applicable regulatory capital adequacy ratios.[132] This was sufficient for the aid to fall under the "emergency aid" umbrella and so remain authorised for a six month period.[133] The final recapitalisation for Anglo Irish Bank would also be deemed "necessary" under the Banking Communication in order to ensure that the bank could continue as a going concern and also discharge deposits.[134] By this stage Anglo Irish Bank was subject to a resolution plan but despite this a further State aid recapitalisation was deemed "necessary" to conclude this plan.[135] Therefore the Commission's application of the "serious disturbance" exemption during the 2008 financial crisis, failed

[128] *Ibid* at para.64.
[129] Commission Decision NN12/2010 and Cc211/2010 of 31/03/2010 *Second Recapitalisation of Anglo Irish Bank and restructuring of Anglo Irish Bank*, OJ C(2010) 2235 at paras.164-165 available at http://ec.europa.eu/competition/state_aid/cases/235166/235166_1110647_39_1.pdf [last accessed on 07/11/2018].
[130] *Ibid* at para.56.
[131] *Ibid* at para.123.
[132] *Ibid* at para.156.
[133] *Ibid* para.163.
[134] N.122 at para. 62.
[135] *Ibid* at para.69.

to place adequate restrictions on the concept of "minimum necessary". This failure led to Member States becoming the only source of funding for struggling financial institutions at the expense of Union citizens and competing undertakings.

The level of State intervention in respect of Hypo Real Estate also mirrors that of Anglo Irish Bank. Initially the support provided was a loan of €35 billion from the Federal Government of Germany in order to facilitate wider banking sector support for the real estate lender.[136] This support met the Rescue and Restructuring Guidelines criteria for rescue aid, namely, the aid was provided under market conditions, was aimed at addressing a social difficulty, was limited in both duration and amount and the financial institution had not received aid within the prior ten years.[137] Subsequent aid provided to Hypo Real Estate in form of recapitalisations and additional guarantees was, as in the case of Anglo Irish Bank, deemed to meet the "necessity" criterion even though the underlying question of long-term viability was still unanswered.[138] A parallel line seems to have developed during the interaction with the Commission and Hypo Real Estate whereby continued State support in various forms was considered compatible despite the successful restructuring of the recipient financial institution remaining uncertain.

The key question that arises when rescue aid is provided to an undertaking is whether this support merely facilitates the continuation of the firm's own internal failings. In effect the rescue aid, at least from an initial perspective, simply reinforces the *status quo* position of the recipient undertaking in question. Although this *status quo* position may in time be altered via the acquisition or liquidation of the recipient firm. The fact remains that rescue aid does have conflicting objectives between maintaining the short-term market survival of the recipient undertaking and the longer-term objective of

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[136] N.100 at para.10.
[137] *Ibid* at paras 28-33.
[138] Commission Decision N694/2009 of 21/12/2009 *Emergency Guarantees for Hypo Real Estate*, OJ C(2009) 10636 at para.29 available at http://ec.europa.eu/competition/state_aid/cases/234342/234342_1037902_26_2.pdf [last accessed on 07/11/2018].

market equilibrium. In this context market equilibrium refers to a market where there has been no form of State aid intervention in question. Both objectives may in certain occasions overlap and align with each other. For instance, if the causes of a firm's failure remain exceptional in the context of the firm itself or the wider industry then intervention is objectively justified. The amount of rescue aid should then reflect the "exceptional" basis of the financial challenges facing the firm. In effect the possible failure of the firm is not due to consistent mismanagement or imprudent market behaviour but instead caused by some external or indeed internal anomaly.[139] In these circumstances rescue aid should not only meet the short-term interests of the recipient undertaking but also restore the longer-term objective of a competitive market place. In contrast with the above, the underlying basis for why a firm is failing may not be due to any external or internal anomaly but due to consistently poor market performance and lack of product innovation.

When researching the various causes behind an organisation's failure, Mellahi found a number of different schools of thought as to what could trigger a firm's collapse.[140] Some scholars place weight on external issues facing the firm while another branch of research examines this failure via an organisational studies angle.[141] For the latter branch the possible failure of a firm may be "linked with internal inadequacies in dealing with external threats".[142] Soltész and Lyons also comment how when a firm becomes loss-making that this constitutes a "market signal that resources are better used elsewhere".[143] The market has changed in line with "customer preferences" but the firm in question has failed to respond to these changes in its production lines.[144] This failing to respond effectively to customer preferences could also undermine the innovation strategy of the firm particular where the short-term

[139] See for example Barings Bank in Chapter 1.
[140] K. Mellahi and A. Wilkinson, "Organisational Failure: A critique of recent research and a proposed integrative framework", (2004) Vol.5-6 International Journal of Management Reviews pp.21-41, available at http://onlinelibrary.wiley.com/doi/10.1111/j.1460-8545.2004.00095.x/epdf [last accessed on 09/09/2017].
[141] *Ibid* at p.21.
[142] *Ibid* at p.28.
[143] U. Stolész and B. Lyons, "Rescue and Restructuring Aid" in Philip Werner and Vincent Verouden, ed., *EU State Aid Control: Law and Economics*, (The Hague: Wolters Kluwer, 2016) p.415 at p.416.
[144] *Ibid*.

costs of innovation remain considerable for the undertaking in question. Market innovation failures may therefore arise where management is unable to develop an exclusive means for innovation due to financial constraints and a lack of expertise.[145]

If this is the case, then any rescue aid provided not only prolongs this failure but may also constitute an artificial non-market led impetus for this firm to restructure its business lines at the expense of market rivals. This aid may indirectly subsidise the recipient undertaking's future product or market innovation which may also undermine the market position of non-aided competitors. But for present purposes the key question is how best to frame the "minimum necessary" provision of aid where the recipient may not be long-term viable but poses a systemic threat. Market equilibrium may not necessarily be achieved via determining a financial institution's long-term viability in this context but via assessing the level of support required to protect the wider public and economic interests of the Member State in question. Without this support the wider instability may spread and a market without the presence of some form of State support may trigger a complete collapse. Thus a market may only function with State intervention but the question then arises as to how much should this support encompass?

5.5.2. Time for a new approach: From minimum necessary to operational necessity

On a related to note to that above, how one can then apply the term "minimum necessary" during a systemic crisis? If one considers the application of this State aid limitation in other markets or sectors a similar issue also arises. For example, in the case of a failing airline or car manufacturer the "minimum necessary" may constitute a considerable injection of State aid. Nicolaides and Bolsa Ferruz have both examined the level of State aid advanced to various undertakings between the years of 2000-2013.[146] As part of this study

[145]"Innovation market failures and state aid: developing criteria", Oxera Report for the European Commission Directorate General for Enterprise and Industry, 25/08/06, at p.9 available at *bookshop.europa.eu/.../**innovation-market-failures-and-state-aid**.../NB7406273ENC_00*.[last accessed on 07/11/2018].

[146] M.A. Bolsa Ferruz and P. Nicolaides, "The Economics of State aid for the Rescue and Restructuring of Firms in Difficulty: Theoretical Considerations, Empirical Analysis and

a number of substantial supports provided by Member States to non-financial undertakings under Rescue and Restructuring Guidelines were critically assessed, these include the UK's support to Continental Railways, France's support to Alstom and Greek aid to Trainose.[147]

In all three cases the aid was provided to an undertaking with responsibility for a crucial piece of national infrastructure, be it a railway network or the maintenance of nuclear power stations. The level of support in each case ranged from €1 billion to €6 billion, thus making these three examples the "largest interventions" recorded by the authors.[148] What each of these examples illustrate is how the level of aid can in effect wax or wane depending on the level of economic importance the proposed recipient undertaking poses. For instance, the French authorities raised the possible direct and indirect job losses arising from the liquidation of Alstom while another possible adverse consequence was redacted.[149] Although it may be difficult to ascertain what this redacted comment related to, it could presumably have touched on issues of energy security for the wider French economy.[150]In any case as Galand et al. comment applying the "limitation of aid to the minimum represented a challenge for the Commission as the financial needs of Alstom were huge".[151]

Therefore, the underlying business or impediments to viability are such that only the provision of substantial rescue and restructuring aid is sufficient to ensure the continued operation of the undertaking in question. In a similar

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Proposals for Reform" College of Europe, Bruges Economic Research Papers 27/2013 at p.19 available at https://webcache.googleusercontent.com/search?q=cache:Z3y2pHaFZkwJ:https://www.coleurope.eu/system/files_force/research-paper/beer27.pdf%3Fdownload%3D1+&cd=1&hl=en&ct=clnk&gl=ie [last accessed 07/11/2018].

[147] *Ibid*.

[148] *Ibid*.

[149] Commission Decision (2005/418/EC) of 7/07/2004 *on the aid measures implemented by France for Alstom* [2005] OJ L150/24 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005D0418&from=EN [last accessed on 07/11/2018].

[150] *Ibid* at paras. 84-86.

[151] C. Galand, E. Marteil, A. Bacchiega, F. Malbo, E.Valle, "Commission authorises restructuring aid to Alstom under conditions", (2004) Competition Policy Newsletter No.3 pp.13-15 at p.15 available at http://ec.europa.eu/competition/publications/cpn/2004_3_13.pdf [last accessed on 07/11/2018].

manner, the level of rescue aid to a financial institution in times of wider market instability may extend the parameters of the "minimum necessary" criterion. Wood and Ali Kabiri discuss the complexities inherent in trying to remove and replace a failing financial institution from the wider banking sector.[152] They place significant emphasis on the fact that in other lines of business it may be particularly easy for a new entrant to acquire another firm if the former already has a "well-known" name.[153] In some cases this acquisition may see a joint-name being established as in the case of Abbey-Santander in the United Kingdom in 2004.[154] However, in the case of Northern Rock an immediate solution had to be arranged in order to ensure that a contagion effect did not arise.[155] Therefore in the absence of another market operator taking on the liabilities of Northern Rock the State had to step in and in effect finance the bank's operations. What Wood and Ali Kabiri propose as a solution to the complexities of bank resolution is that financial institutions adopt "living wills".[156] This refers to the need for financial institutions to have detailed resolution plans in place so that regulators and policymakers will be able to take prescribed steps of gradually resolving the bank with the aim of not triggering further market instability. Although this is now part of the European bank resolution landscape the fact remains that before a determination may be made as to the long-term viability of a financial institution some form of State support may be necessary to meet the needs of customers and depositors.[157]

Therefore, any future State Aid Crisis Framework should consider altering the "minimum necessary" criterion with a new "operationally necessary" strand. Although in general operating aid is not authorised by the

[152] G. Wood with A. Kabiri, "Firm Stability and system stability", in John Raymond La Brosse, Rodrigo Olivares-Caminal and Dalvinder Singh, (eds.)., *Managing risk in the financial system*, (Cheltenham England: Edward Elgar Publishing, 2011) p.181.
[153] *Ibid* at pp.183-184.
[154] *Ibid*.
[155] *Ibid* at p.185.
[156] *Ibid* at pp.187-189.
[157] Directive (2014/59/EU) of 15/05/2014, of the European Parliament and of the Council, establishing a framework for the recovery and resolution of credit institutions and investments firms, [2014] OJ L173/190 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN [last accessed on 07/11/2018].

Commission, there are circumstances in which this form of support may be found compatible with the EU Treaties. For instance, under the Commission's Guidelines on State aid to Airports and Airlines, Member State are able to advance operating aid to certain airports provided that this support meets wider Community interests.[158] Therefore in 2014 the Commission approved operating aid to Groningen Airport so that the recipient in this case could continue to provide a transport route for a geographically isolated area of the Netherlands.[159] In a similar vein under Regional State Aid Guidelines support can be provided to certain undertakings so that the costs associated with operating in an economically disadvantaged region can be alleviated.[160] This aid does not extend to large undertakings but only Small and Medium Sized Enterprises.[161] Operating aid to financial services and insurance undertakings is also prohibited under the new Regional State aid Guidelines.[162] The definition of "operating aid" set out in these Guidelines includes costs associated with the day-to-day management and operations of the recipient undertaking.[163] Costs associated with employees, material and communication all fall under the term "operating aid".[164] When authorising "operating aid", the Commission has the advantage of examining the exact needs of the applicant undertaking. Applying a similar approach to financial institutions even those that are insolvent may act as a counter to the need for a Member State to keep providing repetitive aid to a financial institution.

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[158] Commission Communication (2014/C99/3) of 04/04/2014 Guidelines on State aid to the airlines and airports" [2014] OJ C99/3 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0404%2801%29&from=EN [last accessed on 07/11/2018].

[159] Commission Decision SA.25248 NN43/*2009* of 09/04/2014 *The Netherlands-Operating Aid in favour of Groningen Airport Eelde NV* C(2014) 2218 at para.47 available at http://ec.europa.eu/competition/state_aid/cases/232516/232516_1535484_246_2.pdf [last accessed on 09/091/2017].

[160] Commission Communication (2013/C209/01) of 23/07/2013 Guidelines for regional State aid for 2014-2019 [2013] OJ C209/01 available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF [last accessed on 07/11/2018].

[161] *Ibid* at para.14.

[162] *Ibid* at para.17.

[163] *Ibid* at C209/7.

[164] *Ibid*.

5.5.3. Operationally Necessary Aid and Financial Institutions

If one was to consider the value of “operating aid” from the context of consumer choice and economic development in peripheral regions of the Union, then clearly there are wider benefits from the provision of this aid. Equally, providing some form of operating aid to financial institutions in times of systemic crisis ensures that the interests of consumers, in this case not only depositors but also commercial undertakings, can be protected, while the wider payment system of a Member State can be maintained. The question remains though as to what degree this support should be limited so that the sovereign-bank link is not further entrenched during the initial phases of the crisis.

One possible benchmark that should be used to determine the level of support provided under the “operationally necessary” criterion is assessing the wider role of the recipient financial institution. If the financial institution has an active retail branch network and performs a key role in the Member State’s payment system architecture, then the initial provision of “operationally necessary” aid should reflect this. In contrast, as noted above a systemically important financial institution may not necessarily have a retail branch network but due to certain overlapping determinants with other domestic financial institutions fall within the systemically important threshold. Therefore, a low level of operating aid may be sufficient to maintain the day-to-day business of this financial institution particularly where the level of deposits with the bank remain stable and other business lines can be gradually wound down without triggering wider systemic affects. If the core operations of the financial institution include the provision of credit to consumers and processing payments, then clearly a more substantial injection of operating aid may be required.

Further, the “operationally necessary” criterion could remain restricted in time to a 6 month period as under the Rescue and Restructuring Guidelines.[165]

[165] Commission Communication 92014/C249/01) of 31/07/2014 Guidelines on State aid for rescuing and restructuring firms in difficulty [2014] OJ C249/1 at para.12 available at http://eur-lex.europa.eu/legal-

Examining the financial institution's previous balance sheets and current costs base should ensure that an accurate level of aid for meeting the operating costs of the recipient can be ascertained. This figure may need to be inflated due to the wider market instability that may be pertaining at this point in time which should also reduce the need for repetitive applications for operating aid. In this way the Member State in question can ensure that it has additional discretion if the operational costs increase due to some further unforeseen disturbance.

But determining where best to utilise this aid may need to be further assessed by the Commission and Member State. Therefore, a targeted approach should be adopted whereby the initial operating aid is divided into two core strands. These should encompass consumer service provision and inter-bank processes. In the case of the former, operating aid should be aimed at ensuring that consumers have continued access to essential banking services and are able to access their funds where possible. The second strand may arise where the recipient financial institution maintains an essential part of payment system infrastructure or engages in processing transactions that involve other financial institutions. This second strand should then ensure system wide stability.

If during this six-month period the financial institution has to meet other costs such as the repayment of bondholders, then these debts should still be discharged by the institution's own resources and not via any operating aid provided by the Member State. This requirement should ensure that the operating aid provided is then targeted specially for meeting the needs of depositors or the maintenance of a specific part of banking infrastructure. The positive of a new "operationally necessary" test is that it provides the Commission and Member States with a concrete basis for determining the level of aid an insolvent but systemically important financial institution may require rather than applying a "minimum necessary" criterion that could remain open ended as per the last financial crisis.

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content/EN/TXT/PDF/?uri=CELEX:52014XC0731%2801%29&from=EN [last accessed on 07/11/2018]..

5.6.1. Competition Distortion Safeguards and Insolvent Financial Institutions

In order to cover all aspects of how a future State aid crisis framework will apply to insolvent financial institutions, possible competition distortion controls should be considered and set out. The possible competition distortion controls that may apply to an insolvent financial institution may not necessarily be the same as those that apply to a long-term viable financial institution. Such nuances will now be examined below When considering State aid applications under Article 107(3)(b)TFEU during the financial crisis the Commission appeared to view actual competition issues in a rather narrow light. Werner and Maier note how the accelerated procedure adopted by the Commission during the initial phase of the financial crisis may have resulted in competitors having less of an opportunity to challenge the terms of State aid provision.[166]

The prevailing environment at the time was such that stability appeared in most cases to trump competition considerations. As noted earlier, a firm may require recourse to State aid due to the behaviour of the undertaking in question or due to "[m]arket or sector specific factors".[167]For instance in certain industries the price increase of raw materials and relocation of key customers may trigger financial difficulties for those engaged in this sector.[168] Alternatively an undertaking may struggle after an industry wide shock, which may be exacerbated by the failure to diversify its business lines.[169] A similar issue may arise in the banking sector, as seen during the 2008 financial crisis, where a financial institution may struggle for survival due to external shocks but these shocks may actually further highlight internal weaknesses.[170]

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[166] P. Werner and M. Maier, "Procedure in Crisis? Overview and Assessment of the Commission's State aid Procedure during the Current Crisis", (2009) Vol.8 (2) EStAL pp.177-186 at p.185.

[167] "Should aid be granted to firms in difficulty? A study on counterfactual scenarios to restructuring state aid" (2009) Oxera report prepared for the European Commission at p.90-91 available http://www.oxera.com/Oxera/media/Oxera/Restructuring-state-aid.pdf?ext=.pdf [last accessed on 07/11/2018].

[168] *Ibid*.

[169] *Ibid*.

[170] As noted by Jenny above.

Certain banks such as Anglo Irish Bank and Northern Rock would fall under this category.

According to the Commission there are three forms of competition distortion.[171] Firstly, State aid may dis-incentivise other competing undertakings from actually investing in research and development if these efforts are in effect countered by an inefficient rival accessing State support to maintain the *status quo*.[172] Secondly, State aid may affect the "product market" as competitors respond to any moves made by the supported undertaking.[173] Thirdly, State aid may impact on capital inputs and the location of investment.[174] If one examines these three different strands of competition distortion it may appear at first somewhat difficult to apply these to the banking sector more generally.

Investment in research and development in the banking sector may not necessarily result in savings for consumers but may increase profits. The final strand is more difficult to assess in a banking context as "input markets" are not easily reconciled with structure of the financial industry. However, one can see a correlation between the second strand and competition within the banking sector. For instance, if a recipient financial institution increases deposit interest rates in order to attract funding then competing undertakings will have to respond to this new price threshold established by the bailed-out bank. In the case of the Dutch financial group ING, certain Italian banks argued that its Italian subsidiary, ING Direct Italia, had increased its deposit interest rate from 3.50% to 4.20% for new customers.[175] In response to this deposit rate increase another Italian bank, Banca Sistema had to raise its

[171] Common Principles for an Economic Assessment of the Compatibility of State aid under Article 87.3. at para.44 available at http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf [last accessed on 07/11/2018].
[172] *Ibid*.
[173] *Ibid*.
[174] *Ibid*.
[175] Commission Decision SA.33305 (2012/C) and SA.29832 (2012/C) of 16/11/2012 *State aid implemented by the Netherlands for ING*, OJ C(2012) 8238 at para.30 available at http://ec.europa.eu/competition/state_aid/cases/244692/244692_1419091_108_2.pdf [last accessed on 07/11/2018].

deposit rate above the new benchmark set by the State supported ING group.[176]

In this example one could argue that an artificial price has been set for deposits as if the price-leader was not "bailed-out" then efficient market operators would set a more realistic, undistorted, rate of return. In addition to this adverse effect on the "product market" one could posit that there is an adverse consequence for competitors as the "bailed-out" financial institution continues to utilise resources and assets that could be deployed more productively elsewhere. One positive outcome of when an inefficient undertaking exits a market is the disposal of under-utilised labour and assets to more efficient rival undertakings.[177] The EU State aid regime though seeks to alleviate the effects of State support on the wider market through either structural or behavioural constraints. Zimmer and Blaschczok comment how behavioural constraints mainly focus on restricting the recipient's behaviour from activity that is directly related to the aid in question.[178] In contrast, structural constraints such as the disposal of business units or subsidiaries "constitute significant intervention both in entrepreneurial freedom of the undertaking and the structure of the affected market".[179]

5.6.2. State aid and Regulatory Capital Ratios

A recurring feature evident in the State aid applications for financial institutions such as Anglo Irish Bank and WestLB is the fact that these banks had breached or were on the threshold of breaching regulatory capital ratios.[180] In the 1998 Credit Lyonnais decision the Commission again reiterated that State support provided to meet regulatory standards was not exempt from State aid oversight.[181] During the financial crisis the Commission has accepted that State aid may be provided on the basis that the

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[176] *Ibid*.
[177] N.167 at p.113.
[178] D. Zimmer and M. Blaschczok, "The role of competition in European State aid law control during the financial market crisis" (2011) Vol.32(1) E.C.L.R. pp.9-16 at p.11.
[179] *Ibid*.
[180] Commission Decision C40/2009 (ex N555/2009) of 22/12/2009 *Germany Additional aid for WestLB related to the spin-off of assets*, OJ C(2009) 10715, at para. 13 available at http://ec.europa.eu/competition/state_aid/cases/234461/234461_1039399_162_1.pdf [last accessed on 07/11/2018].
[181] N.10 at L221/62.

recipient financial institution needs to meet regulatory capital ratios. If these ratios are not met, then the bank may enter insolvency. In the case of Northern Rock the UK financial regulator agreed to waiver a restriction on a bank including Tier-2 capital as part of capital resources.[182] Gebski comments that during the mid-1990s up to 2008, the main form of State aid intervention for banks was to ensure that the recipient met "the minimum solvency ratio required by the EC Solvency Banking Directive".[183] In Credit Lyonnais the Commission viewed competition policy in the banking sector and prudential regulation as two sides of the same coin. According to the Commission both policies "are designed to achieve a common end, namely the development of a competitive, healthy banking sector".[184]

However, an obvious moral hazard concern arises if financial institutions are able to avail of State aid in cases where these banks are likely to breach capital ratios under financial regulation control. While no financial institution may deliberately aim to breach capital ratios, there may be cases where over-expansion undermines capital ratios substantially which in turn require a State bail-out. This becomes particularly evident in cases where the recipient financial institution has actually eroded their capital base in order to increase lending. A situation which arose in the case of Northern Rock as the bank came to the conclusion that, "under current Basel II capital requirements it was overcapitalised and proceeded to reduce its capital accordingly, so as to increase lending".[185]This example illustrates the limitations of capital requirements namely, that the adequacy or not of capital buffers depends on wider financial circumstances.[186] Although since the financial crisis new Basel III requirements have been implemented, with adverse scenarios

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[182] Commission Decision n°C 14/2008 (ex NN 1/2008) of 28/10/2009 *State aid implemented by the United Kingdom for Northern Rock*, OJ (2009) 8102, at para.20 available at http://ec.europa.eu/competition/state_aid/cases/225083/225083_1058677_200_1.pdf [last accessed on 07/11/2018].
[183] N.50 at p.98.
[184] N.10 at L221/62-63.
[185] N.21 at.p28.
[186] P. Teply, "The Key Challenges of the New Banking Regulations", (2010) Vol.6(4) International Journal of Economics and Management Engineering pp.1300-1303 at p.1302 available at https://waset.org/publications/15123/the-key-challenges-of-the-new-bank-regulations[last accessed on 07/11/2018].

included in the risk weighing for counterparty links.[187] Nevertheless, the practice of Member States intervening and utilising State resources to ensure that domestic financial institutions meet regulatory capital standards illustrates the problems posed when State aid and financial regulation overlap. If financial institutions are able to access further funding after breaching capital ratios, then there is no effective deterrent to operate in a prudent manner. This in turn may raise the spectre of a future banking crisis as past intervention measures are seen as indicative of future ones.

As noted above other banks also received substantial State aid even though the management policies prior to this support were a contributory factor giving rise for this intervention in the first place. If one considers the cases of both Fortis and Royal Bank of Scotland, then a conclusion can quickly be drawn that the internal decisions made by management in these financial institutions was the key factor behind the subsequent decline in the financial performance of both. Although the Commission acknowledged in the case of Fortis that the problems facing the lender were due to a number of different factors, one such problem included the bank's participation in the purchase of ABN AMRO.[188] In respect of Royal Bank of Scotland, not only did the bank adopt an aggressive expansion policy via acquisition it also engaged increasing credit provision.[189] In certain cases financial institutions that had availed of State aid in the past to invest in high risk products now had to access further State support. One stark illustration of this was certain German Landesbanken which utilised a pre-existing State guarantee to access increased funding at a reduced price.[190] However this funding was then used to invest in high-risk financial instruments such as sub-prime mortgages.[191]

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[187] "Basel III: Finalising post-crisis reforms", Basel International Committee on Banking Supervision, December 2017, at p.109 available at https://www.bis.org/bcbs/publ/d424.pdf [last accessed on 07/11/2018].

[188] N. 19.

[189] House of Commons Treasury Committee, "The FSA's Report into the failure of RBS", Fifth Report of Session 2012-2013 19/10/201 at pp.7-8, available at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/640/640.pdf [last accessed on 07/11/2018].

[190] F. Hüffner, "The German Banking System: Lessons From the Financial Crisis", OECD Economic Department Working Papers No. 788 at p.11 available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=eco/wkp(2010)44 [last accessed on 07/11/2018].

[191] *Ibid*.

The Commission's application of Article 107 (3)(b) TFEU during the 2008 financial crisis thus failed to distinguish adequately between financial institutions that had entered difficult due to wider market pressures and those that had engaged in imprudent behaviour prior to the crisis.

Whenever a failing undertaking receives State support the question of moral hazard remains a complex issue. At first glance during the financial crisis it appeared that exceptional support was required in order to engender wider stability. In effect, a presumption arose that the financial system as whole was liable to fail. This presumption in turn propagates a wider stance among competition authorities that despite the internal failings within a recipient financial institution moral hazard becomes a peripheral concern due to wider market instability. Certain policymakers such as Timothy Geithner believed that moral hazard concerns could be set aside or were peripheral as the wider financial sector was in danger of collapse.[192] Moral hazard may also difficult to counter in an environment where multiple financial institutions are receiving financial support from governments and States. For example, in the second Anglo Irish Bank recapitalisation decision the Commission concluded that the aid advanced to Anglo Irish Bank did not give rise to moral hazard concerns as other financial institutions within the Irish market were also beneficiaries of State aid either from Ireland or other Member States. Further State aid conditions aimed at minimising competition distortion were deemed unnecessary.[193] Even though the Commission would also note in the same Decision that Anglo Irish Bank "will receive the larger recapitalisation than most of the other aided banks" and this "aid" can result in a "serious distortion of competition even in an environment where many banks are in receipt of state aid".[194] As will be discussed further below, in certain cases there will be a default form of competition distortion where an insolvent institution

[192] Hearing with Treasury Secretary, Timothy Geithner, Hearing Congressional Oversight Panel, One Hundred and Eleventh Congress, First Session, December 10th 2009, at p.55 available at ttps://www.gpo.gov/fdsys/pkg/CHRG-111shrg55245/pdf/CHRG-111shrg55245.pdf[last accessed on 07/11/2018].
[193] N. 129 at para. 76.
[194] *Ibid* at para.139.

receives aid even if more prudent rivals have also received some level of assistance.

5.6.3. Default competition distortion versus competitor's stability

If a market environment functions correctly, then an insolvent financial institution or undertaking should be subject to an exit policy so that viable competitors can then absorb the valuable parts of the failed entity. Unfortunately, if an insolvent undertaking remains in situ via the intervention of State aid then this continued presence by itself constitutes a competitive distortion. Instead of the customer base and assets of an insolvent undertaking been re-allocated to more prudent and efficient rivals the undertaking in question remains active on the market. For example, prior to the financial crisis, all three Irish financial institutions charged similar deposit interest rates. According to one report from the now defunct Irish Financial Regulator examining deposit rates from 1998 to 2003, each of the above institutions paid within interest to customers within a similar interest range across different deposit products.[195] Due to the credit crunch in late 2007, Anglo Irish Bank introduced a new deposit rate for savers in 2008, with an average interest of 8%, the highest available and one that remained in place post State recapitalisation.[196]

However, there are other commentators who argue that in the case of banking the continued presence of an insolvent financial institution in the market place may engender positive externalities. As Savvides and Antionou comment, "[w]hile in non-financial industries the collapse of a competitor would be welcomed by rival firms, the collapse of a financial institution propagates and amplifies shocks throughout the entire sector".[197] For instance, in the first Credit Lyonnais decision the Commission also considered the adverse effect

[195] Financial Regulator, "Interest Rate Pass Through A Study of the Extent and Speed of Interest Rate Pass-Through on a Basket of Retail Banking Products", July 2004, at p.22 and p.26.
[196] *Financial New Year*, Consumer Choice, January 2009, pp.16-19 at p.17, available at http://thecai.ie/wp-content/uploads/2011/10/FINANCIALNEWYEARjan09.pdf [last accessed on 07/11/2018].
[197] N.27 at p.364.

on the recipient rivals should the bank enter insolvency.[198] Notwithstanding this the Commission was still unwilling to accept that aid to Credit Lyonnais constituted a "common European interest".[199] This illustrates the complexity that the Commission must overcome when deciding whether or not to set aside competition distortion safeguard measures in times of a bank failure. If a bank collapses and this triggers further instability, then this instability may have a more detrimental impact on a rival financial institutions then the ongoing presence of a bailed out imprudent competitor.

Other commentators also touch on how if one financial institution is rescued from collapse then the obvious positive effect this has on recipient's competitors may suffice as an alternative form of "compensation" for these other institutions. "One important implication is that rivals benefit from the stability created by bailouts, so it is no longer obvious that rivals need 'compensating'".[200] If one follows this line of reasoning then the "bailed-out" institution should then be immune from further behavioural or structural *quid pro quo* measures. These measures will be discussed further below. Perhaps this stance is correct and undermines somewhat the default distortion argument outlined above of where an insolvent financial institution remains active as a market participant. It may also be the case, as with Anglo Irish Bank, that the insolvent recipient is removed in time from the banking sector which thus counters any competitive distortion posed by the initial State aid intervention.[201] Although, according to Gerard non-aided banks have performed better than aided financial institutions, one must still consider the adverse competitive imbalances where an institution on the threshold of insolvency with recourse to State aid continues to operate.[202] In these cases one must then assess the level of behavioural or structural conditions the recipient must meet in order to counter any market distortions. The pre-

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[198] Commission Decision (95/547/EC) of 26/12/1995 Credit Lyonnais [1995] OJ L308/92 at L308/114 available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:31995D0547 [last accessed on 07/11/2018].

[199] *Ibid*.

[200] N.46 at p.43.

[201] N.36 at p.265.

[202] D. MB Gerard, "Overvew-Managing The Financial Crisis in Europe: The Role of EU State Aid Law Enforcement", in in M. Merola, J. Derenne and J. Rivas (eds.), *Competition Law at Times of Economic Crisis – In Need for Adjustment?* (Brussels: Bruylant, 2013) p. 231 at p.244.

existing Communications applied by the Commission during the 2008 financial crisis, show the Commission applying established competition distortion safeguard measures. However, a new State Aid Crisis Framework will have to encompass tailored measures that better strike the balance between engendering stability and maintaining a competitive banking sector undistorted via the presence of insolvent rivals.

5.6.4. New Competition Distortion Safeguards for Insolvent Institutions: New behavioural obligations and liquidation fees

The Irish authorities and Commission's response to Anglo Irish Bank illustrates the conflict between maintaining financial stability while also applying some form of effective competition distortion safeguards. One way to resolve this contradiction in times of financial crises would be to apply a graduated approach when applying competition protections in the banking sector. Under this approach, an insolvent but systemically important financial institution could be provided with State support for a short period of time prior to liquidation. However, this institution would be subject to strict behavioural controls and should promote, where possible, the business lines and services of its market rivals.

Deposit interest rates should be subject to a strict cap while the resource of the financial institution should be specifically focused on maintaining existing business until a liquidation plan can be implemented. Implementation would be overseen by both the relevant Member State and the Commission via the appointment of a trustee which is already common practice within the State aid domain. However, as noted above State aid intervention for an insolvent financial institution may provide an indirect benefit to market rivals by preventing the spread of market contagion. Thus one way to strike a balance between the indirect benefit of this State aid intervention would be to apply a liquidation surcharge on any businesses or subsidiaries disposed of by the insolvent bank. Under this proposal the disposal would not only resolve any competition concerns related to an insolvent financial institution continually operating as market actor but also the additional costs would help fund the liquidation process. In this way further State resources would not be required during the liquidation process while viable banks would be able to grow their market share without the competitive distortion of an insolvent bank continuing to operate in this market. The purchasing undertaking is in effect repaying a repaying a contribution via this surcharge to the Member State for the indirect benefit of the support provided to the insolvent institution.

Conclusion

As can be seen the Commission and Member States' response to the 2008 financial crisis was such that almost all banks were deemed systemically important. In reality, in times of financial market distress even peripheral financial institutions may become systemically important if they have some form of interconnectedness with other banks. However, clearly there needs to be a new State Aid Crisis Framework with specific reference to what does or does not constitute a systemically important institution. In this way a Member State's resources can be then utilised in a more efficient and effective manner while market discipline is not subverted. Where intervention is required then this can be done in balanced manner in way that does not reinforce the sovereign-bank link. The current crisis framework provides a limited basis on which to address the question of systemic importance whereby a default presumption arose that almost all financial institutions were systemically important. A future crisis framework will need to establish a set of criteria whereby the question of systemic importance is not simply based on wider prevailing environmental factors but entails an assessment of the specific internal factors affecting a financial institution. However, during a financial crisis these internal factors may become fused with parallel characteristics that other market participants also share with the failing financial institution. Where this arises then the systemic importance threshold becomes lower as the possibility of contagion via the collapse of one financial institution increases. Where the possible overlap between a Member State's domestic financial institutions does not constitute a negative market perception and so the systemic test is not satisfied the next question for both the Commission and domestic authorities is whether this undertaking actually has a long-term viable business model. Alternatively, a bank may indeed be systemically important but still retain long-term viability rather than enter a controlled systemic importance liquidation process as set out in this Chapter. This will be examined in Chapter 6.

Once the new proposed test for systemic importance is applied the Commission should then apply the next test which relates to the level of aid that a Member State should provide to a non-long-term viable but systemically important bank. This level of aid should reflect the basic operational needs of the recipient financial institution so that the financial institution can be resolved in a controlled manner. Thus operational aid will be primarily focused on discharging operational needs of the bank in question including repaying depositors so as to contain possible contagion.

To address the possible competition distortions that may arise from a Member State providing funding to a non-long-term viable bank this Chapter sets out a proposed liquidation surcharge and the recipient financial institution actively promoting the business lines of its competitors. The first safeguard acts as a counter measure to a possible wider market benefit that arises from the “bail-out” of the systemically important financial institution that derives to other market actors within the banking sector. The second safeguard ensures that a non-long-term viable financial institution does not continue to act as a market distortion via its continuing presence within the banking sector. Further competition safeguard measures for long-term viable financial institutions will be discussed in Chapter 6.

Chapter Six: State aid and Long-term Viable Banks: The need for a new approach?

Introduction

In response to the financial crisis of 2008 the EU Commission adopted State aid framework to establish boundaries on how exactly Article 107(3)(b) TFEU could be utilised to stymie the collapse of financial institutions. This Chapter seeks to critically assess how the Commission and Member States applied the crisis framework in respect of long-term viable banks and from this then establish new rules for a future framework. As noted in Chapter 5 the Commission adopted a somewhat lax approach when determining what constituted a systemically important financial institution during the initial phases of the financial crisis. A financial institution may fall within the scope of the term "systemically important" even though the long-term viability of this bank remains circumspect. One way to resolve this complex problem is for the Commission to adopt dual-fold questioning when assessing State aid applications for financial institutions during financial crises. If the Commission and Member State conclude that a financial institution is systemically important then some form of State support will be required. However, it is the second part of the question that this Chapter seeks to address, namely, whether a systemically important financial institution is also in fact a long-term viable financial institution. This Chapter aims to establish a new test for policymakers to apply so as to ensure that State resources are appropriately targeted to financial institutions that remain, and will retain long-term viability in times of a future financial crisis. But, this test will be multi-faceted as the question of how much State aid should be provided to a long-term financial institution will also need to be addressed. Establishing a new test for long-term viability cannot be done in isolation from addressing possible competition distortion threats that may arise from providing financial support to such a financial institution. Therefore, the final part of this Chapter sets out new competition distortion safeguards that not only aim to tackle current distortions within a Member State's banking sector but also possible future ones that may arise.

A new State Aid Crisis Framework will need to establish a set of criteria for determining what is or is not a long-term viable financial institution. These new criteria will then need to ensure that Member States utilise limited resources in an efficient and effective manner. Thus the above steps will seek to address how the Commission applied the three conditions for State aid under Article 107(3)(b)TFEU for long-term viable banks following the same structure of the two previous Chapters for establishing a new approach to bank guarantee schemes and how a new State Aid Crisis Framework should address the question of systemic importance. .

6.1.1. Irish Financial Institutions and the question of long-term viability

To establish a new test for what is or is not a long-term viable financial institution one must first examine the business models of financial institutions that were deemed long-term viable under the existing State aid framework. If one first examines Irish financial institutions prior to the financial crisis it becomes clear that there were two different categories of banks. As noted in Chapter 1, the Irish banking sector went through a period of considerable growth prior to the 2008 financial crisis. In some cases, this growth was focused on property related lending, particular by financial institutions such as Anglo Irish Bank and Irish Nationwide Building Society. While the other two Irish banks, Bank of Ireland and Allied Irish Banks, also engaged in high risk lending to property developers, both banks also expanded their credit provision in the mortgage sector. For instance, according to the financial reports of both banks from the years 2004 to 2006, mortgage lending became a key driver for market growth.[1] However, in parallel to this excessive concentration on mortgage lending both financial institutions also maintained a substantial branch network throughout Ireland and provided a range of core

[1] Allied Irish Banks Annual Report 2008 at p.73 available at https://aib.ie/content/dam/aib/investorrelations/docs/Annual%20General%20Meeting/2009/annual-financial-report-2009.pdf [last accessed on 07/11/2018]; Bank of Ireland Annual Report 2007 at p.117 available at https://investorrelations.bankofireland.com//wp-content/assets/ar2008.pdf [last accessed on 07/11/2018].

banking services such as payment processing, overdraft facilities and provision of current and deposit accounts.[2] As discussed in Chapter 5, both Anglo Irish Bank and Irish Nationwide Building Society did not have the same deposit and retail base within Ireland as Allied Irish Banks or Bank of Ireland. The former financial institutions did perform key roles in one particular sector of the Irish economy namely property development as discussed in the last Chapter but their domestic competitors had more diversified and sustainable business lines. Thus one could posit that Allied Irish Banks and Bank of Ireland had a stronger basis for falling under the long-term viable category than Anglo Irish Bank and Irish Nationwide Building Society. However, in a financial crisis the question of long-term viability becomes difficult to ascertain as is seen from the last Chapter. In fact, the question of long-term viability may become confused with the question of systemic importance. Both though remain separate considerations. For example, Irish Life and Permanent prior to the crisis had also become overly exposed to mortgage lending with a loan book of €27.9 billion.[3] But unlike both Allied Irish Banks and Bank of Ireland did not have a strong retail network. Although one could describe Irish Life and Permanent, now rebranded as Permanent TSB, as a peripheral market operator the financial institution was also supported by the Irish State. This bank will though be examined in Chapter 8 as a case study in the difficulty of ascertaining the related questions of systemic importance and long-term viability.[4]

6.1.2. Other European Banks and the Question of Long-term Viability

If one is seeking to develop a long-term viability test as part of a future State Aid Crisis Framework, then the business models of other financial institutions in the Union must be examined. This should then provide a better basis for understanding how long-term viability may arise in different contexts. For

[2] *Ibid* at p.14; *Ibid* at p.19.
[3] Irish Life and Permanent Annual Report 2008 at p.22 available at http://www.permanenttsbgroup.ie/~/media/Files/I/Irish-Life-And-Permanent/Attachments/pdf/annual-and-interim-reports/2008/arep08.pdf [last accessed on 07/11/2018].
[4] See Chapter 8 at p.290.

instance, a number of financial institutions in the Netherlands were subject to substantial restructuring programmes in line with the crisis framework. In contrast with Irish banks, Dutch financial institutions had adopted an international focus in their business investments. As Masselink and Van den Noord note the "[t]otal financial claims of Dutch banks amounted to 300% of GDP".[5] A considerable proportion of these claims in turn were related to the American financial sector.[6] Irish financial institutions also had international subsidiaries but not to the same extent as their Dutch peers.[7]

As noted in Chapter 5, a number of financial institutions formed a consortium to acquire ABN AMRO.[8] For Dutch policymakers this particular factor represented an additional challenge in devising a crisis response for ABN AMRO. In order to insulate ABN AMRO from the wider pressures of the parent financial institution, in this case the Fortis Group, the Dutch authorities decided to acquire ABN AMRO and divest it from the wider banking group.[9] Separating ABN AMRO from the wider Fortis Group placed considerable strain on the financial resources of the Dutch unit of the business. Therefore the short-term viability of ABN AMRO became dependent on the provision of State aid and liquidity support from the Dutch authorities.[10]

In contrast, the State intervention devised for the ING banking group followed a more routine path. This second Dutch State aid recipient was not part of a wider EU banking group but did encompass a diversified business structure. For instance, ING not only engaged in retail banking but also the sale of insurance products and asset management.[11] According to the State aid

[5] M. Masselink and P. Van den Noord, The Global Financial Crisis and its effects on the Netherlands, Vol. 6 (10) Ecofin Country Focus at p. 3 available at http://ec.europa.eu/economy_finance/publications/publication16339_en.pdf [last accessed on 07/11/2018].
[6] *Ibid*.
[7] N.1 at p.13; and at p.103.
[8] Commission Decision C11/09 (related to NN2/10, (ex N429/09) and N19/10) of 15/04/2010 *Recapitalisation measures in favour of FBN and ABN AMRO group* [2010] OJ C95/10 at 12 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2010:095:FULL&from=EN [last accessed on 07/11/2018]; See Chapter 5.
[9] *Ibid* at para.13.
[10] *Ibid* at C95/15-17 paras.34-57.
[11] IGN Annual Report 2015 at available at https://www.ing.com/Investor-relations/Annual-Reports.htm [last accessed on 11/07/2016].

applications submitted to the Commission by the Dutch authorities ING is the nineteenth largest institution in the world.[12] Hence in many ways ING provides yet another example of the "too big to fail" problem evident throughout the Union during the financial crisis. While ABN AMRO was previously part of a wider banking group, ING itself, was prior to the crisis, a considerable market presence in its own right both domestically and internationally.[13] However, both financial institutions required the support of the Dutch State in order to remain active market operators. The examples of these Dutch financial institutions illustrate the problem when trying to determine what is or is not a long-term viable financial institution. Both ING and ABN AMRO had diversified business lines, strong market shares within their domestic market and in the case of ING, an international presence. Yet despite all of these factors both financial institutions still required State aid during the 2008 financial crisis.

An interesting facet to the ABN AMRO State aid application was the fact that two of its parent institutions also required State aid from their respective Member States. In the case of Fortis, this support was at least partly tempered by the presence of private sector participation in the form of BNP.[14] In contrast, Royal Bank of Scotland required support which only the UK authorities could provide.[15] The latter had positioned itself as a dominant presence in the UK domestic banking sector from retail banking to corporate finance.[16] In effect Royal Bank of Scotland adopted a universal banking model similar to both ING and Lloyds Banking Group. Yet despite this universal business model, Royal Bank of Scotland also required State aid

[12] Commission Decision C10/2009 (ex N138/2009) of 31.03.2009 *illiquid assets back-up facility, The Netherlands* OJ C(2009) 2585 at para.7 available at http://ec.europa.eu/competition/state_aid/cases/230724/230724_958423_46_1.pdf [last accessed on 07/11/2018].
[13] *Ibid* at para.7.
[14] Commission Decision No.574/2008 of 19/11/2008 *Belgium State Guarantees for Fortis Bank* OJ C(2008) 7387 at para.6 at available at http://ec.europa.eu/competition/state_aid/cases/228379/228379_1018353_32_1.pdf [last accessed on 07/11/2018].
[15] Commission Decision No N 422/2009 and N 621/2009 of 4/12/2009 *United Kingdom Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme* OJ C(2009)10112 at paras. 12-21 available at http://ec.europa.eu/competition/state_aid/cases/233798/233798_1093298_30_2.pdf [last accessed on 07/11/2018].
[16] *Ibid* at para.10.

support just like other UK financial institutions with more limited business models such as Northern Rock and Bradford and Bingley. Although a larger financial institution than Northern Rock and Bradford and Bingley, this did not necessarily mean that it had a more robust position to withstand the 2008 financial crisis. If anything the financial institution may have fallen under the "too-big-to-fail" category.

Yet State aid was not just advanced to financial institutions falling within the scope of the "too-big-to-fail" label. In other jurisdictions smaller banks were also provided with State aid but only after a consolidation strategy was adopted by policymakers. For example, a number of Spanish savings institutions also received State support even though the level of contagion threat posed by such institutions remained localised in particular regions of the Member State in question. Cajas were an integral part of the Spanish banking sector prior to the financial crisis, yet a number of these regional banks have now been merged to form larger financial institutions.[17] Despite the limited focus of Cajas on providing credit to local markets, this did not result in these financial institutions adopting a prudent approach to lending.[18] Cajas developed a reliance on wholesale funding which in turn placed these regional institutions in a vulnerable position once the financial crisis developed.[19] Devising a restructuring plan for Cajas entailed the formulation of a unique legal arrangement so that individually each Cajas would still exist as a separate foundation.[20] However, under an "institutional protection scheme" a number of Cajas agreed to form new consolidated banking corporations which could then avail of State support.[21] In this way new financial institutions such as Bankia and Caixabank were established.[22] Both these financial institutions now engage in different business lines, for

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[17] R. Nunez Largos and J. Walkowicz, "Restructuring the Spanish Banking System: (2008-2013): Part 1: from cajas into banks: the end of a 150 year long story", (2013) Vol.28(5) Journal of International Banking Law and Regulation pp.188-195 at p.190.
[18] *Ibid*.
[19] *Ibid* at p.189.
[20] *Ibid* at p.190.
[21] *Ibid* at p.191.
[22] Commission Decision No.SA34820(2012/N) of 27/06/2012 *Spain Rescue aid to BFA Bankia* OJ C(2012) 4384 at paras.6-8 available at http://ec.europa.eu/competition/state_aid/cases/245134/245134_1341455_209_1.pdf [last accessed on 07/11/2018].

example Bankia undertakes both retail and business banking along with other more specialised functions such as asset management.[23] Caixabank has adopted a similar multi-faceted business plan which encompasses both personal and corporate banking lines.[24] Instead of applying a diffuse State aid intervention for individual savings institutions the Spanish authorities adopted a policy of consolidation as a means of engendering long-term viability in the sector via the emergence of new national financial institutions.

The Icelandic authorities also adopted a similar policy of consolidation. For example, to prevent the disorderly collapse of BYR Bank State support was provided so that Islandsbankai could merge with this failing financial institution.[25] Islandsbankai itself had been established from the division of Glitnir Bank into a "good bank-bad bank".[26] The Icelandic authorities would need to provide additional support to the acquirer of BYR Bank, further undermining the financial position of the sovereign.[27] Therefore, consolidation may not always be an effective policy in times of financial crisis. For the Spanish authorities Bankia required a continued level of support, such support triggered the Member State's subsequent entry into a Memorandum of Understanding with the International Monetary Fund and the EU Commission.[28] This indicates the need for a new State Aid Crisis Framework to have a specific "minimum necessary" condition in place to

[23] *Ibid* at para.12

[24] Commission Decision No.SA33735 (2012/N) of 28/11/2012 *Spain Restructuring of Catalunya Bank S.A.* OJ C(2012) 8759 at paras.57-58 available at http://ec.europa.eu/competition/state_aid/cases/244292/244292_1400504_213_2.pdf [last accessed on 07/11/2018].

[25] EFTA Surveillance Authority Decision Case No:70526 of October 19th 2011, *on the acquisition of Byr hf by Islandsbanki and the prolongation of the temporary approval of the subordinated loan facility granted to Byr hr*, at paras. 33-34 available at http://www.eftasurv.int/media/decisions/325-11-COL.pdf [last accessed on 07/11/2018].

[26] EFTA Surveillance Authority Decision Case No: 69094 of December 15th 2010, *opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Glitnir Bank hf and the establishment and capitalisation of New Glitnir Bank hf (now renamed Islandsbanki)* at para.60 available at http://www.eftasurv.int/media/decisions/494-10-COL.pdf [last accessed on 11/07/2016].

[27] *Ibid* at para16(b).

[28] Spain Memorandum of Understanding on Financial Sector Conditionality, IMF 20/07/2012 available at http://ec.europa.eu/economy_finance/eu_borrower/mou/2012-07-20-spain-mou_en.pdf [last accessed on 07/11/2018].

ensure that even in the case of a long-term viable bank State resources are subject to some form of protection. An issue further discussed below.

Both the Spanish and Icelandic responses mirror and contrast with the policies implemented in respect of the Irish banking sector. All three States applied recapitalisation schemes to strengthen their domestic banking sector. But both the Spanish and Icelandic authorities adopted a more intrusive form of market restructuring, via the emergence of new banks, than their Irish counterparts. This is evident by the emergence of new financial institutions such as Bankai and Islandsbankia.[29] Although these were continuations of pre-existing banks, no similar effort was undertaken in the Irish banking sector to establish new financial institutions from the original market incumbents. For example, no proposals were discussed about possibly establishing new financial institutions from merging different business lines from across Bank of Ireland and Allied Irish Banks.[30] The establishment of NAMA was designed as an asset management company rather than a new financial institution with a wider economic basis in retail banking and non-property related lending. Across these jurisdictions, different approaches to maintaining a financial institution's long-term viability were adopted either by recapitalising existing market operators or merging and consolidating smaller banks into new banking groups. But the underlying question of what actually constituted a long-term viable bank prior to these measures were taken was not itself adequately addressed.

The Greek authorities also adopted an initial policy of strengthening the financial position of pre-existing market operators rather than undertake more substantive banking sector reform. For example, under a national recapitalisation scheme both National Bank of Greece and Piraeus Bank received financial support. One of the primary grounds for this support arose from the fact that both financial institutions were required to exchange Greek

[29] N.26.

[30] As was discussed in Chapter 1 merging Anglo Irish Bank and Irish Nationwide Building Society to form a new financial institution was discussed but this proposal was not proceeded with.

sovereign bonds for new liabilities of a lesser value.[31] Thus the exposure of both banks to Greek sovereign bonds gave rise to a rather contradictory scenario where the only source for recapitalisation purposes was the Greek sovereign itself.[32] This illustrates the complexities that may arise in times of systemic crises and how the current State aid framework failed to effectively disentangle Member States from their domestic banking sectors.

According to a 2011 IMF report, Greek banks held an aggregate of Greek government bonds valued at €45 billion.[33] The report further notes that the six largest Greek banks hold 97% of this debt.[34] Both National Bank of Greece and Piraeus Bank appeared to follow wider market trends within the Greek banking sector by investing in sovereign debt. However, notwithstanding the failure of National Bank and Piraeus Bank to diversify their sovereign debt holdings both financial institutions also performed central roles in the wider Greek economy. Before the crisis Piraeus Bank had a substantial presence in the retail banking sector.[35] Similarly, National Bank of Greece has a universal banking model encompassing not just retail services but also more niche markets such as asset management.[36] For the Bank of Greece both of these financial institutions were considered to meet long-term

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[31] Commission Decision SA.34824 (2012/C), SA.36007 (2013/NN), SA.36658 (2014/NN), SA.37156 (2014/NN), SA.3453(2012/NN) of 23/07/2014 *implemented by Greece for the National Bank of Greece Group related to: Recapitalisation and Restructuring of National Bank of Greece, S.A.; Resolution of First Bank S.A. through a National transfer order to National Bank of Greece S.A.; Resolution of Probank S.A. through a National transfer order to National Bank of Greece S.A.; Resolution of Cooperative Bank of Lesvos-Limnos, Cooperative Bank of Achaia and Cooperative Bank of Lamia*, OJ C(2014) 5201 at para.43 available at http://ec.europa.eu/competition/state_aid/cases/253445/253445_1606013_40_2.pdf [last accessed on 07/11/2018].
[32] Commission Decision SA.34122(2011/N) of 28/12/2011 *Greece Second Recapitalisation of Piraeus Bank under the Greek Recapitalisation Scheme*, OJ C(2011)10127 at para.32 available at http://ec.europa.eu/competition/state_aid/cases/243095/243095_1301739_29_2.pdf [last accessed on 07/11/2018].
[33] Greece: Fifth Review under the Stand By Arrangement, Rephasing and Request for Waiver of Non-observance of Performance Criteria, Prepared by the European Department in Consultation with Other Departments, Approved by Reza Moghadam and Lorenza Giorgianni, IMF, November 30th 2011 at p.38 available at https://www.imf.org/external/pubs/ft/scr/2011/cr11351.pdf [last accessed on 07/11/2018].
[34] *Ibid*.
[35] N.32 at para.5.
[36] National Bank of Greece Annual Report 2014, at pp.24-26 available at https://www.nbg.gr/english/the-group/investor-relations/annual-report-offering-circular/Documents/ANNUAL%20REPORT%202014.pdf [last accessed on 07/11/2018].

viability criteria along with Eurobank and Alpha Bank.[37] Yet the Bank of Greece also cautioned that the level of non-performing loans in the Greek banking sector was particularly high and that the Greek banking sector would require an additional €40.5 billion in recapitalisations for the period 2012-2014[38] Therefore, the question of long-term viability in the context of Greek banks was not one that could be easily determined due to the considerable exposure to Greek sovereign bonds and wider economic downturn. A new State Aid Crisis Framework could potentially resolve this question by adopting a counterfactual test which will be further discussed below.

A comparison can be drawn between the Greek banks and with certain German Landesbanken which appeared to follow prevailing market patterns prior to the financial crisis to invest in subprime loans. As noted in Chapter 5 some of these financial institutions such as Hypo Real Estate and WestLB fell into insolvency and required the support of the German authorities during the initial phase of the crisis. In contrast, other German financial institutions which also had exposure to subprime loans were deemed to be fundamentally sound. For example, the German lender IKB required a bailout five times the value of its own equity value in order to meet contractual obligations arising from subprime investments.[39] But unlike Hypo Real Estate and WestLB, IKB bank was provided with substantial State aid so as to return to long-term viability rather than enter liquidation. The above examples illustrate how long-term viability within a banking context may depend on different markets and business lines. Irish financial institutions such as Allied Irish Banks and Bank of Ireland had retail networks as did Dutch financial institutions but these Dutch banks also had significant international presence.[40] Greek

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[37] "Report on the Recapitalisation and Restructuring Needs Of The Greek Banking Sector", Bank of Greece, December 2012 at p.5 available at http://www.bankofgreece.gr/BogEkdoseis/Report_on_the_recapitalisation_and_restructuring.pdf [last accessed on 07/11/2018].
[38] *Ibid* at p.39.
[39] J. Odenius, "Germany: Policy Lessons from Financial Turbulence", (2008) Vol.37(5) IMF Survey pp.77-78 at p.78 available at http://documents.worldbank.org/curated/en/507991468143062722/pdf/WPS5324.pdf [last accessed on 07/11/2018].
[40] "Perspectives on the structure of the Dutch banking sector", DeNederlandscheBank, at p.25 available at https://www.dnb.nl/en/binaries/DNB-study%20Perspective%20on%20the%20structure%20of%20the%20Dutch%20banking%20sector_tcm47-323322_tcm47-334492.pdf [last accessed on 07/11/2018].

financial institutions, such as National Bank of Greece and Piraeus Bank also had retail networks but following Basel II rules became overly exposed to sovereign debt holdings.[41] However, both these financial institutions also went through considerable restructuring programmes. For instance, Piraeus Bank and National Bank of Greece were in effect used as consolidation vehicles by the Greek authorities as smaller domestic banks were assimilated into their operations.[42] In a German context, specialisation in a specific field was considered sufficient for IKB to fall under long-term viable category despite Irish financial institutions with the same level of specialisation in the property sector not falling under the long-term viable category. However, it is posited that the consolidation and specialisation of certain financial institutions does not necessarily constitute an effective test for determining whether or not a financial institution is a long-term viable one. Delving further into the Commission's decisional practice during the last financial crisis when applying the "appropriate" criterion, may point to what test a future State Aid Crisis Framework may adopt.

6.2.1. Commission Decisional Practice

As noted in earlier Chapters, the three conditions for authorising aid under Article 107(3)(b) TFEU are (i) is the aid in question "appropriate"; (ii) is the amount of aid the "minimum necessary" to achieve the objective of the support provided, and (iii) is the aid in question "proportionate" considering the possible adverse impact on competition. In previous Chapters how the Commission applied each of these criteria in respect of guarantee schemes and insolvent financial institutions was examined and new criteria proposed for future financial crises. In this Chapter the above three criteria will again be examined but this time in the context of the Commission's decisional practice for long-term viable financial institutions. The first criterion the

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[41] A. Blundell-Wignall and P. Slovik, "The EU Stress Test and Sovereign Debt Exposure", (2010) *OECD Working Papers on Finance, Insurance and Private Pensions*, No.4 at p.8 available at https://www.oecd.org/finance/financial-markets/45820698.pdf [last accessed on 07/11/2018].

[42] Commission Decision State aid no SA.41503(2015/N) of 16/04/2015-*Greece Resolution of Panellinia Bank through a transfer order Piraeus Bank*, OJ C(2015)2606 at para.115 available at http://ec.europa.eu/competition/state_aid/cases/258024/258024_1680824_119_2.pdf [last accessed on 07/11/2018]; N.31 at paras.71-92.

"appropriateness" of the aid provided by a Member State, will now be discussed and assessed next.

6.2.2. Appropriate aid and long-term viability

If one examines the Commission decisions in respect of Irish financial institutions such as Allied Irish Banks and Bank of Ireland similarities with the Commission's stance on Anglo are evident. The Commission initially considered Anglo Irish Bank to fall under the long-term viable strand and so a restructuring plan was put in place to achieve this objective.[43] For all three financial institutions, Anglo Irish, Allied Irish Banks and Bank of Ireland, the primary reason for the State aid was based on "public policy grounds", the Irish State was in effect seeking to counter further deterioration in the institutions' balance sheets.[44] Therefore, one could posit that in the initial decisions for all three Irish financial institutions the "appropriate" benchmark was met as short-term considerations took primacy over possible longer-term problems within the recipient banks. This aligns somewhat with the proposed test for "systemic importance" as outlined under Chapter 5 whereby in times of systemic crisis the threshold for what constitutes a systemically important financial institution may be lowered due to the threat posed by contagion. The second strand of this test is then determining whether the "systemically important" financial institution in question is either a long-term viable institution or an insolvent one.

6.2.2.b. Restructuring and Viability

Under the crisis framework the Commission had established a set of factors to distinguish between fundamentally sound and distressed financial institutions. The former had to submit a viability plan while the latter had to

[43] Commission Decision N356/2009 of 26/05/2009 *Recapitalisation of Anglo-Irish Bank by the Irish State*, OJ C(2009) 5185 at para.43 available at http://ec.europa.eu/competition/state_aid/cases/231723/231723_970996_46_2.pdf [last accessed on 07/11/2018].

[44] Commission Decision N241/2009 of 12/05/2009 *Recapitalisation of Allied Irish Bank by the Irish State*, OJ C(2009) 3828 at para.56 available at http://ec.europa.eu/competition/state_aid/cases/231023/231023_1153993_38_2.pdf [last accessed on 07/11/2018].

develop a restructuring plan.[45] Post the Recapitalisation Communication, all State aid beneficiaries had to submit a restructuring plan rather than just distressed financial institutions.[46]

As noted in Chapter 5, the distinguishing factor for determining whether a financial institution was fundamentally sound or not was dependent on the level of recapitalisation this bank required.[47] But the Commission decided to revoke this distinction between viability and restructuring plans and instead apply a uniform condition whereby all recipient financial institutions submitted a restructuring plan.[48] This particular amendment to the Commission's oversight of State aid applications during the financial crisis highlights the complexity involved in demarcating the line between insolvent and long-term viable financial institutions. For instance, what are the exact differences between a restructuring plan and a viability plan if both essentially entail the same degree of restructuring? If the Commission authorised the restructuring plan for Anglo Irish Bank that saw the financial institution divided into two separate banks, would this then be retrospectively viewed as a merely a restructuring plan rather than a viability one?[49] If one considers that the Spanish banking group Bankia was subject to a similar restructuring programme with the establishment of a new Steady Bank Unit and a Legacy Bank Unit, this again raises the reverse question as to whether the level of restructuring is not necessarily related to whether the bank is fundamentally sound or distressed during a crisis but rather does this undertaking have some underlying business model that denotes long-term viability?[50] This also

[45] Commission Communication (2009/C195/04) of 19/08/2009 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 C195/5 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0819%2803%29&from=EN [last accessed on 07/11/2018].
[46] Commission Communication (2010/C329/07) of 7/12/2010 The application from the 1st of January 2011 of State aid rules to support measures in favour of banks in the context of the financial crisis [2010] OJ C329/07 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010XC1207(04)&from=EN [last accessed on 07/11/2018].
[47] *Ibid* at para.12.
[48] *Ibid* at para.14-15.
[49] Commission Decision No.SA32540 (2011/N) and C11/2010 (ex N667/2009) of 29/06/2011 *implemented by Ireland for Anglo Irish Bank and Irish Nationwide Building Society*, OJ C(2011) 4432 at paras. 42-43 available at [last accessed on 07/11/2018].
[50] Commission Decision State aid SA.35253(2012/N) of 28/11/2012-*Spain Restructuring and Recapitalisation of the BFA Group*, OJ C(2012)8764 at paras.68-73 available at

relates to the question of whether devising a benchmark for distressed financial institutions based on the level of aid in proportion to risk weighted assets is an accurate way to determine whether a bank is either distressed or sound?[51] Furthermore, should a new State Aid Crisis Framework adopt the same risk weighted assets based test or a new test that better reflects the nuances of long-term viability during times of systemic financial crises?

As noted in Chapter 3, the Viability and Restructuring Communication sets out the parameters for what constitutes a long-term viable financial institution.[52] Under this Communication long-term viability arises where a bank is able to discharge all costs associated with depreciation and other financial charges and generate a sufficient return on equity.[53] A circular argument though may arise whereby a financial institution may fall under the long-term viable category not necessarily due to the inherent strengths within this bank but due to the substantial recapitalisation provided by the Member State in question. This will now be examined below

6.2.2.c. Appropriateness of State aid recapitalisations for Irish and other financial institutions

When applying the "appropriateness" criterion, the Commission appears to have during the initial phases of the crisis, placed considerable value on the need to engender wider economic stability via the increase in regulatory capital ratios. Both Allied Irish Banks and Bank of Ireland received initial State aid recapitalisations of €3.5 billion each.[54] The central purpose of both recapitalisations was to increase the capital buffers of both so that regulatory capital thresholds could be met. A similar problem arose in respect of Anglo Irish Bank whereby the erosion of capital buffers triggered a State aid response instead of resolution measures on the part of the Member State.[55] Yet the grounds of these three recapitalisations were not solely justified on

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http://ec.europa.eu/competition/state_aid/cases/246568/246568_1406507_239_4.pdf [last accessed on 07/11/2018].

[51] N.44 at para.31.

[52] *Ibid* at para.13.

[53] *Ibid*.

[54] N.44 at para.1.

[55] N.43 at para.23.

stability grounds but also on the need to extend credit to the wider economy.[56] The Commission was willing to place considerable weight on both of these factors in respect of both Allied Irish Banks and Bank of Ireland. Therefore, in this light the initial State aid granted to both financial institutions was deemed “appropriate” under the Article 107(3)(b) TFEU exemption.

Another interesting aspect of the first State aid application for recapitalising Allied Irish Banks was the acceptance of the Irish sovereign that the primary reason for this intervention was based on stability grounds rather than as an investment strategy.[57] A similar position was adopted when Anglo Irish Bank received initial State aid support.[58] Therefore, despite the underlying differences between Anglo Irish Bank and Allied Irish Banks, both applications expressly failed to raise such differences. From this one could extrapolate that during the initial stages of the crisis the distinction between insolvent and long-term viable banks was, as noted in Chapter 5, not clearly considered. However, some form of “appropriate” benchmark is required to distinguish between banks such as Anglo Irish Bank and long-term viable banks such as Allied Irish Banks, one a financial institutions with a significant retail network and a presence within the wider Irish economy, the other a “monoline” lender with limited links to the Irish payment system via retail branches and providing retail banking services.[59] A new State aid Crisis Framework will have to include a test for what constitutes a long-term viable financial institution. In the context of other European financial institutions, the question of long-term viability can also be seen to raise certain complex issues. This will now be examined next in the context of two German financial institutions where the question of long-term viability was answered in the affirmative in both cases despite inherent differences between the business models of both financial institutions.

[56] *Ibid* at para.43.
[57] N.44 at para.47.
[58] N.43 para 23.
[59] Fintan Drury, former Non-Executive Director of Anglo Irish Bank, transcript, 30/07/2015 line 283, available at https://inquiries.oireachtas.ie/banking/hearings/fintan-drury-former-non-executive-director-anglo-irish-bank/#para_276 [last accessed on 07/11/2018].

6.3.1. Appropriateness of State aid support for other European banks: NordLB and IKB

As can been seen from the case of the Irish banks Allied Irish Banks and Bank of Ireland, the Commission considered the initial State aid support on the grounds of financial stability rather than as a normal rescue and restructuring application. Similarly, in the case of a number of German banks, while the Commission did consider the various different market operations of each State aid applicant, long-term viability was arguably not critically assessed.

For example, a State bond guarantee scheme provided to the specialised lender NordLB was authorised to ensure that this bank could continue to operate. In this case NordLB was not seeking to access the pre-existing Federal German State guarantee scheme but sought to avail of regional State support in order to compete with other State supported German financial institutions for the issuance of inter-bank finance.[60] A substantial State aid guarantee scheme was established whereby NordLB could issue up to 75% of guaranteed debt for a five year maturity.[61] The maturity timeframe for the debt issued in turn primarily corresponded with the refinancing cliff then facing the financial institution between 2009 through to 2014.[62] Despite NordLB's substantial market presence in certain niche areas of finance lending, such as aircraft and logistics, this financial institution also performed a key role "as a Landesbank for Lower Saxony and Saxony-Anhalt and acts as central bank for 58 savings banks in Lower Saxony, Saxony-Anhalt and Mecklenburg-Western Pomerania".[63]

The particular market characteristics of NordLB raise a number of interesting points in respect of long-term viability and financial institutions. Firstly, this financial institution required some form of external support in order to compete with other State support provided to German and EU financial

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[60] Commission Decision N655/2008 of 22/12/08 *Secured guaranteed medium-term note programme* OJ C(2008) 8985 at para.1 available at http://ec.europa.eu/competition/state_aid/cases/228946/228946_987690_26_1.pdf [last accessed on 07/11/2018].
[61] *Ibid* at para. 22.
[62] *Ibid*.
[63] *Ibid* at para. 2.

institutions in the inter-bank market. Secondly, although NordLB does perform a wider market role for other financial institutions and regional banking markets in Germany, the focus of the Commission remained primarily on the commercial lending business of the bank. Thirdly, at the time of the first NordLB State aid application, the Commission was informed by the German authorities that the existing shareholders in the bank were not willing "to recapitalise the bank under the conditions prevailing on the market".[64]

If one considers these three factors, then the issue of long-term viability becomes even more complex. The vulnerable market position of other market operators had undermined the sustainability of NordLB to access capital markets without some form of State aid support. Therefore, the underlying financial position of the recipient financial institution was largely dependent on also accessing State funding due to wider market instability. In respect of NordLB's market activities, as noted above, the lending and financial services with a wider economic scope were considered more important for policymakers than the non-performing business lines of the bank. But the question remains whether a wider examination of the bank's activities would have raised questions as to NordLB's long-term viability. For example, was the position of NordLB as a clearing bank for other savings institutions one that could have been transferred to another financial institution? While NordLB's reliance on wholesale funding should have raised the related question as to whether or not this financial institution had a sustainable business model in the absence of this funding source? Finally, there was the reluctance of existing shareholders to invest further in the financial institution. Although shareholders were unlikely to invest in NordLB in times of market turmoil this still raises the question as to why no private market investor was willing to step in and provide a capital injection if the firm was considered to have a long-term market future. This relates back to the question of how intensive the Member State's and Commission's review of NordLB's business lines was if private market investors were unwilling to

[64] *Ibid* at para. 18.

provide capital to this financial institution. In contrast to NordLB, private market investors had no reluctance in acquiring equity in Bank of Ireland.[65]

Similarly, in the case of IKB the Commission and German authorities placed considerable emphasis on certain aspects of the financial institution's business models while failing to address others. Despite IKB's substantial exposure to subprime mortgages, this did not act as a barrier for this financial institution accessing State support.[66] In both the case of NordLB and IKB the German authorities and the Commission were of the view that a State aid solution was "appropriate" to restore these financial institutions to long-term viability. But this still raises questions about whether State aid should realistically be used to resolve the problems facing a financial institution when a market based solution may be more appropriate. But if the market has failed then determining whether or not an undertaking is a long-term viable one becomes a difficult task.

6.3.2. Market Failure as an external or internal factor and the question of long-term viability

As noted in Chapters 1, 4 and 5, systemic financial crises will require some form of response by policymakers so that the market failure triggered by a restriction in credit supply can be alleviated. These responses may include bank guarantee schemes, and bank recapitalisation schemes. However, market failure can take many different forms. According to Bacon, there are a number of reasons as to why governments may wish to grant State aid to an undertaking.[67] For example, in certain cases the market alone may fail "to provide the optimal level of good or service".[68] More generally market failures may arise due to "externalities" and "asymmetric or imperfect

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[65] "Wilbur Ross sells €477 million Bank of Ireland stake" at para.2, RTE news, Updated Tuesday, 10 June 2014 18:58, available at https://www.rte.ie/news/business/2014/0610/622756-bank-of-ireland-ross/ [last accessed on 01/07/2017].
[66] Commission Decision N639/2008 of 22/12/2008 *Guarantee for IKB* OJ C(2008)8978 at para. 3 available at http://ec.europa.eu/competition/state_aid/cases/228885/228885_1034463_25_1.pdf [last accessed on 07/11/2018].
[67] K. Bacon, *European Union Law of State Aid* 3rd ed. (Oxford: Oxford University Publishing, 2017) at pp.8-9.
[68] *Ibid.*

information" failings.[69] The former does not necessarily refer to market instability but to how the conduct of certain market actors may affect those in the wider economy.[70] Asymmetric or imperfect information refers to the reaction of market actors where they have insufficient information to determine how to respond to consumer wants and needs.[71]

Both strands of market failure relate to some degree to the problems facing the banking sector post the sub-prime crisis of 2008. For example, the inter-bank funding markets contracted as there was a lack of accurate information available to market participants as to the viability or otherwise of financial counterparties. Central banks may provide emergency liquidity as a short-term measure but State aid measures may also be required. However, the question remains how these responses tie in with the question of long-term viability both at a macro and micro level. This raises a related question as to whether the overall problem facing an undertaking or market sector is solely an internal development or associated with other external factors. A future State Aid Crisis Framework will have to resolve this particular question in order to ensure that limited State resources are utilised effectively either to liquidate a financial institution or to return one that has an underlying long-term viable model to financial health.

A similar question arose in the European airline sector. Since 1994 there have been a number of cases where the Commission has decided to waive a restrictive application of the "one-time last-time" principle as established under the Rescue and Restructuring Guidelines and industry specific Communications. For instance, Lykotrafiti examines how the Commission addressed the problem posed by applying the Market Economy Investor Principle and the "one-time last-time" principle in the airlines sector.[72] In the case of Sabena, the Commission was willing to authorise a second State aid injection to the failing airline on the basis that this second measure was

[69] *Ibid*.
[70] *Ibid*.
[71] *Ibid*.
[72] A. Lyktrafiti, "The intersection between the market economy investor principle and the one time last time principle in the context of airline restructuring operations", in Erika Szyszczak, ed. *Research Handbook on European State aid law*,(Cheltenham: Edward Elgar Publishing, 2011) p.105 at p.107.

provided to a subsidiary of the original State aid recipient.[73] Thus the Commission adopted a rather nuanced position whereby the loan provided by the Belgian State to Sabena could be transferred to Delta Air Transport and used as rescue aid so long as the recipient continued to adhere to the conditions applicable to the initial rescue aid decision addressed to Sabena.[74]

However, this "rescue aid" could not be used as "restructuring" aid as the Belgian government had agreed under the original State aid programme for Sabena in the 1990s not to provide further support to the undertaking.[75] Yet how one can exactly distinguish between "recuse" and "restructuring" aid in this instance? This is especially the case where the rescue may very well have facilitated the subsequent restructuring of the airline. For example, an undertaking receiving rescue aid that then is in a position to utilise their post-rescue aid revenue for restructuring may not be in this position to begin with had it not been for the rescue aid in the first place. As Lykotrafiti states, "[t]he fungibility of money makes the distinction between rescuing with public funds and subsequent restructuring with the beneficiary's own means difficult".[76]

As noted in Chapter 5, during the financial crisis the Commission did not apply the "one-time last-time" principle to financial institutions. However, a similar stance also appears to have been adopted in respect of non-banking State aid recipients. Although, the Commission did not explicitly discount the principle, in certain cases it sought to recast certain multiple State aid provisions as part of the same rescue package or invoked a *de minis* State aid doctrine as an exemption.[77] Instead of applying a strict application of this principle the Commission adopted a flexible approach whereby certain support could be construed as a continuation of existing aid rather than a new tranche of aid.[78] But such an approach fails to address the underlying question

[73] *Ibid*.
[74] *Ibid*.
[75] *Ibid*.
[76] *Ibid*.
[77] M. Merola, L. Cappelletti and B. Veronese, "The One time last time principle and the financial crisis" in Jacques Derenne, Massimo Merola and Jose Rivas ed. , *Competition Law in times of economic crisis: in Need of Adjustment?* GCLC Forum Annual Series (Brussels: Bruylant Publishing, 2013) p.517 at p.526.
[78] *Ibid* at p.527.

whether the recipient does actually have a viable future without recourse to State support.

In the context of the financial crisis, certain commentators, such as Kavanagh and Coppi, argue that State aid to the financial sector during the crisis was an efficient remedy as "it returns "perturbed markets" to a normal state".[79] They also comment that a counterfactual may need to be applied when assessing the grounds for State aid to the banking sector.[80] But ideally any such counterfactual does not preclude an examination of any possible internal failings evident within certain financial institutions. It is only by examining the internal business models of recipient financial institutions that policymakers, it is posited, can effectively determine whether a financial institution is or is not a long-term viable undertaking. Such an examination however may need to be preceded by assessing possible external factors that may blur the line between insolvency and long-term viability.

6.3.3. External Factors and Long-term viability

If one considers the market failures arising from the sub-optimal provision of goods or services or asymmetric or imperfect information, then arguably such failures could be said to constitute internal market failures. In other words, the undertaking in question has failed to innovative, has failed to meet the demands of customers or has not responded effectively to market signals to expand or reduce production.[81] These failings arise from internal shortfalls within this undertaking. In contrast, an alternative argument could be posited that external factors such as financial regulation and political measures contributed to the behaviour of both US and EU financial institutions prior to the 2008 financial crisis. Across different industries a PEST analysis may be performed that seeks to assess the political, economic, social and

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[79] J. Kavanagh and L. Coppi, "Economic Characteristics of the State aid enforcement in the financial sector and lessons from the financial crisis", in Jacques Derenne, Massimo Merola and Jose Rivas ed., *Competition Law in times of economic crisis: in Need of Adjustment?* GCLC Forum Annual Series (Brussels: Bruylant Publishing, 2013) p.333 at p.336.

[80] *Ibid* at pp. 344-345.

[81] [81] Oxera, *Innovation market failures and state aid: developing criteria*, Report for the European Commission Directorate General for Enterprise and Industry, at p.9 (2006) available at *bookshop.europa.eu/.../**innovation-market-failures-and-state-aid**.../NB7406273ENC_00* .[last accessed on 09/01/2017].

technological threats a firm may face.[82] From a systemic crisis perspective, as will be examined below, two main external factors may be evident if one were to develop and apply a tailored PEST analysis. These include regulatory factors and the market actions of other competing financial institutions. This is not to say that multiple causes may arise at the same time and these may be inter-related. For example, there may be a cross-convergence between external, such as the lowering of capital adequacy thresholds, and internal factors, for instance a financial institution that already has an aggressive business model that will be amplified by this external development, that make ascertaining the sole cause of a financial institution's failure difficult for policymakers.

According to Tarr, financial institutions in the United States adopted high risk business models mainly due to the adverse effect of US public policy.[83] For example, under the *Community Investment Act* US banks were incentivised to "lower mortgage standards".[84] Promoting home ownership became a central tenet of US law makers in Congress. Similarly, Irish government policy adversely influenced the decision-making of Irish financial institutions. The Irish financial regulator failed to apply specific controls to restrict property related lending on the part of banks to safeguard against a property collapse. As a result of this failure Irish financial institutions became over reliant on one particular market segment for their business growth.[85] One could also posit that the decision of the Länders in Germany to provide a public guarantee to Landesbanken such as WestLB and SachsenLB distorted the investment decisions made by these financial institutions prior to the 2008 financial crisis.[86] Due to the substantial subsidy provided by the Länders'

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[82] C. Barbara, D. Cortis, R. Perotti and C. Sammut, "The European Insurance Industry: A PEST Analysis",(2017) Vol.14(5) International Journal of Financial Studies, at p2. available at https://www.mdpi.com/2227-7072/5/2/14/pd [last accessed on 07/11/2018].

[83] D. G. Tarr, "The Political, Regulatory and Market Failures That Caused the US Financial Crisis", Policy Research Working Paper 5324, The World Bank Development Research Group, Finance and Private Sector Development Team, May 2010 at p.14 available at http://documents.worldbank.org/curated/en/507991468143062722/pdf/WPS5324.pdf [last accessed on 07/11/2018].

[84] *Ibid*.

[85] See Chapter 5 at p.114.

[86] F. Hüffner, "The German Banking System: Lessons from the financial crisis", Organisation of Economic Development and Co-operation, Economics Department Working Paper No.788, July 1st 2010, at p.10 available at

guarantee certain Landesbanken lowered investment due diligence and thus began to purchase complex sub-prime mortgage backed securities.[87] Although one could submit that the failure of Landesbanken management to consider the risks associated with these products constituted an internal failing, the incentive to purchase these securities derived from an external source.

These examples provide evidence that the market failure triggered from the 2008 financial crisis was not necessarily due solely to the misaligned internal incentives of US or EU financial institutions. In certain cases, there were external factors that may have induced certain financial institutions to behave in an imprudent manner. Past banking crises illustrate to some degree a causal relationship between the market performance of the relevant banking sector and wider public policies pursued by financial regulators and governments. For example, the Japanese banking crisis of the 1990s was mainly caused by the Bank of Japan's decision to increase liquidity to counter the increasing value of the yen.[88] As a result of this market intervention equity and property markets in Japan continued to rise, posing a profitable investment for Japanese financial institutions.[89] Once the Japanese stock market collapsed Japanese financial institutions were exposed to loans where the underlying collateral had decreased to below the value of the principal loan.[90] Regulatory oversight was also inadequate as "[d]isclosure rules were lax and takeover bids difficult to implement".[91] Japanese financial institutions "did not behave as profit maximizers" as their lending policy became extended beyond "the profit maximising level".[92] Therefore one could submit that the financial

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http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=eco/wkp(2010)44 [last accessed on 07/11/2018].

[87] *Ibid*.

[88] D. K. Nanto, "The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990s", Congressional Research Service Report for Congress May 4th 2009, available at http://fpc.state.gov/documents/organization/125542.pdf [last accessed on 07/11/2018].

[89] *Ibid* at p.3.

[90] *Ibid* at p.4.

[91] U. Vollmer and R. Bebenroth, "The Financial Crisis in Japan: Causes and Policy Reactions by the Bank of Japan", (2012) Vol.9 (1) The European Journal of Comparative Economics pp.51-77 at p. 60 available at http://eaces.liuc.it/18242979201201/182429792012090103.pdf [last accessed on 07/11/2018].

[92] *Ibid*.

profile and performance of Japanese banks became adversely affected by wider economic factors. Similarly, the Swedish banking crisis of the late 1980s through to the early 1990s was mainly triggered by the deregulation of the Swedish financial sector resulting in the abolition of "liquidity ratios", "interest ceilings" and "lending ceilings".[93] There was also a related external economic shock in the form of the European Single Exchange crisis.[94] The risk-weighting attached to sovereign bonds under Basel II would also constitute a regulatory development that resulted in financial institutions becoming overly exposed to the debts of economically vulnerable sovereigns prior to the financial crisis.[95]

Hence the sub-prime crisis of 2008 and other past financial crisis illustrate how external factors remain a considerable trigger for banking sector instability. If one applies this factor to State aid control, then the basis of a long-term viability benchmark can be established. For instance, in order to properly extrapolate whether a financial institution can be restored to long-term viability a central and related question must be whether the market growth and overall business strategy of this bank was affected by external events. In the Irish banking sector both Allied Irish Banks and Bank of Ireland were influenced by the low interest rates determined by the European Central Bank and the failure of the Irish domestic authorities to restrict the growth in property prices.[96] While Anglo Irish Bank and Irish Nationwide Building Society had exceptionally high loan to deposit ratios prior to the 2008 crisis, Allied Irish and Bank of Ireland also had excessively high loan-to-deposit

[93] P. Englund, "The Swedish Financial Crisis Roots and Consequences" Vol.15(3) Oxford Review of Economic pp.80-97 at p.83 available at http://www.contrahour.com/contrahour/files/theswedishbankingcrisisrootsandconsequences.pdf [last accessed on 07/11/2018].
[94] *Ibid* at p.92.
[95] A. Lenarčič, D. Mevis and D. Siklós, "Tackling sovereign risks in European Banks", European Stability Mechanism, March 2016, at p.12 available at https://www.esm.europa.eu/sites/default/files/21032016_esm_discussionpaper1_final.pdf [last accessed on 07/11/2018]. See also the example of Greek financial institutions exposure to their domestic sovereign above. See also the example of Greek financial institutions exposure to their domestic sovereign albeit Gray and de Cecco do note how one bank in particular, Piraeus Bank, appeared to have acted imprudently by becoming over exposed to Greek sovereign bonds. See Gray and F. de Cecco, "Competition, stability and moral hazard: the tension between financial regulation and State aid control", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.20 at p.36.
[96] See the belated ban on hundred percent mortgages in Chapter 1 at p.6.

ratios.[97] According to the annual reports of Allied Irish Banks and Bank of Ireland, the value of their mortgage loan books was roughly €27 billion each in 2009.[98] Wider market developments such as increasing property prices and aggressive market moves by new competitors, meant that both Allied Irish Banks and Bank of Ireland reacted to these factors by increasing their lending.[99] An irrational form of bank lending had become the rational form of banking for these two financial institutions. Status quo bias had developed within these financial institutions whereby reducing their balance sheets at the expense of market share would have been perceived as a loss best avoided by meeting the market expectations derived from this status quo bias.[100] When status quo bias arises, a common position or thought process becomes the core practice of those within the industry or group in question.[101] In effect, this means that these same undertakings or individuals are then reluctant to depart from this common position for fear of producing a loss that will greatly exceed any possible gain that might arise from leaving the accepted status quo.[102] The causal factors leading to this status quo bias in a banking context may be another financial institution performing the role of "guru" which will be discussed below or other factors such as the growth in the availability of wholesale funding or political factors such as the promotion of home ownership. Therefore, it may be the case if a status quo bias becomes evident

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[97] K. Regling and M. Watson, A Preliminary Report on the Sources of the Irish Banking Crisis, at p.34 available at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf [last accessed on 07/11/2018].

[98] AIB Annual Report 2009 at p.31 available at https://aib.ie/content/dam/aib/investorrelations/docs/resultscentre/annualreport/annual-report-2009.pdf [last accessed on 07/11/2018]; Bank of Ireland Annual Report 2009 at 43 available at https://www.bankofireland.com/fs/doc/publications/investor-relations/annual-report-2009.pdf [last accessed on 07/11/2018].

[99] Regling K. and M. Watson M., A Preliminary Report on the Sources of the Irish Banking Crisis, at p.29 available at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf [last accessed on 07/11/2018].

[100] M. Rubinstin, "Rational Markets: Yes or No? The Affirmative Case", Institute of Business and Economic Research, Research Program in Finance Working Papers RPF-294, 2000 at p.5 available at http://www.nyu.edu/econ/user/bisina/rubinstein.pdf[last accessed on 07/11/2018].

[101] *Ibid*.

[102] *Ibid*.

within a market that this becomes an external factor to undertakings within this market.

For example, Allied Irish Banks sought to compete aggressively with Anglo Irish Bank in the provision of property development lending and finance.[103] By the end of September 2008 Allied Irish Banks had a property development loan book of €23.7 billion.[104] In contrast, Bank of Ireland only had a property development loan book of €13.1 billion at the same point in time.[105] The Commission did not seem to place any substantial weight on the different levels of development lending between both banks. When assessing both the first and second recapitalisations of Allied Irish Banks the Commission failed to assess the underlying reasons as to why the bank had engaged in an aggressive lending policy. A critical question also absent from the Commission's decisions in respect of Bank of Ireland.

In both cases the Commission applied the question of long-term restoration via a restructuring prism. Therefore the considerable restructuring of Bank of Ireland was authorised by the Commission even though this entailed "a substantial deleveraging of the bank's balance sheet by reducing the assets in the non-core loan portfolios".[106] Similarly, in the Commission's most recent Allied Irish Banks decision, the benchmark to determine whether the bank could be restored to long-term viability was the test adopted under the Restructuring Communication.[107] However, the obvious failing with this

103 Transcript of Jim O'Leary, former Independent Non-executive Director, Allied Irish Banks line available at http://opac.oireachtas.ie/AWData/Library3/Banking/JimOLearyJOL00001.pdf#page=7 [last accessed on 07/11/2018].

104 Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland, Report of the Commission of Investigation into the Banking Sector in Ireland, March 2011, at p.34 available at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf [last accessed on 07/11/2018].

105 *Ibid*.

106 Commission Decision SA.33216 of 11/07/2011 *Second Rescue of Bank of Ireland*, OJ C(2011)5018 at para 184 available at http://ec.europa.eu/competition/state_aid/cases/241558/241558_1347276_81_1.pdf [last accessed on 07/11/2018].

107 Commission Decision (2015/218/EU) of 07/05/2014 on the State aid Nos.SA.29786 (ex N 633/09), SA.33296 (11/N), SA.31891 (ex N 553/10), N 241/09, N 160/10 and SA.30995 (ex C25/10) of *implemented by Ireland for the restructuring of Allied Irish Banks plc and EBS Building Society* [2014] OJ L44/40 available at http://eur-lex.europa.eu/legal-

approach is the *ex-post* analysis of the bank in question. A recipient financial institution may very well be "able to cover all its costs and provide an appropriate return on equity, taking into account the risk profile of the bank" post the provision of State aid.[108] But the question remains whether this State aid in question should be provided in the first instance. This again relates to the issue of whether a financial institution becomes subject to status quo bias due to a number of external factors that gave rise to the crisis and whether in the absence of these external factors the financial institution would not require State aid. This in turn provides the Commission with benchmark that could be applied in times of future financial crises under a new State Aid Crisis Framework.

For German banks such as IKB and NordLB, a similar issue arises as to whether or not State aid was provided on the basis of actually returning these institutions to long-term viability. While, the *ex-post* effect of the various State aid recapitalisations was to return these financial institutions to some form of long-term viability. But the underlying question remains as to whether this aid should have been provided in the first case. Unlike other German banks that have a diversified ranged of services and business lines, IKB primarily engages in niche securities and complex financial trading. The financial institution's exposure to the subprime mortgages sector, necessitating both a State guarantee and capital injection, provides further evidence that this bank was not a prudent market operator. This becomes even more evident if one examines the restructuring plan submitted by IKB to the Commission. It seems that, unlike other financial institutions, IKB did not have a credit risk committee.[109] Further, the bank it seems initially entered into the international securities market in order to diversify its market base which itself provides an indication, albeit not concrete evidence, that the institution was not generating sufficient revenue from its core business

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content/EN/TXT/PDF/?uri=CELEX:32015D0218&from=EN [last accessed on 07/11/2018].

[108] N.44 at para.13.

[109] Commission Decision C 10/2008 (ex CP 233/07 and ex NN 7/08) of D/2008 *IKB, Germany* at para.22 available at http://ec.europa.eu/competition/state_aid/cases/224577/224577_796737_4_1.pdf [last accessed on 07/11/2018].

lines.[110] Although, IKB also provided structured finance for corporations and lending products for SMEs, there is evidence to suggest that the bank failed to match the maturity between assets and liabilities for its other business lines.[111]

Therefore, one could conclude that IKB was not necessarily a long-term viable bank due to the inherent risk control failings within this financial institution. Also unlike NordLB, the other markets the bank operated in could easily be served by competing financial institutions. Whereas NordLB prior to the financial crisis performed a central role in clearing transactions for other regional banks, IKB had a relatively narrow business model limited to providing finance to the SME sector.[112] If one proposes that external factors should be used as a guide as to whether or not a bank is actually a long-term viable financial institution then where a financial institution, such as IKB, has internal failings simply accentuated by these external factors the question of long-term viability is then not satisfied. These external factors should include regulatory developments and the behaviour of competing financial institutions. However, in terms of the latter factor yet another question must then be asked, namely did the financial institution in question adopt a position of "dominant failure" as the internal failings within this bank were the dominant reason for this failing position? Indeed, the financial institution in question could be said to have engendered the status quo bias of imprudent behaviour within the market place. A future State Aid Crisis Framework will have to include some criterion so as to determine whether or not a financial institution can be said to have established a market status quo bias. If this is then possible, both EU Member States and the Commission should then be better able to distinguish between insolvent and long-term viable financial institutions.

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[110] Commission Decision N400/2009 of 17.08.2009 *Liquidity Guarantee for IKB*, OJ C(2009)6429 at para.9 available at http://ec.europa.eu/competition/state_aid/cases/232234/232234_998349_66_1.pdf [last accessed on 07/11/2018].
[111] *Ibid* at para.18.
[112] *Ibid* at para.6.

6.3.4. Position of Dominant Failure and State aid

To determine what constitutes a position of dominant failure, one may need to consider the approach to dominance as applied in both the EU and the US. In EU competition law and US anti-trust law a key consideration when assessing possible mergers between rival undertakings is how the new entity will impact on competition. Both jurisdictions apply different tests to assess this impact, the Commission applies a "significant impediment to competition test" while in the United States the test is whether the merger "substantially lessens competition".[113]Although this issue will be discussed further below, from a pure competition perspective one can draw a parallel between the question of market dominance an undertaking may pose and the question of "dominant failure" for the purposes of a banking crisis. Market dominance as established under the EU Merger Regulation follows a test known as the "significant impediment to effective competition".[114] Under this test the Commission will assess a proposed merger to determine whether or not the newly created undertaking will undermine competition in the relevant market place.[115]

A similar approach could be adopted in respect of assessing whether a financial institution can be said to fall within the parameters of a position of "dominant failure". Whereas the above test focuses on the effects, if any, on the wider market that a merger may cause, this "dominant failure" test may be used as a benchmark to determine whether a financial institution's business model is such as to be an impediment to long-term viability. Furthermore, the financial institution in question itself may constitute an external factor that adversely impacts on other market participants. Coppi states how the Commission has failed to place sufficient consideration on the notion of

[113]Clayton Anti-trust Act 1914 s.7, 15 United States Code S.18 available at https://www.law.cornell.edu/uscode/text/15/18 [last accessed on 07/11/2018] and for European standard see footnote 114.

[114] Council Regulation (139/2004) of 20/01/2004 on the control of concentrations between undertakings (the EC Merger Regulation), [2004] OJ L 24/1 at 4 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004R0139&from=EN [last accessed on 07/11/2018].

[115] L. Coppi, "The role of economics in State aid analysis and the balancing test", in Erika Szyszczak, ed. *Research Handbook on European State aid law*, (Cheltenham: Edward Elgar Publishing, 2011) p. 64.

market power as a form of market failure.[116] Although not directly relevant *per se* to the proposed concept of "dominant failure", arguably there are certain parallels. For instance, Coppi suggests that market power results in a reduction to competition within a given market place and that wider market efficiency is less likely to be reached as a result.[117] One can draw a parallel from what constitutes market power from a competition perspective and the concept of a financial institution in a position of "dominant failure".

In most cases a financial institution in this particular position will have attained some level of market power, for example in the case of Anglo Irish Bank this market power was evident in the property development banking sector. However, this particular position may not have been attained via product innovation or business efficiencies but by a high risk market strategy that did not necessarily lend itself to long-term viability. Similarly, in the case of Halifax Bank of Scotland group in the United Kingdom, this institution had adopted a business strategy primarily based on international expansion, cost leadership and capital discipline.[118]But this business strategy was flawed as diversification was mainly dependent on expansion into the Irish market place, "over-reliance on wholesale funding" and "lack of sufficient credit risk capabilities".[119] Although Halifax Bank of Scotland management sought to further expand the bank's market presence and diversify its product range, this was not necessarily an expansion based on prudent internal management. In both of the above cases one can see how Anglo Irish Bank and Halifax Bank of Scotland exercised a market power in certain banking sectors based on an imprudent business model. However, the market power exercised by these financial institutions did not only impact on just these financial institutions.

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[116] *Ibid* at p.78.
[117] *Ibid*.
[118] The Failure of HBOS plc (HBOS) A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority, Bank of England Prudential Regulation Authority, November 2015, at p.57 available at http://www.bankofengland.co.uk/pra/Documents/publications/reports/hbos.pdf [last accessed on 07/11/2018].
[119] *Ibid* at p.58.

The actions of these financial institutions, it is posited also triggered the "guru effect".[120] As noted above, Irish financial institutions such as Allied Irish Bank and Bank of Ireland reacted to the market growth and aggressive lending policies of Anglo Irish Bank within the Irish banking sector. In this case, Anglo Irish Bank had adopted the role of the "guru", that of market leader and thus entrenched the status quo bias of increased lending related to the construction and property sectors.

6.3.5. Counterfactual test and existing State aid principles

One possible way to formulate a new long-term viable test for financial institutions under a new State Aid Crisis Framework is to utilise a counterfactual test with the counterfactual scenario absent the external factors as discussed above. Counterfactual tests are regularly applied in different domains of State aid law, for instance under the Commission's guidance on State aid to the aviation sector, a Member State must provide evidence that the proposed infrastructural investment will not be undertaken in the absence of State support.[121] Conversely, in respect of the car manufacturing sector in the EU, Grigolon and Leheyda suggest that due to the public support provided to this particular sector, possible in-depth market restructuring was deterred.[122]Further, they found that while State aid to Opel may have benefitted consumers throughout the Union, aid provided to both Peugeot and Renault realistically only benefitted French consumers.[123] In certain cases the absence of State support may not actually impact on the wider market or indeed the consumer's interest. The presence of aid may actually undermine market incentives on the part of recipients to restructure and innovate. Thus in the latter case above, the absence of aid may have disadvantaged French

[120] I. Filiz, T. Nahmer, M. Spiwoks and K. Bizer, "Portfolio diversification: the influence of herding, status quo bias, and the gambler's fallacy", (2018) Vol.32 Financ Mark Portf Manag pp.167-205 at p.171 available at https://link.springer.com/content/pdf/10.1007%2Fs11408-018-0311-x.pdf [last accessed on 07/11/2018].

[121] See footnote 16 in Chapter 3.

[122] L. Grigolon and N. Leyheda, "State aid in financial crisis: always good aid", March 2012 at p. 28 available at https://feb.kuleuven.be/public/n07082/GrigolonLeheydaStateAid.pdf [last accessed on 07/11/2018].

[123] *Ibid.*

consumers but presumably both Peugeot and Renault would have still released new models in the absence of this State support in any case. Similarly, when determining whether or not a financial institution qualifies as a long-term viable institution a counterfactual test should be utilised. Under this test possible external factors should be assessed to determine whether in the absence of these developments the financial institution in question would have required State support. For example, it may be that without the effect of regulatory developments or political objectives, the financial institution in question would still have required State aid.

If this conclusion is drawn by the Member State and the Commission, then the first strand of the updated "appropriateness" test is satisfied. However, this particular strand becomes more difficult to apply in cases where a bank may hold a position of "dominant failure" in the relevant banking market. In these cases, the Member State and Commission must apply a slightly different test, mainly whether the financial institution in question would have still required some form of external assistance regardless of wider market factors. Therefore, in order to determine whether a financial institution actually falls within the position of "dominant failure" one must first determine whether the internal failings are such within the bank that they outweigh the wider macro factors. In effect the counterfactual question in this case is whether even in the absence of external factors the financial institution in question would still have required some form of support due to the internal failings within this bank.

The positives of applying a counterfactual test of this nature mainly relates to the "efficiency" argument and competition distortion grounds.[124] Under the "efficiency" principle of State aid law, State support should only be deployed to resolve a market failure.[125] However, where a recipient is intrinsically a poorly managed and imprudent market operator then the failure in question is not market related but based on internal institutional factors. This aligns with

[124] *Evaluation in the field of State aid law*, DG Competition Issues Paper, 12.04.2013, at pp.8-9 available at http://ec.europa.eu/competition/state_aid/modernisation/evaluation_issues_paper_en.pdf [last accessed 07/11/2018].
[125] *Ibid* at p.2.

Jenny's categorisation of different types of failures.[126] If a financial institution's failing remains based on the poor internal management of said bank then clearly the proposed counterfactual is not met.[127] There of course limitations to applying a counterfactual test particularly in light of a crisis where multiple factors may be the underlying cause. For example, in the case of Anglo Irish Bank, while there where external factors including lax oversight from the Irish financial regulation, there were also internal failings within this bank. However, under the external factor test Anglo Irish Bank would fail due to these latter failings placing it in a position of dominant failure and as a "market leader" or "guru" that helped form a status quo that other competing financial institutions were reluctant to depart from.

From a competition distortion perspective ensuring that inefficient undertakings do not avail of State support should reduce the implicit support certain financial institutions seek to leverage due to their size rather than their underlying business model. Most State aid commentators have highlighted the need for both Member States and the Commission to apply a balancing test in respect of State aid provision. In effect this test refers to the need to assess whether the positive effects of any aid provided will counter any possible negative consequences of the aid.[128] Therefore to counter these possible negative effects of State aid intervention, support should only be limited to financial institutions with an actual long-term basis of market survival. This does not necessarily preclude the use of State aid to finance the controlled liquidation of a systemically important but insolvent financial institution. However, the above proposal should ensure that State aid is properly utilised for supporting actual long-term viable financial institutions rather than initially deployed to support non-long-term viable financial institutions followed by these banks then being liquidated.

[126] F. Jenny, "The Economic and Financial Crisis, Regulation and Competition" (2009) Vol.32(4) World Competition pp.449-464 at p.454-455.
[127] N.115 at p.65.
[128] *Ibid* at p.68.

6.3.6. Past State Aid Intervention and the question of long-term viability

Establishing a long-term viable test for financial institutions under a new "appropriateness" benchmark, is just one strand that may need to be included in a future State Aid Crisis Framework. Another strand may need to address the problem posed where a financial institution falls under the long-term viable benchmark but has a history of receiving State aid in the past. As noted in Chapter 5, during the financial crisis the Commission did not apply "a one-time last-time" principle to financial institutions that required external assistance due to wider market instability. However, in certain cases a financial institution may have had a history of seeking State support which would provide some indication that the bank has certain internal failings that may be best resolved via a market exit rather than continuous State aid.

There are a number of examples where a Member State may seek to evade the "one-time last- time" principle in order to maintain the market presence of a national champion or State owned entity. For instance, in the European automobile manufacturing sector figures from 2010 indicate that there was overcapacity of between 20% and 30%.[129] Yet despite this, certain Member States, such as France, sought to commit public funds to domestic car makers such as Peugeot Criteön (PSA Group) which had a market share of some 10.2% of the EU car market in 2016, the second largest market share.[130] Although not directly related to the "one-time last-time" principle, this does show how Member States remain unlikely to avoid State aid as a response even when there may be overcapacity in a given market sector. This ties in with Member States also seeking to overcome the "one-time last-time" principle, where an undertaking of national consequence requires additional aid despite already receiving financial support from the Member State in question. For example, in the airline sector certain European carriers have had

[129] L. Grigolon, N. Lehedya and F. Verboven, "Public Sector Support for the European Car Industry", Centre for Economic Research Discussion Paper No.12-77 October 2012 at p. 13 available at ftp://ftp.zew.de/pub/zew-docs/dp/dp12077.pdf [last accessed on 07/11/2018].

[130] Selected passenger car manufactures' European market share from January 2016 to August 2016, based on new registrations, available at https://www.statista.com/statistics/263421/market-share-of-selected-car-maunfacturers-in-europe/ [last accessed on 07/11/2018].

to rely on continued State support due to the failure of the initial restructuring plans.[131]

Chari has examined past State intervention in the European airlines sector in respect of two particular State owned airlines, namely Iberia and Aer Lingus.[132] The initial State support advanced to Iberia did qualify as compatible State aid under the then applicable Rescue and Restructuring Guidelines. However, subsequent support from State resources was deemed not to constitute State aid as this particular support was in line with the investment decisions a normal market economic investor would have made.[133] The Commission adopted a similar position when assessing yet further State support in the form of the Spanish State injecting an additional 20 billion pesetas into the airline in 1999.[134] Yet again the Commission considered this support to be in line with the Market Economic Investor Principle as at this point in time new private investors were willing to inject substantial funds into European airlines.[135]

The key consideration from this case is the fact that the Commission was willing to in effect waive the "one-time last-time" principle due to the subsequent support qualifying as normal market economic investment. But the question must then be asked why these private investors did not provide the capital injection from their own resources in these cases? A point also raised by Chari who notes that "[o]ne might argue that this may have been a 'sleight of hand', considering that we do not know if either AA or BA [the proposed investors in this case] would have actually effected the injection if the Commission had refused to allow the aid to go through".[136] Instead of past State aid interventions acting as a bar for further State investment in this case

[131] Commission Decision C 26/08 (ex NN 31/08) of 25/02/2009 *On the loan of Eur300 million granted by Italy to Alitalia* [2008] OJ L52/3 at para.47 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009D0155&from=EN [last accessed on 07/11/2018].
[132] R. S. Chari, "State Aids in the Airline Sector: A Comparative Analysis of Iberia and Aer Lingus" Studies in Public Policy 13, The Policy Institute Trinity College Dublin, 2004 at p.18 available at https://www.tcd.ie/policy-institute/assets/pdf/BP13_Airlines_Chari.pdf [last accessed on 07/11/2018].
[133] *Ibid*.
[134] *Ibid* at p.15.
[135] *Ibid* at pp.19-20.
[136] *Ibid* at p.19.

the Commission simply applied a rather lax interpretation of the Market Economic Investor Principle. In contrast, the Commission adopted a far more restrictive approach when assessing any possible State support, be it via actual State aid or investment, to Aer Lingus post the September 2001 terrorist attacks.[137] It must be pointed out that this particular position was taken by the then Commissioner for Transport and Energy and a formal decision by DG Competition was not issued as no official application was made by the Irish authorities.[138] Therefore, it seems the Commission is flexible when determining whether more support should or should not be provided to an undertaking. But should this flexibility be allowed when determining whether or not a financial institution that meets the long-term viable criteria also has a history of State aid support?

The above two examples illustrate the problems posed by the question of long-term viability and intermittent, if not regular forms, of State intervention. If an initial rescue and restructuring process ultimately fails, then this should indicate that the firm in question should exit the market place. In certain cases, a State aid recipient may though become a dominant market player within the industry in question. This is not only a European problem, for example the Japanese government provided a substantial capital injection to Japan Airways in order to allow for this undertaking to exit bankruptcy.[139] Thus Japan Airways may now be considered a long-term viable undertaking but only due to the support provided by the Japanese State, and is in fact a dominant market operator in the Asian airline sector. [140] Japan Airways has now superseded its' nearest rival Allways Nippon Airways by generating a

[137] *Ibid* at p.29.
[138] C. Sweeney, "State aid to Aer Lingus ruled out" Irish Independent (October 7th 2001) available at http://www.independent.ie/business/irish/state-aid-to-aer-lingus-ruled-out-26251208.html [last accessed on 07/11/2018].
[139] Announcement of Filing of Application for Support from the Enterprise Turnaround Corporation of Japan (ETIC) and the ETIC's Decision to Support out Restructuring; Filing of the Petitions for the Commencement of Corporate Reorganisation Proceedings and the Court's Decision on Commencement of these Proceedings, January 19th 2010 available at https://www.jal.com/en/ir/finance/pdf/10019.pdf [last accessed on 07/11/2018].
[140] *LCCs continue to see market share growth in Japanese domestic market ANA and JAL focus on international growth*, 28th July 2015, Airline Network News and Analysis available at http://www.anna.aero/2015/07/28/lccs-continue-see-market-share-growth-japanese-domestic-market-ana-jal-focus-international-growth/ [last accessed 07/11/2018].

higher net capital ratio.[141] But subsequent efforts to minimise the competition distortion arising from this support to Japan Airways, by the relocation of landing slots, are now considered too "late to undo the competitive advantage the carrier enjoys".[142] An alternative option, and one more conducive to market efficiencies, would have seen a viable competitor purchasing the remaining business units of the airline during its financial difficulties. In cases where a past recipient of State aid becomes a key market operator in a sector then this may trigger future market competition distortions. This in turn relates back to whether or not a financial institution meets the long-term viability benchmark under the new State Aid Crisis Framework, but does have a history of receiving State aid. The Commission will have to determine whether the "one-time, last-time" principle should be set aside in these circumstances. Thus a new State Aid Crisis Framework will also have to address this complex issue as the non-application of the "one-time, last-time" principle may either trigger future competition distortions or buttress pre-existing ones within the banking sector in question.

6.3.7. Past State aid intervention in the Banking Sector and Market Presence

There are cases when certain Member States have provided past financial assistance to domestic financial institutions. As examined in previous Chapters, both German and Austrian Ländesbanken were subject to a State guarantee scheme as they were publicly owned institutions.[143] Some of the financial institutions subject to this guarantee required additional support post the lapse of these schemes[144]. Examples of State support of this nature may raise certain complexities in the context of determining long-term viability. For instance, prior to their entry into the then Common Market, both the

[141] K. Inagaki, "Japan's State aid rules still lack sufficient teeth" Financial Times April 16th 2015 available at http://www.ft.com/intl/cms/s/0/ca24e8e4-fb1f-11e5-b3f6-11d5706b613b.html#axzz4BvlME0tH [last accessed on 07/11/2018].
[142] *Ibid*.
[143] See Chapter 4 at p.54-55.
[144] For example, WestLB.

Swedish and Spanish States provided substantial support to their banking sectors.[145]

There are though limitations to applying such a past State aid intervention test. For example, in the case of the 2008 financial crisis, a number of non-long-term viable financial institutions would have actually satisfied this particular criterion. Financial institutions such as Anglo Irish Bank and Hypo Real Estate, did not avail of past State aid support while other market actors such as Allied Irish Banks do have a record of some form of State assistance.[146] Thus a balancing test may need to be applied between how much emphasis should be placed on the past State aid support advanced to a domestic financial institution and the future needs of the wider economy.

If one was to apply the position of "dominant failure" to both Allied Irish Banks and Bank of Ireland, then arguably both would not satisfy this test. The key reason why neither financial institution falls under this category is due to their diversified business lines, and the fact that both banks were not solely engaged in property related lending. Further, both Allied Irish Banks and Bank of Ireland had a number of profitable units and a wide retail network which could easily be leveraged to return these banks to long-term viability. For example, even at the beginning of the crisis Allied Irish Banks could list a number of different income streams in addition to mortgage or property related lending.[147] In contrast, in its 2008 annual report Anglo Irish Bank's results further illustrated the limited range of income generated from actual banking business conducted by that institution.[148] For the former, there were a number of different revenue generating businesses such as investment banking and asset management fees.[149] While for the latter, income mainly

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[145] *Bank Failures in Mature Economies*, Basel Committee on Banking Supervision, Working Paper No.13, April 2004 at pp-27-31 and p. 34-40 available at http://www.bis.org/publ/bcbs_wp13.pdf [last accessed on 07/11/2018].
[146] Insurance Corporation of Ireland, 1985 General Insurance Convention, available at https://www.actuaries.org.uk/documents/insurance-corporation-ireland[last accessed on 07/11/2018].
[147] AIB Annual Financial Report 2008 available at https://aib.ie/content/dam/aib/investorrelations/docs/resultscentre/annualreport/annual-report-2008.pdf [last accessed on 07/11/2018].
[148] Anglo Irish Bank Annual Report 2008 available at http://online.hemscottir.com/ir/ckl/ar_2008/ar.jsp [last accessed on 07/11/2018].
[149] N.147 at p.28

derived from leveraging revenue from existing outstanding bank loans rather than a diversified revenue base.[150] In the above cases, Allied Irish Bank clearly has a more diversified business model and will retain a key role in the future needs of the Irish economy. Therefore, the importance of this role outweighs the past State aid intervention received by the Irish State. Furthermore, a new State Aid Crisis Framework can also leverage the pre-existing criteria for setting aside the "one-time, last-time" principle as under the Rescue and Restructuring Guidelines 2014.[151] Both of these measures should then ensure that conflict between providing additional State aid to a financial institution that meets the long-term viable criterion but that has received State aid in the past is resolved.

6.4.1. Minimum Necessary Criterion and Long-term viable banks

The above proposal for establishing a new long-term viable test for what constitutes a long-term viable financial institution cannot be applied in isolation from the need to develop a new "minimum necessary" principle. A new State Aid Crisis Framework will have to encompass a new formulation for what level of State aid should be provided to a long-term viable financial institution. In the cases of Anglo Irish Bank and Hypo Real Estate, the Irish and German authorities failed to appreciate the inherent insolvency of both financial institutions.[152] Hence, from an economic efficiency perspective the capital provided to these banks did not only fail to provide a return, this capital also constituted a *de facto* sunk cost for both State budgets. Both Allied Irish Banks and Bank of Ireland have also received substantial State support from the Irish State since the 2008 financial crisis. Although the latter has since repaid most of the State aid advanced, Allied Irish Banks still remains unlikely to discharge the €20.8 billion recapitalisation in full for a considerable period of time.[153] As of August 2018 Allied Irish Banks has

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[150] N.148 at p.32.

[151] Commission Communication 92014/C249/01) of 31/07/2014 Guidelines on State aid for rescuing and restructuring firms in difficulty [2014] OJ C249/1 at para.70 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0731%2801%29&from=EN [last accessed on 07/11/2018].

[152] See Chapter 5.

[153] Bank of Ireland Annual Report 2017 at p.4 available at https://www.bankofireland.com/fs/doc/wysiwyg/boi-annual-report-2014.pdf [last accessed

repaid the Irish State just €10.05 billion of this sum including the proceeds of a recent share issues.[154]

Other financial institutions throughout the Union have also struggled to generate sufficient revenue to be in a position to repay the recapitalisations granted by Member States. In the United Kingdom, the total financial support provided to Royal Bank of Scotland exceeded £45 billion.[155] According to the National Audit Office of the UK if the State's shares were disposed of in March 2016 this would have resulted in a cash loss of some £23 billion for the UK taxpayer.[156] The sale of 7.7% of its shareholding for £2.5 billion saw the UK lose £2 billion in June 2018.[157] Yet in contrast, Lloyds Banking Group has repaid the UK Treasury the full recapitalisation costs of £20.3 billion with an additional £900 million also returned to the State.[158] Similarly, the Dutch financial institution ING has repaid in full the crisis support provided by the Dutch taxpayer at the end of 2014.[159] While ABN AMRO has still to repay a considerable remainder of the €21.6 billion provided by the Dutch State.[160]

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on 17/07/2016]; Allied Irish Banks Annual Report 2017 at p.5 available at https://aib.ie/content/dam/aib/investorrelations/docs/resultscentre/annualreport/annual-financial-report-2016.pdf [last accessed on 07/11/2018].

[154] Shareholding and Financial Advisory Division, Fact Book: Q3 2017, at p.17 available at https://www.finance.gov.ie/wp-content/uploads/2017/08/171017-SFAD-Fact-Book-Update-Q32017.pdf[last accessed on 09/07/2017].

[155] *The UK Government Investment in Royal Bank of Scotland*, Rothschild Report 10th June 2015, at p.5 available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/434153/Rothschild_report_on_the_UK_investment_in_RBS.PDF [last accessed on 07/11/2018].

[156] National Audit Office, *Taxpayer Support for Banks: FAQs* last updated July 2016, available at https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/.

[157] "UK government sells 7.7% stake in Royal Bank of Scotland", RTE News, Updated/Tuesday, 5TH June 2018 08:02 available at https://www.rte.ie/news/business/2018/0605/968218-rbs-stake-sale/ [last accessed on 07/11/2018].

[158] HM Treasury and UK Government Investments Limited, The Return of Lloyds Banking Group to private ownership, Report by the Comptroller and Auditor General, at p.7 available at https://www.nao.org.uk/wp-content/uploads/2018/06/The-return-of-Lloyds-Banking-Group-to-private-ownership.pdf [last accessed on 07/11/2018].

[159] IGN Banking Group Annual Report 2014 at p.8 available at http://www.ing.com/Investor-relations/Annual-Reports.htm [last accessed on 07/11/2018].

[160] Plans for the Sale of ABN AMRO available at https://www.government.nl/topics/state-owned-enterprises/contents/sale-of-abn-amro-asr-and-sns-reaal/plans-for-the-sale-of-abn-amro [last accessed on 07/11/2018]: *Developments of Intervention Costs for the Credit Crisis*, Rekenkarmer Netherlands, 23rd May 2017, at p.3 available at https://www.rekenkamer.nl/.../ontwikkelingen-interventies-kredietcr.. .[last accessed on 07/11/2018].

As noted in Chapter 5, the "minimum necessary" criterion in respect of systemically important, but non-long-term viable financial institutions, may be applied in an overly flexible manner by both Member States and the Commission. A parallel issue arises in respect of the level of support provided to financial institutions that are deemed to have a viable market future. For instance, if State aid rules fail to link possible long-term viability with the return on investment for Member States then State resources are not efficiently utilised and competition distortions arise.

6.4.2. State Investment and the Market Economic Investor Principle

To formulate a new benchmark for what constitutes an appropriate level of State aid to a long-term viable financial institution one must first consider if an existing benchmark may point a way forward. One possible pointer is the market economic investor principle. As noted in Chapter 2 of the Thesis, the market economic investor principle allows for a Member State to act as a normal market operator without falling foul of European State aid controls. Under the market economic investor principle State support provided by a Member State to an undertaking is compared with how an actual private market operator would have responded. In cases where this benchmark is met then the support in question does not fall under the State aid regime as there is no aid in question. During the financial crisis, most Member States were willing to concede that the support provided to domestic financial institutions did not satisfy the Market Economic Investor Principle mainly due to the substantial resources a State has over private investors and the wider economic concerns facing Member States that a normal market investor does not have to consider.[161]

Throughout different economic sectors the Commission has applied the Market Economic Investor Principle. For present purposes certain specific infrastructural projects may constitute the best form of comparison with the banking sector. First, certain infrastructural projects may entail some degree

[161] R.F. Owen, "Sunk Costs, News and Economic Methodology", at p.17 available at https://www.fep.up.pt/conferences/earie2005/cd_rom/Session%20III/III.J/rowen.pdf [last accessed on 07/11/2018].

of "sunk costs" that investors may not be able to recover during the lifetime of the initial investment. These costs refer to the level of investment that investors must expend at the preliminary stage of a project such as planning permission, engineering surveys and possible reports that will not on their own generate a return for the investors in question.[162] Second, infrastructural projects may meet two objectives, from the State's perspective a social utility may be established which improves the standard of living for the population overall but may also constitute an investment opportunity for private market operators.

One example of this particular overlap between social utility and investment opportunity is the broadband infrastructure sector in different Member States. Under the Commission guidelines Member States are allowed to provide substantial financial assistance to certain providers seeking to extend broadband reach to isolated locations.[163] However, there are also cases where a State emanation may decide to invest in commercially profitable broadband markets, such as the city of Amsterdam's investment in one broadband provider.[164] In this case the Commission found that the support provided by this State body was in line with normal market considerations.[165] The financial commitment by the Amsterdam municipality was undertaken with the aim of ensuring that any return generated would be divided up equally among the investing parties and that any initial investment costs met by the State body would be reimbursed after a certain period of time by the other investors in question.[166] Although Gaal et al. note how State aid in the

[162] Commission Decision State aid N 255/2009 of 12/05/2009-Belguim and N 274/2009- of 12/05/2009 *Luxembourg, Additional aid for Fortis Banque, Fortis Banque Luxembourg and Fortis Holding* OJ C(2009) 3907 at para.44 available at http://ec.europa.eu/competition/state_aid/cases/231240/231240_1040772_26_1.pdf [last accessed on 07/11/2018].
[163] Commission Communication (2013/C5/1) of 26/01/2013 on EU Guidelines on the application of State aid rules to the rapid deployment of broadband networks [2013] OJ C 25/1 available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:025:0001:0026:EN:PDF [last accessed on 07/11/2018].
[164] Commission Decision C53/2006 (ex 262/2005, ex CP127/2004) of 11/02/07 *Investment by the city of Amsterdam in a fibre-to-the-home (FttH) network* OJ C(2007) 6072 available at http://ec.europa.eu/competition/state_aid/cases/218055/218055_760366_119_1.pdf [last accessed on 07/11/2018].
[165] *Ibid* at para.177.
[166] *Ibid* at paras.54-56.

broadband market in Amsterdam may crowd out private investors, this concern should not be dismissed simply due to the fact that the support in question does not constitute State aid.[167] But this raises additional questions in respect of whether this particular joint venture would have occurred even in the absence of the Amsterdam municipality participating in such a project. Presumably there was some key advantage for private investors by participating in an investment opportunity with a State body.

The above case illustrates how the Market Economic Investor Principle may not always be a concrete principle to apply in cases where investment return may conflate with social need. For instance, did the Amsterdam authority actually behave as a normal market economic investor when determining whether or not to commit funds to the broadband project? For example, would not a normal economic investor sought to invest funds in a project that might have yielded a better financial return? A similar issue may also be extrapolated in respect of when a Member State seeks to provide State aid to a long-term viable financial institution. Would for instance, a Member State recapitalise a long-term viable financial institution regardless of the level of funding required? Would not an actual market operator seek to place a limit on the level of recapitalisation that this investor may be liable for? How these questions are answered will depend on what the exact long-term objectives are for both a Member State and a private market operator. The former may have social and economic objectives that the latter does not need to address as this party remains active for the purpose of a return on its investment.

6.4.3. State's role and the minimum necessary

In the above case of the Amsterdam broadband network, the Commission arguably failed to sufficiently demark the line between the State's role in providing for certain public services and its role as a private market operator. Therefore, the exact line between the acts of a private market operator and the

[167] N. Gaál, L. PaPaDias and A. Riedl, "Citynet Amsterdam: an application of the market economy investor principle in the electronic communications sector", (2008) Vol.1 Competition Policy Newsletter pp.82-85 available at https://www.mtitc.government.bg/upload/docs/2008_1_82.pdf [last accessed on 07/11/2018].

State performing a number of different functions has become blurred. For example, when assessing the capital support provided by the French State to the energy giant EDF, the CJEU appeared to endorse a position that even where a Member State performs its role as a public authority, the application of the Market Economic Investor Principle may still apply.**[168]** As Thomas succinctly sets out while "it was settled case law… that the State when the State acts as a public authority (by using its fiscal prerogatives for example), this test cannot be applied as there is no private investor to which the State can be compared to".[169] However, the EDF case saw the CJEU try and distinguish between when the State acts as a shareholder and a public body exercising "public power".[170]

The key issue in this case was whether or not the accounting record of a debt EDF owed to the French State constituted an advantage granted to the energy firm.[171]For the Commission the central question was whether one could apply the test in a case where the actual conduct of the State fell more within the remit of regulatory action rather than that of a shareholder.[172] The French State argued that in effect this support should be seen as an investment in line with the Market Economic Investor Principle. But the Commission dismissed this position as "[w]hile a "Member State may act as a shareholder in addition to exercising its powers as a public authority, it must not combine its role as a State wielding public power with that of a shareholder".[173] In other words, the Commission was not willing to accept that the French authorities could utilise a regulatory power in favour of an undertaking and claim that this

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[168] Case C-124/10P *Commission v. Électricité de France (EDF)* EU:C:2012:318 available at http://curia.europa.eu/juris/document/document.jsf?text=&docid=123502&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=2180477 [last accessed on 07/11/2018].
[169] S. Thomas, "The EDF Judgment of the CJEU in Case C-124.10P: Towards a Public Investor Test in EU State Aid Law?" European Union Law Blog posted 18th September 2012 available at http://europeanlawblog.eu/?p=827 [last accessed on 07/11/2018].
[170] N.168 at para. 81
[171] *Ibid* at para. 95.
[172] Commission Decision of 1(2005/126/EC) of 16/12/2003 *on the State aid granted by France to EDF and the electricity and gas industries*, [2005] OJ L49/9 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005D0145&from=ENL [last accessed on 07/11/2018].
[173] *Ibid* at para.97.

complied with the Market Economic Investor Principle as no market economic operator could exercise an equivalent regulatory function. The CJEU though adopted a contrasting position, "the possibility that there might be a difference between the cost to the private investor and the cost to the State as investor does not preclude application of the private investor test".[174] Therefore, even though there are obvious differences between the role of a State and a private investor in terms of both regulatory power the former can apply and resources the latter has at its disposal, the CJEU held that the Market Economic Investor Principle could still apply. Although this case delves deep into the exact parameters of what constitutes a market economic investor and how the principle interacts with how the State exercises its various functions. This case does illustrate how a State may utilise its functions and resources in a combined manner. Similarly, during a financial crisis, a Member State may seek to provide State aid to a long-term viable bank not just on the basis of possible future returns but for other considerations as well.

6.4.4. Long-term viable banks and the minimum necessary: The Rational State Actor

An overview of the above Commission decisions and the CJEU judgment in *EDF*, illustrate how the role of the State as an investor remains multifaceted. When investing in broadband infrastructure, a State body may act as a normal market investor, but the State may also straddle two roles at once. For instance, in the *EDF* case the State could utilise its regulatory responsibilities as a private investor even though such an investor in the private sphere remains a hypothetical undertaking. These examples do though provide a context for formulating some form of "minimum necessary" criterion in respect of State aid provision to long-term viable banks under a future State Aid Crisis Framework for the banking sector.

In certain circumstances the State may provide services and products to meet a public demand private actors are not willing to satisfy. Tanzi cites economists such as Paul Samuelson and Richard Musgrave who both argue

[174] N.165 at para.96.

that in certain cases the State may need to intervene in order to provide public goods.[175] Private actors supplying this demand may also receive some form of subsidy from the State.[176] The same author also notes how as a legislator the State may pass regulations seeking to curb the excesses of the market economy.[177]Therefore the State may fulfil a dual role of service provider and of market regulator. Arrowsmith when discussing public procurement law and State aid also touches on this issue of what role the State may take.[178] For example, in a Public Private Partnership, the State may transfer land to an investor but the *quid pro quo* from this investor may be any number of acts. For example, the State may require the investor to provide building services for a reduced price, or for the investor to pay an annual fee to the State.[179] Alternatively, the State may simply seek an improvement over this land that a private investor can undertake which has a wider public policy benefit.[180]

Other commentators have also examined the role of the State as an agent for economic development and growth.[181] This is clearly seen in EU State aid policy where Regional Guidelines allow Member States to in effect subsidise development for the wider good of an economically marginalised community.[182] Yet the State also has a central role in maintaining market stability in certain key sectors of the economy. Prior to the "public goods" position developed by both Samuelson and Musgrave, there was the co-ordination principle.[183] In effect this relates to the willingness of individuals

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[175] V. Tanzi, "The Changing role of the State in the Economy: A Historical Perspective", a Working Paper of the IMF September 1997at p.11 available at https://www.imf.org/external/pubs/ft/wp/wp97114.pdf[last accessed on 07/11/2018].
[176] *Ibid*.
[177] *Ibid* at pp.19-20.
[178] S. Arrowsmith, "Public Private Partnerships and the European Procurement Rules: EU Policies in Conflict?" (2000) Vol.37(3) CML Rev pp.709-737 at p.719.
[179] *Ibid*.
[180] *Ibid*.
[181] E. S. Reinert "The role of the state in economic growth" (1999) Vol.26(4) Journal of Economic Studies pp.268-326 available at http://www.othercanon.org/uploads/state-paper-pdf.pdf [last accessed on 07/11/2018].
[182] Commission Communication *Guidelines for regional State aid for 2014-2019* OJ [2013] C 209/01 available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF.
[183] R. Hardin, "Economic Theories of the State" in Dennis C. Mueller's (eds.) *Perspectives on Public Choice a Handbook*, (Cambridge University Press, 1997) pp.21-34 at p. 25 available at http://www.nyu.edu/gsas/dept/politics/faculty/hardin/research/EcoTheorState.pdf [last accessed on 07/11/2018].

to concede certain powers to the State in exchange for security and protection.[184] In a similar vein, the State itself may have to strike a balance between the different needs and wants of its citizens. With limited resources, a State may need to forgo certain projects to meet certain term emergency costs.

Specifically, in the context of a banking crisis, the State must ensure the provision of banking services, protect the wider public interests and co-ordinate the various responses. The first task not only protects the wider economy it also helps meet the second task as individuals within the State are still able to access banking services and so this reduces the risk of social disruption. Co-ordinating the various responses to the financial crisis, is also a role that the State is best suited to perform due to its regulatory powers and resource base. One could posit that these roles represent what a "rational" State actor may perform in times of banking instability. Yet the next question relates to the level of State resources a State actor may be willing to provide to a long-term viable financial institution. As noted above, a State will have limited resources and from these limited resources, decisions will have to be made as to which projects will have to be forgone to meet the stability costs of the financial crisis. This becomes even more important where the possibility of financial return from the intervention taken by the State remains unlikely. While a rational market investor, in line with the Market Economic Investor Principle, will seek to provide funds in order to generate a return, a rational State actor has wider considerations and objectives to consider. These include: (i) restrictions on available resources; (ii) the limited possibility of a full return on any capital provided, (iii) the opportunity costs of arising from any funds provided to the banking sector.

Hence to determine what the "minimum necessary" amount of aid should be for a long-term viable financial institution, a rational State actor test should be formulated. Under this test the above considerations should be applied as to whether a hypothetical rational State would provide the proposed funds in question to the financial institution in question. These include the available

[184] *Ibid.*

resources of the State, the opportunity costs of providing funds to this financial institution and finally whether there will be an underlying return from this investment. For instance, if the proposed financial institution's recapitalisation or guarantee is beyond the actual resources of a hypothetical rational State in the same position as that of the Member State, then this test is not met. However, it may be that a Member State does have the resources in place but that the likelihood of full repayment remains unlikely thus the level of aid should be reduced to reflect this.

Where the above two criteria, that of the possible restrictions on available resources and the limited possibility of a fully return on capital provided, have been satisfied, an additional penalty for any "opportunity costs" the State has forgone due to this intervention should apply to the recipient financial institution to meet the third criterion.[185] This additional charge could be determined by calculating the possible alternative social and infrastructure expenditure a State has possibly forgone against the benefit of maintaining a stable and functioning banking sector. In this way the "minimum necessary" criterion would then not only be met it would also further incentivise financial institutions to seek alternative funding sources in order to avoid additional costs associated with this "opportunity cost" charge. Nicolaides and Schoenmaekers discuss the notion of the State as a consumer in the context of public procurement law.[186] In these cases the State has needs that in most cases no normal private consumer requires, such as the construction of bridges or motorways.[187] Further, the State is subject to certain restrictions that a private consumer is not, these include tender conditions which preclude cheaper suppliers and acceptance on the State's part that suppliers may charge a premium.[188] In a similar vein, a hypothetical rational State actor may be willing to forgo the opportunity costs associated with any recapitalisation or

[185] H. W. Friederiszick, Lars-Henrik Roller and Vincent Verouden, "European State aid Control: An Economic Framework" in Paolo Bucirossi (eds.) Handbook of Anti-trust Economics (Cambridge: MIT Press, 2008) pp.625-669 at p. 637at available at http://ec.europa.eu/dgs/competition/economist/esac.pdf [last accessed on 07/11/2018].
[186] P. Nicolaides and S. Schoenmaekers, "Public Procurement, Public Private Partnerships and State Aid Rules: A Symbiotic Relationship", (2014) Vol.9(1) Eur. Procurement and Pub. Private Partnership L. Rev. pp.50-69.
[187] *Ibid* at p.51
[188] *Ibid* at p.52.

guarantee provided to a financial institution if this engenders financial stability. Hence there may be cases where this proposed additional recapitalisation threshold may not be applicable due to the wider economic factors prevailing at the time of the recapitalisation or guarantee in question.

6.5.1. Commission Decisional Practice: Proportionality of State aid measures and Competition Distortions

A key aspect of EU State aid control is ensuring that any aid an undertaking receives is offset against certain *quid pro quo* measures. These measures may include disposing of business units in other jurisdictions, exiting certain markets or facilitating the entry of new market competitors. As noted Chapter 3 in certain cases the recipient financial institution may have to divest of a profitable business unit or subsidiary as was the case with Allied Irish Banks' disposal of its Polish subsidiary. Therefore, the Commission has a difficult balance to strike between ensuring that sufficient competition distortion safeguards are applied while also ensuring that these measures do not jeopardise the long-term viability of the financial institution in question.

6.5.2. Competition Distortion Safeguards for Long-term Viable Banks

Discussed in the previous Chapter was the need for a new State Aid Crisis Framework to encompass specific competition distortion measures for insolvent but systemically important financial institutions. However, a future State Aid Crisis Framework will also have to include specific competition distortion safeguards for long-term viable financial institutions. In many ways these competition distortion safeguards will have to address far more complex issues than ones adopted for an insolvent financial institution that will exit the banking sector overtime. As evident in the proposals set out in the previous Chapter, policymakers may be able to apply competition distortion safeguards that specifically facilitate the gradual liquidation of an insolvent but systemically important financial institution. However, in the context of long-term viable financial institutions competition distortion measures will need to designed in a way that reflects the impact on future economic stability, competitors and also bank consumers. The reason for this remains twofold. First, unlike an insolvent financial institution that will exit the market in time, a long-term viable financial institution will continue to operate and as such may constitute a future systemic threat to a Member State's banking sector. Second, a long-term viable financial institution may acquire considerable market share either due to acquiring other financial institution's business lines or by the exiting of other financial institutions in the last crisis. This may result in competition distortions that impact on consumers and competing institutions. Therefore, a future State Aid Crisis Framework will have to address these challenges. Challenges that were not, it is posited adequately tackled by the Commission during the financial crisis.

The financial crisis represented an insight as to whether or not the Commission would lower the "proportionately" threshold in respect of financial institutions availing of State aid in times of a systemic crisis. There are two forms of competition safeguards the Commission may apply, these are either behavioural or structural. For the purposes of establishing new competition distortion safeguards, the difference between these two measures will be set out. The former includes placing a cap on executive remuneration and for Irish banks also encompassed complying with a Corporate Social Responsibility programme initiated by the Irish government.[189] Irish financial institutions were also subject to certain management controls such as seeking government approval before raising inter-bank deposits and undertaking risk management arrangements to ensure that these institutions did not trigger the guarantee scheme.[190] In contrast with behavioural safeguards, the latter structural safeguards are designed to reduce the market presence of a recipient financial institution via the disposal of business units or subsidiaries. For example, in the case of Bank of Ireland this entailed the bank's withdrawal from its insurance business.[191] While for Allied Irish Banks these structural

[189] Commission Decision State aid N.149/2009 of 26/03/2009, *Recapitalisation of Bank of Ireland by the Irish State*, OJ C(2009)2349, at para.37 available at http://ec.europa.eu/competition/state_aid/cases/230254/230254_997291_29_2.pdf [last accessed on 07/11/2018].

[190] *Ibid*.

[191] Commission Decision State aid N546/2009 of 15/07/2010, *Restructuring of Bank of Ireland*, OJ C(2010)4963, at paras.55-62 available at http://ec.europa.eu/competition/state_aid/cases/233382/233382_1163194_133_2.pdf [last accessed on 07/11/2018].

measures included the disposal of both Allied Irish Banks Jersey Trust and shares in foreign banks in both Poland and the Baltics.[192]

One of the key issues with imposing competition distortion safeguards on a recipient undertaking is whether or not this measure is a genuine penalty for accessing State support or simply a step the recipient is likely to take in any case so as to return to long-term viability. Franchoo et al. comment how in the case of the Hungarian Bank MKB, the disposal of that financial institution's "noncore car fleet management business" was "presented as a viability measure even though it did not seem to have caused losses to the bank".[193] The authors posit that the disposal of this particular business line was more of a penalty than a viability measure to reflect the fact that only two Hungarian banks received State aid including MKB.[194] In contrast, Greek financial institutions were subject to less intrusive safeguards as most of the domestic banking sector received State support.[195] But the greater the number of financial institutions in one jurisdiction that have received State aid does not necessarily preclude the application of aggressive competition distortion safeguards.

For example, in the case of Commerzbank the German authorities agreed to a balance sheet reduction from €1.100 billion to €600 billion, a balance sheet reduction of some 45%.[196] This despite the fact that at least seven other German banks also received State support. Although one could consider such an extensive balance sheet reduction as indirectly resolving the "Too-Big-To-Fail" problem posed by Commerzbank. The level of this reduction as a direct

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[192]Commission Decision on State aid SA.29786 (ex N633/2009), SA.33296 (2011/N), SA.31891 (ex N553/2010), N241/2009 and N160/2010 and C25/2010 (ex N212/2010) of 07/05.*2014 implemented by Ireland for the restructuring of Allied Irish Banks plc. and EBS Building Society*, OJ C(2014)2638 at para.50 available at http://ec.europa.eu/competition/state_aid/cases/233873/233873_1581273_451_2.pdf [last accessed on 09/01/207].

[193] T. Franchoo, N. Baeten and J. Baker, "The Application of European Competition Law in the Financial Services Sector", (2016) Vol.7(7) Journal of European Competition Law and Practice pp.483-500 at p. 486.

[194] *Ibid*.

[195] *Ibid* at p.487.

[196] Commission Decision State aid n° SA.34539(2012/N) of 30/03/2012, *Germany Amendment to the restructuring plan of Commerzbank*, OJ C(2012)227 at para.10 available at http://ec.europa.eu/competition/state_aid/cases/231053/231053_959312_23_1.pdf [last accessed on 07/11/2018].

quid pro quo for the State recapitalisation provided to Commerzbank, €18 billion, still seems questionable. While €18 billion is indeed a large sum of aid, the markets Commerzbank operates in are varied, and not necessarily solely focused on the domestic German market. Even if one considers Deutsche bank as a competitor to Commerzbank, the former as of 2017 had total assets on its balance sheet of €1.475 billion therefore arguably the State aid provided to the latter does not necessarily constitute a major competition distortion.[197] It also remains questionable whether imposing market divestments on Commerzbank will improve competition in these markets.[198] Presumably, Commerzbank could be restored to long-term viability without the need for such a substantial balance sheet reduction. This conflation between viability measure and competition distortion safeguard is also seen in the Commission's assessment of BayernLB's restructuring programme.[199] In this case the closure of BayernLB's Asian business, the closure of branches in key markets and the downsizing of its London and New York branches were deemed to be "viability measures".[200] Although referring primarily about the price leadership bans and restrictions imposed on management remuneration, Dewatripont's comment that the Commission in effect "'tied the hands' of bailout recipients" also rings through in respect of BayernLB.[201]

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[197] Deutsch Bank Annual Report 2017 at p.1 available at https://www.db.com/ir/en/download/DB_Annual_Report_2017.pdf [last accessed on 07/11/2018]. According to the 2017 balance sheet of Commerzbank this financial institution had total assets of 452.5 billion, Commerzbank Annual Report 2017 at p.1 available at https://www.commerzbank.com/media/en/aktionaere/service/archive/konzern/2018_2/Geschaeftsbericht_2017_Konzern_EN.pdf [last accessed on 07/11/2018].

[198] C. Ahlborn and D. Piccinin, "The Great Recession and Other Mishaps: the Commission's policy of restructuring aid in times of crisis", in Erike Szyszczak ed. *Research Handbook of European State aid Law* (Cheltenham; Edward Elgar Publishing, 2011) pp.124 at p.153.

[199] Commission Decision State aid N254/2009 of 12/05/2009, *BayernLB, Germany and Hypo Group Adria Austria*, OJ C(2009)3811 at para.95 available at http://ec.europa.eu/competition/state_aid/cases/231280/231280_966999_16_1.pdf [last accessed on 07/11/2018].

[200] *Ibid*.

[201] M. Dewatripont, "European Banking: Bail-out Bail-in State Aid Control", (2014) Vol.34 International Journal of Industrial Organisation, pp.33-47 at p.41 available at http://ac.els-cdn.com/S0167718714000289/1-s2.0-S0167718714000289-main.pdf?_tid=43db2cf8-7d05-11e7-b15f-00000aab0f01&acdnat=1502284902_32048b64af63dcc7583ef56d7206f8c6 [last accessed on 07/11/2018]. Gray and de Cecco also highlight similar issues in respect of how recipient financial institutions in the Netherlands are restricted in what pricing strategies they can adopt resulting in Rabo Bank becoming the market leader in setting interest rate increases as this bank received no State aid knowing that its aided competitors will have to follow

If financial institutions are subject to both excessive behavioural and structural conditions then this in turn may make it more difficult for these financial institutions to regain viability and profitability.

Soltész and Von Köckritz also address the Commission's competition distortion safeguard policies and question whether these measures strike the correct balance between penalising State aid recipients while also ensuring that these banks are able to retain long-term viability.[202] Wider economic considerations may also be impeded by the nature of the safeguards imposed on recipient financial institutions. For example, if efforts to comply with a balance sheet reduction measure result in credit restriction then this will impact the wider economy.[203] In a similar vein, a non-price leadership clause may adversely affect consumers.[204] Therefore, a number of conflicting and overlapping objectives remain in play when the question of what form competition distortion safeguards should take when applied to the banking sector. These conflicting and overlapping objectives will need to be teased out as part of a new State Aid Crisis Framework. For example, should a financial institution that meets the above proposed long-term viability test then be subject to over burdensome competition distortion safeguards that then undermine its long-term viability? If not, then what measures can be put in place as an alternative response so that the needs of both the financial institution itself and the wider considerations such as consumer interests and future economic stability be met? This will now be further examined below.

6.5.3. Financial Stability and Competition in the Banking Sector

As noted above the consequences of competition distortion safeguards when applied to the banking sector may be varied and complex. One area in particular where these complexities lay is in the interaction between

suit. See J. Gray and F. de Cecco, "Competition, stability and moral hazard: the tension between financial regulation and State aid control", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.20 at p.43.

[202] U. Soltész and C. Von Köckritz, "From State aid Control to the Regulation of the European Banking System-DG Comp and the Restructuring of Banks", (2010) Vol.6(1) ECJ pp.285-307 at p.306.

[203] *Ibid*.

[204] *Ibid*.

competition and financial stability in banking. A report by the International Competition Anti-trust Network on the interaction between financial regulation and competition published three years prior to the 2008 financial crisis, set out a number of recommendations for policy makers to promote competition in banking.[205] Thus, jurisdictions should, "promote an open and competitive banking environment without unjustified restrictions on entry, ownership or exit" while from a competition perspective, "agencies should" ensure that the banking sector is not exempt from competition rules and that depositors are able to switch without additional costs.[206]

One can clearly see a possible link between promoting unrestricted market access on competition grounds and the possible adverse effect this may have for consumer interests and market stability. For example, as noted in the opening Chapter, the emergence of Icelandic bank subsidiaries in the United Kingdom and the Netherlands may have initially benefited consumers, especially retail depositors, but the subsequent demise of the Icelandic banking sector meant that these same consumers were vulnerable to losing their savings.[207] On a similar theme, if one examines the pre-crisis banking sectors of a number of Member States, one common theme is the fragmented nature of various domestic banking markets. For example in Spain, the emergence of the Cajas savings banks resulted in an expansion of credit, a positive for Spanish consumers, but not necessarily from a financial stability perspective.[208] Although, in some cases certain Cajas may have behaved in an imprudent manner due to political factors rather than competitive market

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[205] *An Increasing role for Competition in the Regulation of Banks*, International Competition Network Anti-trust Enforcement in Regulated Sectors Report Subgroup 1, Bonn September 2005 available at http://www.internationalcompetitionnetwork.org/uploads/library/doc382.pdf [last accessed on 07/11/2018].
[206] *Ibid* at p.27.
[207] See Chapter 1 at p.7.
[208] M. Otero-Iglesias, S. Royo, F. Steinberg, "The Spanish Financial Crisis: Lessons for the European Banking Union", Royal Institute Elcano, Inform 20, March 2016 at p.12 available at http://www.realinstitutoelcano.org/wps/wcm/connect/990df1804c31d6e0b752bf07355a34ad/Informe-Elcano-20-Spanish-financial-crisis-Lessons-European-Banking-Union.pdf?MOD=AJPERES&CACHEID=990df1804c31d6e0b752bf07355a34ad [last accessed on 07/11/2018].

pressures, the underlying point remains that a disparate banking market may undermine wider market stability.[209]

In contrast, the Dutch banking sector prior to the financial crisis was considered by both domestic regulators and the OECD to lack sufficient competition.[210] According to the latter the absence of new market entrants could be due to "low profitability", "entry barriers" or costs related to the establishment of a market presence.[211] However, though the Dutch banking sector, unlike the Spanish one, had in effect three dominant financial institution groups, ABN AMRO, ING and Fortis, this market also experienced a substantial loss of value and business during the financial crisis. In many ways the Dutch market mirrors the Irish banking sector, where two financial institutions currently dominate the retail banking sector.

Even though a number of UK based banks did enter the Irish banking market prior to the crisis, these new market participants did not necessarily erode the pre-existing market dominance of either Allied Irish Banks or Bank of Ireland. Yet the presence of these new market entrants may have resulted, according to Hanley and Rae, in competition being "misdirected towards the more attractive profit margins available in commercial property lending".[212] Banks such as HBOS Ireland, also introduced hundred per cent mortgages, a promotion soon followed by Irish financial institutions.[213] Yet Hanley and Rae do state that the problem facing the Irish banking sector "was not competition per se, but the institutional framework that provided a weak constraint on the worst excesses of increasingly reckless banks".[214] A position also taken by the OECD, which found that oligopolistic, rather than

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[209] *Ibid* at p.13.
[210] *Review of Competition in the Dutch Retail Banking Sector*, by the Secretariat, Working Paper No.2 on Competition and Regulation 4th June 2007, Directorate for Financial and Enterprise Affairs the Competition Committee, Organisation of Economic Co-operation and Development, available at http://www.oecd.org/regreform/sectors/39347699.pdf [last accessed on 07/11/2018].
[211] *Ibid* at p.6.
[212] C. Hanley and A. Rae, "Stability and Competition in Irish Banking: Friends or Foe?", Competition Authority Conference Paper for the DEW Kenmare Conference October 2011 at p.10 available at http://www.ccpc.ie/sites/default/files/2011-10-14%20Competition%20Policy%20%26%20Financial%20Stability%20-%20Friends%20or%20Foes%20PAPER.pdf [last accessed on 07/11/2018].
[213] *Ibid*,
[214] *Ibid*.

competitive banking sectors are the primary cause of market instability.[215] In these circumstances incumbent banks are considered to be systemically important, leading to moral hazard, perceived guarantees and excessive risk taking".[216] If one examines the current banking sector in Ireland then it is clear that the two remaining pillar banks, Allied Irish Banks and Bank of Ireland, remain systemically important. In effect a presumption of State support in a future crisis applies to these financial institutions. Yet prior to the financial crisis where a Member State's banking sector was subject to more competition such as the United Kingdom, this did not prevent such jurisdictions from experiencing a financial crisis. In the Irish banking sector, competition within the mortgage lending sector by foreign banks had the effect of triggering imprudent behaviour by incumbent financial institutions. In effect the above examples illustrate that whether competition is or is not conducive to banking sector stability is not a clear cur answer for regulators and policymakers to answer. These nuances will have to be addressed under a new State Aid Crisis Framework when the Commission seeks to apply either behavioural or structural measures to a long-term viable financial institution. However, the macro question of stability is not the only nuance that will need to be addressed. How competition impacts on the consumer will also be another strand that will need to be unknotted by the Commission and Member States. This will now be examined below.

6.5.4. Competition in the Banking Sector and impact on the Consumer

In different markets and industries competition can reduce prices for the final end user be they a commercial, industrial or personal customer. However, in the banking sector as noted above, competition may not necessarily be conducive to wider market stability or beneficial for consumer interests. Under Minsky's second theorem of the financial instability hypothesis, instability arises after a period of prolonged prosperity when financial relationships that once engendered a stable economy start to become

[215] *Competition Issues in the Financial Sector Key Findings*, Competition Committee Organisation of Economic Co-operation and Development, 2011 at p. 42 available at http://www.oecd.org/regreform/sectors/47836843.pdf [last accessed on 07/11/2018].
[216] *Ibid*.

relationships that trigger instability.[217] For instance, in a competitive marketplace banks may not engage in prudent lending to their customer base but instead lower lending standards to increase market share and counter the market growth of a rival. This also follows Stücke's suggestion that in some cases "[r]ather than compete to build consumers' trust in their business, firms instead compete in devising better or new ways to exploit consumers".[218] One example Stücke refers to is the credit card industry where companies may abuse consumer trust in order to increase profits.[219] Therefore in certain cases increased competition among firms may result in firms having a "greater incentive to engage in unethical behaviour that improves their costs (relative to competitors)".[220] This example illustrates how in the context of banking, competition may not necessarily be a positive for consumers. The incentive to increase sales or increase lending on financial institutions via the actions of rivals, including a possible guru institution as discussed above, may result in adverse consequences for the consumer. Although examined under the prism of financial stability, one could also posit that the entry of Icelandic banks in the UK deposit market did not necessarily engender long-term positives for consumers availing of higher interest rates. Had it not been for the intervention of the UK authorities in protecting these deposits, then British banking consumers would have experienced losses related to competition in a Member State's banking sector.

From an Irish perspective, the increase in the number of financial institutions operating within the domestic banking sector, did not necessarily align with the interests of consumers. Inappropriate lending was a common feature across the Irish banking sector with both established and new entrants adopting aggressive business models.[221] To resolve the possible adverse

[217] H.P. Minsky, "The Financial Instability Hypothesis" Levy Economics Institute of Bard College", May 1992, at p.8 available at http://www.levyinstitute.org/pubs/wp74.pdf [last accessed on 07/11/2018].
[218] M. E. Stücke, "Is competition always good?" (2013) Vol.1(1) Journal of Anti-trust Enforcement pp.167-197 at p.174 available at http://antitrust.oxfordjournals.org/content/1/1/162.full.pdf+html[last accessed on 07/11/2018].
[219] *Ibid*.
[220] *Ibid* at p.183.
[221] N.98.
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effects competition within a Member State's banking sector may trigger for consumers, a new State Aid Crisis Framework will have to include specific measures to address such possible effects. This is particularly the case for when applying competition distortion safeguards to long-term viable financial institutions as these banks will continue to operate in this sector whereas a systemically important but insolvent financial institution will be gradually wound down as per the proposals in Chapter 5.

6.5.5. Competition and Market Concentration and Too-Big-To-Fail

Another facet of competition in the banking sector of any Member State is the effect competition may have on individual market operators. As noted above the Commission usually seeks some form of structural or behavioural controls imposed on a State aid recipient in exchange for authorisation of this support. However, such controls may not necessarily resolve the competition constraints or challenges facing individual market participants or the sector as a whole. For instance, in the case of Irish banks, both Allied Irish Banks and Bank of Ireland have an-inbuilt dominance within the Irish market that few if any competition safeguards can resolve. This dominance in turn raises further problems when these financial institutions require State support. In other economic sectors market operators may have to become more efficient and engage in research and development in order to counter the developments of rivals. But in the banking sector the same competitive pressures do not necessarily arise. For example, in the retail sector consumers may still be loyal to one particular bank simply out of habit or due to convenience. A 2008 report from the Office of Fair Trading examining the British market for personal current account found that 47 per cent of consumers did not consider switching from their account provider.[222] The Cruickshank Report also found that in most cases a consumer would purchase a product from their current

[222] "Personal current account in the UK", an OFT market study, Office of Fair Trading, 2008, at p. 20
available at
http://webarchive.nationalarchives.gov.uk/20140402172142/http://oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf [last accessed on 09/102/107].

bank rather than considering other providers, resulting in a "trade-off between convenience and value for money".[223]

Market infrastructure is yet another example of where normal competitive safeguards do not apply in a banking context. If a financial institution has built up a traditional banking network in a particular region or jurisdiction, then it may be hard for new entrants to compete due to this "trade-off between convenience and value for money" as referred to above. Further, a pre-existing market operator may have certain payment processes or information systems that new a market entrant may need to gain access to. For instance, one of the key barriers of entry for the UK retail banking market found by the UK Office of Fair Trading was the access to IT information systems for new entrants.[224] Another problem for any new entrant in the UK banking sector highlighted by the OFT was the limited capacity for these parties to attract customers and thus in time achieve market scale.[225] For the OFT, the scale that a new financial institution should seek to achieve is one which allows it to "recover costs, many of which are sunk".[226]

Similar studies conducted by other bodies within EU Member States have also found market barriers. In one study undertaken by the Dutch Consumer and Markets Authority, potential new entrants to the Dutch retail banking market placed particular emphasis on the "initial investments" for both IT systems and "marketing costs" as substantial barriers for establishing a presence in the personal accounts business line.[227] Although the Consumer and Markets Authority concludes, that while profit margins are low in this particular strand of banking sector, current accounts do have "an important

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[223] *Ibid*: D. Cruickshank, "Competition in the UK Banking Sector, A report to the Chancellor of the Exchequer", March 2000, at para.4.64 available at https://www.vocalink.com/media/1603/cruickshank_report_2000.pdf [last accessed on 07/11/2018].
[224] *Review of Barriers to entry, expansion and exit retail banking*, Office of Fair Trading November 2010 at p.8 available at http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282 [last accessed on 07/11/2018].
[225] *Ibid* at pp.9-10.
[226] *Ibid* at p.11.
[227] *Barriers to entry in the Dutch retail banking sector*, The Netherlands Authority for Consumers and Markets, June 2014, at p.92 available at https://www.acm.nl/en/publications/publication/13257/Barriers-to-entry-into-the-Dutch-retail-banking-sector/ [last accessed on 07/11/2018].

gateway function" and thus "[l]owering the barriers to entry is therefore also important in this market, in part to encourage the competition in other banking markets".[228]

A report by the Irish Competition Authority examining competition in the Irish banking sector, found that there was a marked concentration within the Irish personal accounts market segment.[229] As of 2005 both Allied Irish Banks and Bank of Ireland shared a 70% market share in the personal accounts market within Ireland, thus as the report notes from a competition perspective it becomes even more important for consumers to have the capacity to switch account providers.[230] Although, the Report proposes a number of recommendations to better facilitate consumers switching accounts, such as "increasing the ease and speed" of the switching process, the underlying barrier to competition, namely the dominant position of two banks in this sector is not addressed.[231] However, any wider competitive benefits for consumers arising from improving the switching process will ultimately remain limited where the actual market options are few in number. Unfortunately, the post-crisis banking environment within Ireland remains subject to similar concentration levels as those found by the Competition Authority in 2005 within the personal accounts business line across the sector more generally. A recent report from 2017 has also sought to promote the switching of mortgage providers among consumers and ensuring that this option is not subject to any barriers.[232] In fact since the financial crisis the Irish banking sector has seen the market exit of a number of foreign financial institutions such as Danske Bank and RaboDirect resulting in a further market concentration for Allied Irish Banks and Bank of Ireland.[233] This

[228] *Ibid*.
[229] *Competition in the (non-investment)banking sector in Ireland*, The Competition Authority September 2005 available at http://www.ccpc.ie/sites/default/files/documents/banking%20report.pdf[last accessed on 07/11/2018].
[230] *Ibid* at p.9.
[231] *Ibid*.
[232] *Options for Ireland's Mortgage Market*, Competition and Consumer Protection Commission, 15th June 2017 at p.94 available at https://www.ccpc.ie/business/wp-content/uploads/sites/3/2017/06/CCPC-Mortgages-Options-Paper.pdf [last accessed on 07/11/2018].
[233] M. Paul "RaboDirect to quit Irish market in May" Irish Times February 21st 2018 available at https://www.irishtimes.com/business/financial-services/rabodirect-to-quit-irish-

concentration has resulted in Irish consumers having to pay one of the highest interest rates in the EU according to Central Bank of Ireland figures.[234]

In most cases, the competition safeguards applied as part of the State aid authorisation process were not necessarily specific to resolving the dominant positon a financial institution may have held in a Member State. A similar failing also arises in respect of the Commission's merger control policy during the crisis. For example, even though the OFT in the UK concluded that the merger of HBOS with Lloyds Banking Group would result in a "substantial lessening of competition" within both the UK wide market for personal accounts and the Scottish small and medium sized enterprise lending market, such a merger was waived through on public interest grounds.[235] Despite the issues raised by the OFT, the then UK Sectary for Trade and Industry utilised a legislative exception under the *Enterprise Act 2002* to waive through the merger on public interest grounds.[236] Stephan suggests that one of the primary benefits of exercising this provision under the *Enterprise Act* was to avoid the merger possibly falling under the scope of the Commission's merger control review.[237] Although the newly established Lloyds Banking Group had to divest of certain divisions and business lines in order to avail of State support from the UK, the adverse effect such a merger may have had on both market rivals and consumers was deemed less important than stability.

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market-in-may-1.3400140 [last accessed on 07/11/2018]; "Danske Bank Ireland to exit retail operations here", RTE news, Thursday 31st October 2013 18:22 available athttps://www.rte.ie/news/business/2013/1031/483722-danske-bank[last accessed on 07/11/2018].

[234] Central Bank of Ireland, Statistical Release, 11th January 2019, at p.1 available at https://www.centralbank.ie/docs/default-source/statistics/data-and-analysis/credit-and-banking-statistics/retail-interest-rates/interest-rate-statistics-november-2018.pdf?sfvrsn=4 [last accessed on 18/02/2019].

[235] *Anticipated acquisition by Lloyds TSB plc. of HBOS plc*., Report to the Secretary State for Business Enterprise and Regulatory Reform, 24th October 2008 ,Office of Fair Trading at p.5 available at https://assets.publishing.service.gov.uk/media/5592bba440f0b6156400000c/LLloydstsb.pdf_jsessionid_4EBCDA0A4B36535AF8355B90D18E00A2.pdf [last accessed on 07/11/2018].

[236] *Enterprise Act 2002* at s.45 available at https://www.legislation.gov.uk/ukpga/2002/40/section/45 [last accessed on 07/11/2018].

[237] A. Stephan, "Did Lloyds/HBOS mark the failure of an enduring economics-based system for merger regulation?" Vol.62(4) NILQ pp.539-552 at p.543-544.

Similarly, when imposing structural conditions on a recipient financial institution, the Commission adopts a policy whereby the wider effect on consumers and the market in general are not examined or addressed. Therefore, in certain cases a recipient financial institution, such as Allied Irish Banks in Ireland may have to dispose of profitable subsidiaries as a *quid pro quo* measure for competition distortion concerns.[238] Yet the effect of these divestments may be to further consolidate the position of financial institutions that already have a substantial share of the Union wide banking market. This in turn may not only further undermine the growth and viability of competing financial institutions but also increases the possibility of the acquiring financial institutions becoming "too-big-to-fail". Ratnovski notes how the "ability of modern banks to easily increase scale leads to a more acute TBTF problem".[239] The same author also comments how "[c]ompetition policy tools might need to be used to restrict the size of large banks".[240] However, the Commission's application of competition distortion controls actually provides an example of how competition policy may inadvertently accentuate the too-"big-to-fail problem".

6.6.1. Compensatory Measures: a new approach

If one examines the competition distortion safeguards imposed by the Commission during the financial crisis on both insolvent and long-term viable financial institutions, it becomes clear that the multi-facetted nature of competition within the banking sector is not adequately addressed. Instead, the Commission has adopted a policy whereby the compensatory measures applied to banks correspond with those applicable to other economic sectors. Yet this approach fails to sufficiently resolve the possible stability, consumer protection and wider market problems that may arise within a banking market. While compensatory measures will in most cases have an effect on the

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[238] Commission Decision State aid N553/2010 of 21/12/2014 *Second emergency recapitalisation in favour of Allied Irish Banks plc*. OJ C(2010) 9475 at para.16 available at http://ec.europa.eu/competition/state_aid/cases/238609/238609_1189205_61_2.pdf [last accessed on 07/11/2018]

[239] L. Ratnovski, "Competition Policy for Modern Banks", (2013) IMF Working Paper at p. 9 available at https://www.imf.org/external/pubs/ft/wp/2013/wp13126.pdf [last accessed on 07/11/2018].

[240] *Ibid*.

recipient's market, as both the recipient may lose market share and a rival may gain it via a divestment policy, in most markets the wider economic effects remain limited. The wider effect on the public in general may remain imperceptible in cases where the recipient in question remains active in a specialised market with limited if any direct contact with consumers.

In contrast, any market developments in the banking sector are likely to have considerable impacts on both consumers and the public interest more generally. Therefore, any competition distortion measures should reflect these related factors in times of systemic crisis. As Kokkoris comments there are negative consequences when imposing competition distortion safeguards on a State aid recipient such as a restriction on lending to the real economy. Furthermore, the "imposition of significant divestments may lead to systemic effects and distortions of competition".[241]

6.6.2 Stability Concerns and Too-Big-to Fail

Any structural constraints imposed on a State aid recipient, be it the closure of certain business lines or the divestment of business units or subsidiaries should be tailored to reflect longer-term market considerations. The recently enacted Bank Resolution and Recovery Directive sets out possible impediments to bank resolvability.[242] Therefore this provides a benchmark to some degree for possible compensatory measures that should apply to recipient financial institutions. In effect any business unit or subsidiary disposed of should be done so in order to reduce the market presence of the recipient not only as a form of penalty but as a measure to counter future possible market instability. Yet even aligning competition distortion measures with bank resolution objectives still raises other complexities. If a bank's retail network branch constitutes an impediment to bank resolution but also remains the recipient's primary business line, then a compromise

[241] I. Kokkoris, "The special nature of banks and its challenges for competition policy", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.3 at p.15.
[242] Directive (2014/59/EU) of 15/05/2014, of the European Parliament and of the Council, establishing a framework for the recovery and resolution of credit institutions and investments firms, [2014] OJ L173/190 at Art.17 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN[last accessed on 07/11/2018].

position may have to be adopted. This may entail the recipient selling certain regional networks to a new market entrant. On the one hand this compromise may result in undermining the financial viability of the recipient financial institution in question. On the other, such a divestment policy should reduce the threat of "too-big-to-fail" as the market of the recipient bank will become more fragmented as other banking options become available. This in turn should also improve the position of consumers as more options should develop for credit provision, personal accounts and residential mortgages.

6.6..3. Market Concentration from a Pan-Union perspective

Although the disposal of part of a financial institution's domestic business may reduce the threat of "too-big-to-fail" within the relevant Member State. The same concerns remain from a pan-EU perspective if conversely a recipient bank has to dispose of its foreign business lines. Thus a financial institution with an already considerable pan-Union presence may further expand their market share and so pose a Union-wide systemic threat in a future crisis. Although EU merger controls should ensure that market concentrations are prevented, as seen from the Lloyds-HBOS merger such controls may be easily circumvented. To ensure that any new crisis framework adequately addresses future "too-big-to-fail" concerns at a pan-Union level, restrictions should be placed on the purchaser of a recipient financial institution's divested business. The application of these restrictions should also be supervised by the Commission rather than at a domestic level. This ensures the Commission remains the central authority when determining whether or not these competition safeguards will be adhered which is currently a role performed by the Commission in the competition field. Furthermore, placing this responsibility with the Commission aligns with the proposal for placing oversight of the proposed future crisis framework with this supranational body as set out in Chapter 8.

Such restrictions may entail the purchasing financial institution having to in turn divest of certain business lines and units within their own primary market or agreeing to further dispose of specific sections of the newly acquired business unit. Alternatively, they may encompass certain behavioural safeguards such as the acquiring financial institution refraining from below-cost selling or price leadership in designated business lines or products. The scope of these restrictions will ultimately depend on the balance sheet size of the acquiring financial institution. Thereby the larger the financial institution the more considerable the applicable restrictions should be.

6.6 4. Compensatory Measures and Consumer Interests

A final consideration that any compensatory measures should address under a future State Aid Crisis Framework is the possible impact on consumers these measures may cause. The decline in market share of one market actor and the entry of a new undertaking may not have any tangible effects on the relevant consumer market segment. However, there may be certain circumstances where divestment may negatively affect the consumer in question. This may arise due to the specialised nature of the service or products provided by the relevant business line that may require wider institutional support that a new market entrant may not be able to provide. Similarly, there may be cases where the possible divestment from one financial institution simple concentrates the market shares of a rival domestic bank and so poses a long-term risk to banking competition within the Member State in question. In these particular circumstances an exception to divestment should be considered if consumer interests are best served by the future banking market remaining the same as the market environment *ex-ante* the crisis.

Consumer welfare is a key aspect of anti-trust enforcement and merger control in both the US and the EU. Pera and Auricchio note how Posner's position on anti-trust enforcement was that if a firm's acts benefitted the consumer then no violation had occurred.[243] US anti-trust enforcement has evolved primarily on the basis of this principle, so that if a monopolists' behaviour is in line with "normal market practice" then no anti-trust issues arise.[244] In contrast, under the EU approach specific prohibitions were

[243] A. Pera and V. Auricchio, "Consumer Welfare, Standard of Proof and the Objectives of Competition Policy", (2005) Vol.1(1) ECJ pp.153-177 at p.155-156.
[244] *Ibid* at p.158.

established to ensure that smaller competitors could continue to compete.[245] Daskalova comments how for the EU authorities "[h]arm to producers or sellers, is also considered important for the purposes of EU competition law, regardless of the final effect on consumers".[246] Thus one could argue that this proposed safeguard constitutes an exemption to divestment in line with Posner's position of anti-trust enforcement. However, if this exemption is applied there may still be a need for imposing behavioural constraints on the recipient financial institution so that longer-term new market entrants are able to enter the market place. A reverse price leadership measure could also be imposed whereby the recipient financial institution is barred from increasing their charges or fees without financial grounds for doing so. In this way the consumers in question should then be protected from possible price gouging on the part of the recipient.

Conclusion

The central research question of this Chapter was to determine how best the Commission and Member States can utilise a State aid solution in respect of long-term viable banks. During the 2008 financial crisis the boundary between insolvency and long-term viability was not always easily determined due to wider economic and market factors pertaining at the time. Therefore, any future State Aid Crisis Framework must first, after applying the systemic importance test as set out in Chapter 5 determine whether a financial institution meets the criteria for a long-term viable financial institution. The first part of this Chapter thus sought to develop a specific State aid test for a financial institution's long-term viability. This test seeks to root the question of long-term viability on a counterfactual analysis of whether in the absence of wider market instability the financial institution in question would still have entered financial difficulty. Such an analysis in isolation however will not suffice to encompass the nuances of the financial sector. Therefore, two additional strands are also proposed to complement this counter-factual

[245] *Ibid* at p.160.
[246] V. Daskalova, "Consumer Welfare in EU Competition Law: What Is It (Not) About?", (2015) Vol.11(1) CompLRev pp.133-162 at p.158 available at http://clasf.org/browse-the-complrev/ [last accessed on 07/11/2018].

analysis. First if in certain cases, the financial institution in question is in a position of "dominant failure" and so would still require State support in the absence of the proposed external factors then this financial institution falls outside of the long-term viability criterion. Second, if the financial institution under consideration has a history of State aid intervention this may not fall foul of the long-term viability test provided the financial institution in question has a diversified business line and the reasons for the past State aid intervention have been addressed.

The next step in formulating any new State aid framework for long-term viable banks includes setting a threshold for the level of aid such financial institutions are able to receive from Member States. The role of the State varies from that of regulator to consumer, and so with this in mind the level of support provided to long-term viable banks should reflect the incentives of a rational State actor. If one is able to formulate the actions of a rational State actor, then this in turn should meet the new "minimum necessary" criterion. Furthermore, in light of the different roles of the State and the different social roles it performs, recipient financial institutions should be liable for an opportunity cost penalty when repaying the recapitalisation funds. This fee may be waived though if the benefits of recapitalising the bank or banks in question outweigh the negative costs for the State.

A future State Aid Crisis Framework will also have to address the possible competition distortion safeguards that might arise when providing support to long-term viable financial institutions. However, competition within the banking sector is not a binary issue but instead encompasses a number of different factors which any future safeguards should also address. Therefore, proportionality measures should first seek to remove any barriers to resolving any future "too-big-to-fail" financial institutions. This may require a recipient financial institution dividing up its domestic business structure and selling this to a new market entrant. In this way the recipient financial institution should in theory no longer pose a "too-big-to-fail" threat to the Member State in question. From a pan-EU perspective, where a financial institution seeks to purchase a recipient firm's foreign business this purchase should come with restrictions in cases where the former already has a large market share within the European market banking sector. Finally, in some cases the interests of consumers may be adversely affected by a recipient financial institution having to dispose of their domestic business lines. In these circumstances, divestment as proposed above may be set aside on these grounds, although the recipient financial institution will remain subject to behavioural safeguards.

This Chapter has sought to address the question of what constitutes a long-term viable financial institution as part of a future crisis framework. In this way Member States and the Commission will be able to apply a two stranded test to first determine whether or not a financial institution is systemically important as set out in the previous Chapter and then determine if this financial institution has a long-term viable future. If the proposed test set out in this Chapter is not met, then the suggested market exit steps and minimum operational aid in the previous Chapter should be applied by the Member State in question so that this systemically important but non-long-term viable bank can be wound down in a controlled manner. The last two Chapters have thus been focused on how a future crisis framework will apply to individual financial institutions. However, the next Chapter will address the second market wide response undertaken by Member States after guarantee schemes, namely asset relief measures.

Chapter Seven: Asset Relief Schemes and State aid: a critical evaluation of the Commission application of the Impaired Assets Communication and possible future developments

Introduction

The purpose of this Chapter is to examine the application of the Impaired Assets Communication by the Commission and Member States. As part of the Commission's response to the financial crisis a specific Communication setting out the parameters of State aid for asset relief schemes was issued. When the financial crisis struck, Member States were considering different tools and responses for engendering financial stability. One possible option was the establishment of "bad-banks" or other forms of asset relief schemes so as to transfer non-performing bank assets from financial institutions and place these with a specialised undertaking. Another possible option considered by Member States was the use of "risk-shields" whereby a Member State would meet the losses arising from non-performing losses up to a certain level with the participant financial institution covering the remaining loss. As these measures would require recourse to State aid, the Commission's Impaired Assets Communication established a number of criteria for these interventions to fall within the scope of Article 107(3)(b)TFEU.

When applying this Communication, the Commission has had to balance a number of competing and at times conflicting objectives. These range from ensuring financial institutions subject to an asset relief scheme are in a position to return to viability to also ensuring that these same financial institutions do not become focal points of moral hazard abuse. The central research question throughout this Chapter is whether the Impaired Assets Communication and its application suggest the need for a new asset relief scheme Communication as part of a wider future State Aid Crisis Framework. To achieve this objective, the Chapter starts with an overview of the Irish application of the Impaired Assets Communication in the form of the National Asset Management Agency. Following on from this there is then an examination of past bad-bank schemes from previous financial crisis, with particular focus on the Nordic crises of the early 1990s. While this Communication was specifically aimed at establishing State aid parameters for asset relief schemes during the 2008 financial crisis, there were past examples of bad-bank schemes under the Rescue and Restructuring Guidelines. These past cases are examined to provide a wider context to the subsequent asset relief schemes introduced by Member States during the 2008 crisis.

The Commission's decisional practice under the Impaired Assets Communication is then critically evaluated to set the ground for possible new proposals that may be required in a new Impaired Assets Communication. In particular, there is critical assessment of the long-term economic value criterion applied under the existing Communication and whether this benchmark should be altered to reflect better the impact asset relief may have on both individual financial institutions and the wider banking sector. The possible competition distortion that may arise from an asset relief scheme is also examined and new safeguards proposed as part of a future State Aid Crisis Framework.

7.1.1. National Asset Management Agency: Ireland's bad bank, a background

Before one can delve into the Commission's application of the Impaired Assets Communication to the Irish National Asset Management Agency one must first examine the background to this bad bank and why the Irish State chose this particular resolution response. As noted in Chapter 1, the Irish banking crisis mainly revolved around non-performing loans in the property development and construction sectors. For Irish policymakers the key question was how best to preserve the unaffected business lines and units of Irish banks by addressing these problem loans. Policymakers began to focus on past financial crises, in particular how the Nordic countries removed non-performing loans from their financial institutions. These loans were then placed in specialised asset management companies. Therefore, in past financial crises, as will be further discussed below, the establishment of bad banks was considered a viable crisis management solution.

To assess this possible solution in detail a report was commissioned by the Department of Finance so that the nuances of this possible "bad-bank" option could be teased out.[1] Alternative responses were also considered such as an asset guarantee scheme whereby the non-performing loans would remain on the banks' balance sheets but certain losses would be met by the Irish State.[2] The benefits of this latter approach for the Irish State included the fact that there would be no immediate adverse impact on the Irish Exchequer.[3] While the relevant banks would retain exposure to any subsequent losses and there would be no immediate effect on the banks' equity capital.[4] Though it must be pointed out that continuing losses in the Irish banking sector from 2009 to 2010 may very well have triggered in any case such asset guarantee scheme. In contrast, under a proposed asset sale, the Irish State would purchase bank assets at a significant initial outlay and be liable for any subsequent loss in value that may arise.[5] Although the Irish State would via its asset management company purchase these assets at a discount, a loss could still occur if the relevant property market for these loans entered a prolonged period of price depression.[6] The Irish State would also be liable to recapitalise the Irish banks to meet any capital shortfall arising after this asset transfer from their balance sheets.[7] Despite these adverse outcomes the Bacon report concluded that due to the "characteristic features of the Irish situation it appears that the Asset Management approach has the potential to offer greater assistance to achieving resolution and transparency."[8]

The report also set out the best process for establishing an asset management company and what powers this body would require to acquire transfer the assets and manage their eventual disposal.[9] Most of these recommendations

[1] P. Bacon, Evaluation of the Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions, Proposal for a National Asset Management Agency (NAMA) and Associated Required Policy Initiatives, 20th March 2009.
[2] *Ibid* at p.24.
[3] *Ibid*.
[4] *Ibid*.
[5] *Ibid* at p.25.
[6] *Ibid*.
[7] *Ibid*.
[8] *Ibid* at p.28.
[9] *Ibid* at pp.31-32.

were incorporated in the *National Asset Management Agency Act 2009*, the legislation used to establish the Irish asset management company.[10] Hence the 2009 Act includes provisions for designating the relevant assets for transfer and the effect of this transfer on these bank assets and the banks holding these assets.[11] This Act also allows for NAMA to appoint receivers to bank assets, compulsorily purchase land and undertake certain functions in respect of the development of land.[12] The ECB found that the provisions of the 2009 Act were sufficient to ensure that participation in the scheme remained voluntary and that the asset class in question could be expanded if so required.[13] But the ECB also raised concerns over the propose valuation process, as banks could be over-compensated, and whether there would be sufficient incentives in place to ensure that any over-compensation could be recovered at a later date.[14] An issue that will be returned to later and provides the central State aid strand when it comes to assessing asset relief schemes not just in respect of NAMA but also how other Member States operated their own asset relief schemes.

On a similar vein, Noussia comments how "bad-banks" have a number of "challenges" to address ranging from ensuring that the assets in question are removed in a transparent manner, minimising the costs for the taxpayer, while also curtailing against any future "opportunistic behaviour" on the part of the participating banks.[15] It remains difficult to determine whether NAMA has actually overcome these obstacles. The transparency of the asset removal process remains difficult to determine when there is a price–uplift applied to bank assets designated for transfer.[16] For example, a participating financial institution may have failed to undertake loan due diligence on a non-

[10] *National Assets Management Agency Act 2009* available at http://www.irishstatutebook.ie/eli/2009/act/34/enacted/en/html [last accessed on 07/11/2018].
[11] *Ibid* at ss.69-71 and ss.99-111.
[12] *Ibid* at s.147 and ss.157-170.
[13] *Opinion of the European Central Bank of the 31st of August 2009 on the establishment of the National Assets Management Agency* (CON/2009/68), available at https://www.ecb.europa.eu/ecb/legal/pdf/opinion_con_2009_68_f_sign.pdf [last accessed on 07/11/2018].
[14] *Ibid* at p.7.
[15] K. Noussia, "The "good-bank-bad-bank" concept: a model solution", (2010) Vol.25(8) J.I.B.L.R. pp.401-411 at p. 402.
[16] F. Connolly, "NAMA-LAND", (Dublin: Gill Books, 2017) at p.44.

performing asset yet still apply a valuation in line with the uplifted benchmark. This in turn makes it difficult to determine whether or not the taxpayer's exposure to the "bad-bank" process has actually "minimised" the costs to the taxpayer. On a related note, although outside the scope of this Chapter, there have been a number of concerns that the NAMA process has been subverted by third parties for their own benefit at costs to the Irish State.[17] In some cases employees within NAMA have allegedly utilised confidential information within the agency for their own and others benefit or have subsequently left the agency to pursue employment with property investment firms despite an obvious conflict of interest.[18]

Ingves et al. also examine the advantages and disadvantages of a centralised asset management process like that of NAMA.[19] While the advantages include centralising the bank sector restructuring process within one State agency and setting a uniform price for the assets designated for transfer.[20] There are also a number of potential disadvantages with a centralised asset management company from a crisis resolution perspective, including the possible exercise of political pressure on the work of the company, the possible drop in asset prices once removed from the banks in question, while agreeing a transfer price with private banks may be difficult.[21] Therefore, there were not just State aid related complications and concerns that applied to the Irish asset relief scheme.

Although these potential pitfalls are addressed under the 2009 Act, in practice some of these issues remain difficult to guard against in practice.[22] Similarly, there are a number of State aid issues that the 2009 Act fails to address in detail. For example, in respect of asset price, ultimately the long-term value

[17] H. McGee, "Garda corruption inquiry started into NAMA allegations", Irish Times, (July 16th 2015) available at http://www.irishtimes.com/business/garda-corruption-inquiry-started-into-nama-allegations-1.2286387?mode=sample&auth-failed=1&pw-origin=http%3A%2F%2Fwww.irishtimes.com%2Fbusiness%2Fgarda-corruption-inquiry-started-into-nama-allegations-1.2286387 [last accessed on 07/11/2018].
[18] N.16.
[19] S. Ingves, S.A. Seelig and D. He, "Issues in the Establishment of Asset Management Companies", (2004) IMF Policy Discussion Paper 04/3, at p.9 available at https://www.imf.org/external/pubs/ft/pdp/2004/pdp03.pdf [last accessed on 07/11/2018].
[20] *Ibid*.
[21] *Ibid*.
[22] N.10 at s.16(1) –(2) and ss.119-127.

calculation depends on a number of factors that may fail to encompass moral hazard considerations or the efficient use of State resources. This question in turn affects how one may view the effectiveness or not of the NAMA process as a bank restructuring tool. How other jurisdictions exercised this "bad-bank" solution may provide a benchmark for assessing the Irish authorities own tailored solution which gave rise to NAMA.

7.1.2. Past Asset Relief Scheme and Financial Crises

As noted above, establishing a bad-bank to hold the non-performing loans of banks became a central tenet of financial crisis management in a number of different jurisdictions. Holding non-performing loans and managing the incremental sale of these loans over an extended period allows policymakers to not only control the gradual sale of these assets it also ensures that banks are then unburdened by non-performing loans. In a number of cases governments have established a bad-bank scheme as one of the central planks of their crisis response. These different schemes will now be set out below starting with the different Nordic bad-bank schemes and then an overview of the Japanese and United States responses. By examining these past examples one can see how State aid remains a key factor on how these schemes operated. Furthermore, certain differences become evident between the wider economic environment that was present during these past examples and the one that existed when NAMA was established along with other asset relief schemes post the 2008 financial crisis.

7.1.2.1. Swedish response

In Sweden banks such as Nordbanken and Gota Bank had considerable exposure to the Swedish property sector during the 1980s. By 1985 Nordbanken had total loans valued at SEK84.2billion while Gota Bank had some SEK29 billion in outstanding loans.[23] The sharp downturn in Swedish property prices and a currency crisis meant that both banks required State

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[23] P. Englund, "The Swedish Banking Crisis: Roots and Consequences", (1999) Vol.15(3) Oxford Review of Economic Policy pp.80-97 at p.91 *op cite* Wallander 1994 available at http://www.contrahour.com/contrahour/files/theswedishbankingcrisisrootsandconsequences.pdf [last accessed on 07/11/2018].

guarantees for not just deposits but other liabilities as well as bank bonds.[24] Further intervention was required in the form of a bad-bank scheme, where two new bad-banks, Securum and Retriva, held the bad-debts of Nordbanken and Gota Bank respectively.[25]

A total of SEK67 billion of bank loans were transferred to Securum from Nordbanken, constituting 4.4 per cent of the latter's total banking assets. Of this portfolio 87 per cent were related to real estate lending. According to Schafer and Zimmerman, this figure could be further broken down into "[s]ome 3,000 non-performing loans that had been extended to 1,274 troubled companies".[26] The same commentators note that Retriva received "over 45% of Gota Bank's assets shortly after the bank was nationalized".[27] While there are certain similarities with the approach taken by the Swedish authorities and those pursued by their Irish counterparts, there are key differences. For example, the Swedish bad-bank scheme included two bad-banks rather than one central asset management company. Further, both Swedish bad-banks were not just resolving property related loans but also other corporate and business loans. In contrast, the Irish scheme is primarily focused on property based loans. Another key difference between the Irish and Swedish asset relief schemes relates to the wider financial climate at the time of both these responses. In the case of Ireland, the global financial sector was also entering a period of instability. However, during the Swedish crisis, the wider European economy was stable and so external investors were more likely to either invest in the assets held by the Swedish bad banks or to provide capital to Swedish banks. An advantage neither NAMA or Irish financial institutions had during the earlier phases of the asset relief scheme. This meant that the

[24] L. Jonung, "The Swedish Model for resolving the banking crises 1991-1993: Seven reasons why it was successful", Economic and Financial Affairs, Economic Papers 360, February 2009, at p.12 available at http://ec.europa.eu/economy_finance/publications/pages/publication14098_en.pdf [last accessed on 07/11/2018].

[25] D. Klingebiel, "The Use of Asset Management Companies in the Resolution of Banking Crises Cross- Country Experiences", at p.19 available at https://notendur.hi.is/ajonsson/kennsla_2016/The-use-asset-managment-companies.pdf [last accessed on 09/11/2017].

[26] D. Schafer and K. F. Zimmerman, "Bad Bank(s) and Recapitalisations of the Banking Sector", IZA Policy Paper No.10 June 2009 at p.7 available at http://ftp.iza.org/pp10.pdf [last accessed on 07/11/2018].

[27] *Ibid* at p.8.

Irish State then had to not only fund the asset relief scheme itself but also provide the resulting recapitalisation needs post the transfer of these assets to NAMA.

7.1.2.2. Asset relief schemes in Finland and Norway

Sweden was not the only Nordic country to experience a financial crisis during the 1990s. Finnish banks also required State support via a bad-bank scheme due to their exposure to non-performing property related loans. The Finnish authorities established a single bad-bank, Arsenal, where 34% of the loans transferred were related to real estate while the remainder were across other industries. Unlike either NAMA or the Swedish bad banks, the loans transferred to Arsenal were not subject to a value threshold. The ownership structure of Arsenal also differed from that of both Securum and Retriva in that the Government Guarantee Fund was the ultimate parent company of the bad-bank.[28] Thus, to some degree the Finnish approach married a novel solution with the pre-existing bank intervention architecture.

In contrast, policymakers in Norway decided against establishing a bad-bank scheme as the capitalisation costs involved were considered excessive.[29] There was also considered to be a lack of legal and accountancy expertise required to facilitate the transfer of non-performing loans from financial institutions to an asset management company.[30] Despite the three largest Norwegian banks, DnB, DNK and Fokus, exposure to substantial loan losses, recapitalisation without the transfer of bad loans was the preferred option taken.[31] Therefore the Norwegian authorities adopted a position where resolving these problem loans internally was considered a better and more cost-efficient response than the establishment of a bad bank. Irish

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[28] S. Honkapohja, "The 1990s financial crisis in Nordic countries", Bank of Finland Research Discussion Paper 5, 2009, at p.21 available at http://www.riksbank.se/Upload/Dokument_riksbank/Kat_foa/2009/6_8nov/Honkapohja.pdf [last accessed on 07/11/2018].

[29] *Bank Failures in Mature Economies*, Basel Committee on Banking Supervision, Working Paper No.13, April 2004 at p.24 available at http://www.bis.org/publ/bcbs_wp13.pdf [last accessed on 07/11/2018].

[30] *Ibid*.

[31] *Ibid*.

policymakers had also examined this option but ultimately decided to adopt the asset relief scheme option instead. One could submit that the Norwegian authorities avoided the problem of double-recapitalisation whereas the Irish authorities embraced the need for double-recapitalisation almost by default.

7.1.2.3. Bad-banks in non-European Jurisdictions: Japan

Outside of the European dimension of past asset relief schemes, there were other examples of policymakers adopting bad-banks as response to banking crises. Both the Japanese and United States authorities had to tackle non-performing loans in their banking sectors. An interesting feature of the Japanese crisis is the diverse nature of the Japanese banking sector. For instance, Jusen banks are mainly involved in the provision of credit to the real estate sector, while, a specialised group of co-operative banks are also active to provide financial support to farmers. In many ways a segmented banking sector remains more susceptible to a bad-bank solution as the non-performing loans in each specific sector can be consolidated into one institution and managed more efficiently rather than resolved by each specialised lender individually. For example, in the Savings and Loans Crisis in the United States discussed below, non-performing loans were consolidated into specialised resolution vehicles. Therefore, assets can be pooled and resold in bundles rather than assets entering the market place in an uncoordinated manner resulting in possible loss of value.[32] In the Jusen crisis of the mid-1990s the Japanese government established the Home Loan Administration Corporation to hold the bad loans of mortgage lenders.[33] This work-out vehicle purchased loans valued at ¥6,094.4 billion from seven Jusen.[34] In this particular transaction the Japanese State was liable to compensate the bad-bank for any loss over a set threshold.[35] Koo and Sasakai assess this financial link between the Resolution and Collection Corporation and the Japanese

[32] N.1 at p.27.
[33] R. Koo and M. Sasakai, "Japan's disposal of bad loans: success or failure?-A review of Japan's experience of bad debt disposals and its implications for the global financial crisis", Normura Research Institute, Paper No.151, March 1st 2010, at p.9 available at https://www.nri.com/global/opinion/papers/2010/pdf/np2010151.pdf [last accessed on 07/11/2018].
[34] *Ibid* at p.10
[35] *Ibid*.

treasury and found that overall the exposure to the Japanese State came to some ¥1,159.billion.[36] In this case, the Japanese authorities had managed to place a floor on the losses that Jusen banks were facing. But the crucial difference between the Jusen crisis and the Irish one was the fact that Japan was not subject to any pan-Asian State aid control measures. The question of whether the level of aid provided in this context was "appropriate" or indeed the "minimum necessary" was thus not required.

The Japanese authorities also established another bad-bank specifically designed to address the non-performing corporate loans held by Japanese banks. The Industrial Revitalisation Corporation successfully worked-through these loans and paid a final surplus to the Japanese State of ¥43.28 billion.[37] Nanto sets out a number of lessons from the Japanese banking crisis, albeit few if any directly relate to the Japanese bad-bank strategy, there are some that do touch on how policymakers should respond to non-performing loans.[38] For instance, despite the establishment of different asset relief schemes, the Japanese authorities were reluctant at first to resolve the problems posed by non-performing loans for "zombie firms".[39] Although loans were transferred to bad-banks, actually working-through these distressed assets was not a policy aggressively pursued for fear of wider economic instability.

7.1.2.4. United States Savings and Loans Crisis

During the Savings and Loan Crisis in the United States a specialised resolution company was set-up in conjunction with the Federal Deposit Insurance Corporation in order to address the financial problems facing thrift institutions. Originally thrifts were established to provide real estate mortgages. For example, under the *Garn St-Germain Depository Institutions Act* thrift institutions were no longer statutorily barred from investing in other

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[36] *Ibid* at p.11.
[37] *Ibid* at p.12.
[38] D.K. Nanto, "The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990s", Congressional Research Service, May 2009 at pp.12-14 available at www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA501071 [last accessed on 07/11/2018].
[39] *Ibid* at p.12.

sectors such as corporate and commercial debt.[40] Unfortunately, management within these institutions had little if no experience of how to prudently invest in these new sectors.[41] This management inexperienced combined with fraudulent activities triggered a funding shortfall for US thrift institutions necessitating some form of government intervention.[42]

This intervention took the form of an asset disposal body named the Resolution Trust Corporation where the non-performing property based loans of thrift institutions were transferred to, and gradually disposed of once the market improved. Yet for US lawmakers other concerns also arose so that this central objective of the Resolution Trust Corporation became surmounted with other considerations such as the provision of social housing and market stability in certain "distressed areas".[43] As Davison comments this resulted in the resolution vehicle becoming burdened with a "far more complex decision-making process and hence a more complicated bureaucracy".[44] An assessment of the Resolution Trust Corporation's performance from 1991 found that the resolution body had a "disappointing" record in selling and marketing distressed assets.[45] Difference sales strategies, such as selling assets in bulk, and via auctions, failed to elicit a positive market response although wider economic issues also played a part.[46]

In some cases, the establishment of asset management companies did aid the recovery of a State's banking sector. In Sweden the presence of two asset management companies resulted in a floor price being established for property based assets thereby triggering further market activity.[47] The

[40] W. M. Josel, "The Resolution Trust Corporation: Waste Management and the S and L Crisis", (1991) Vol.59(6) Fordham Law Review pp.339-361 at p.341 available at http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=2931&context=flr [last accessed on 09/12/2016].
[41] *Ibid*.
[42] *Ibid* at p.342.
[43] L. Davison, "Politics and Policy: The Creation of the Resolution Trust Corporation", (2005) Vol.17(2) FDIC Banking Review pp.17-44 available at https://www.fdic.gov/bank/analytical/banking/2005jul/article2.pdf [last accessed on 07/11/2018].
[44] *Ibid* at p.38.
[45] United State General Accounting Office, "Resolution Trust Corporation: Performance to date", February 20th 1991, at p.9 available at http://www.gao.gov/assets/110/103572.pdf [last accessed on 07/11/2018].
[46] *Ibid* at p.24.
[47] N.23.

surpluses generated from both Swedish asset management companies also offset the costs of State intervention.[48] But Klingebiel strikes a more cautious tone when assessing the impact if any of the Finnish bad-bank Arsenal, questioning whether this body had any real effect on corporate restructuring within Finland.[49] Furthermore, "[r]eal lending to the private sector remained strongly negative in real terms in the years after the establishment of Arsenal".[50] In contrast, despite criticism during its lifespan, the same author concludes that the RTC could be described as "successful" as "[o]verall [the] RTC recovered 87 cents to the dollar".[51]

The bad-bank strategy adopted by the Japanese authorities appears to have achieved the objective it was supposed to, namely, to restructure certain segments of the Japanese banking industry. But even then this solution was not an isolated response but part of a wider set of measures such as bank recapitalisation, bank mergers and bank resolution.[52] Fujii and Kawai in particular note that how "recapitalisation and asset purchases can be mutually complementary measures to restore a resilient capital base and banking sector health".[53] Yet one obstacle in the Japanese bad-bank policy was ensuring that banks would transfer their non-performing loans to a national bad bank. As Nakaso comments the transfer of these loans at a deep discount "must have discouraged Japanese bank from disposing of bad loans on a large scale".[54]

Therefore, what the above cases illustrate is the success or not of an asset relief scheme ultimately depends on a number of different factors. It may be that leaving non-performing assets on a bank's balance sheet may remain possible if the downward price pressure for the loans in question lapses after

[48] *Ibid*.
[49] N.25 at p18.
[50] *Ibid*.
[51] *Ibid* at p.15.
[52] M. Fujii and M. Kawai, "Lessons from Japan's Banking Crisis, 1991-2005", ADBI Working Paper Series, Working Paper No.222, June 2010 at p.17 available at https://www.adb.org/sites/default/files/publication/156077/adbi-wp222.pdf [last accessed on 07/11/2018].
[53] *Ibid*.
[54] H. Nakaso, "The financial crisis in Japan during the 1990s: how the Bank of Japan responded and the lessons learnt", Bank of International Settlements Paper No.6, October 2001, at p.21 available at http://www.bis.org/publ/bppdf/bispap06.pdf [last accessed on 09/102/107].

a short period of time. In some cases, a bank may be best placed to work through non-performing loans rather than a newly established asset management company. While in other circumstances the only way long-term recapitalisation plans may be pursued may require as Fujii and Kawai suggest some form of bad-bank scheme.

7.2.1. Rescue and Restructuring Guidelines and Asset Relief Schemes: The pre-crisis environment and a sign of things to come

Prior to the financial crisis as noted in Chapters 3 and 5, Member States had previously intervened via State aid under the Rescue and Restructure Guidelines to support a failing financial institution. For example, the French State provided repeated and substantial State support to Credit Lyonnais. However, the form of these interventions was not just restricted to recapitalisations and guarantee schemes but also the financing of asset relief schemes. A review of how the Rescue and Restructuring Guidelines were applied to asset relief schemes is required to provide a complete picture of how these measures remain an important feature of the bank restructuring process. This also illustrates the importance of ensuring that a future State Aid Crisis Framework has a specific provision for asset relief schemes.

In certain cases, the mechanism used to relieve a recipient financial institution did not directly mirror those introduced by Member States during the 2008 crisis, but there are certain similarities. For example, the restructuring programme for Credit Lyonnais entailed the establishment of a hive-off vehicle where certain non-performing assets of the bank were placed in a new legal entity.[55] The total value of assets transferred to this "hive-off" vehicle amounted to FRF 190 billion.[56] As a result of this intervention the recipient financial institution was able to reduce the level of capital required to offset losses associated with the transferred assets.[57] Furthermore, the actual statutory basis of the entity charged with managing the hive-off vehicle was

[55] Commission Decision (98/490/EC) of 20/05/1998 *concerning aid granted by France to the Credit Lyonnais Group*, [1998] OJ L221/28 available http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998D0490&from=EN [last accessed on 07/11/2018].
[56] *Ibid* at l221/30.
[57] *Ibid*.

such that in effect the French State had provided an unlimited guarantee against these assets.[58] A related factor in this particular restructuring process were the costs associated with the loan provided by the recipient to fund the hive-off entity which the French authorities now sought to reduce in order for Credit Lyonnais to improve its financial position.[59]

When assessing this *de facto* additional aid provided to Credit Lyonnais the Commission did not delve into complex issues of whether this support could be considered an "appropriate" form of intervention or not. The key concern for the Commission was the level of aid associated with this State intervention. According to the Commission in its 1998 decision, the support provided by the French State to Credit Lyonnais was "the largest ever in the history of the Community concerning a single undertaking".[60] Further, the level of financial support from the State remained "disproportionate" to the "modest return" likely to be generated once the restructuring phase concluded.[61] Interestingly, the Commission considered the level of losses generated by the hive-off undertaking to constitute direct aid to Credit Lyonnais.[62] Despite these concerns the aid associated with this particular restructuring process was deemed compatible under the Rescue and Restructuring Guidelines so long as the required competition safeguards were invoked.[63] What this case illustrates though is how complex an asset relief scheme may be when applied to a financial institution such as Credit Lyonnais. In effect Credit Lyonnais was subject to a form of double State aid intervention. First, via the reduction in the capital provisions against the assets transferred to the hive-off vehicle. Second, by the actual losses this vehicle then was potentially exposed to if these assets were to remain non-performing.

[58] *Ibid*.
[59] *Ibid* at L221/70.
[60] *Ibid* at L221/61.
[61] *Ibid*.
[62] *Ibid* at L221/56.
[63] Commission Decision (2005/345/EC) of 18 /02/2004 *on restructuring aid implemented by Germany for Bankgesellschaft Berlin AG*, [2005] OJ L116/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005D0345&from=EN [last accessed on 07/11/2018].

In a similar manner, the Berlin Länder sought to support the restructuring of the regional lender Bankgesellcahft Berlin AG via a risk shield whereby the loans provided by private market participants were in effect State guaranteed.[64] This particular risk shield was designed to facilitate the disposal of the recipient's real estate business unit and as such mirrors the approach later adopted by Member States during the 2008 crisis. Despite the possible competition distortions associated with such a State support raised by a competing undertaking, namely Volksbank, the Commission found that the purpose of this shield was simply to ensure that the "bank does not disappear from the market altogether".[65] Thus the value of aid related to this risk shield was considered to be the "minimum necessary".[66] This response from the Commission harks back to Chapter 5 and the question of what is or is not "minimum necessary" to ensure that a financial institution remains in situ. However, it also highlights how asset relief measures may pose competition distortion threats if these schemes facilitate the continued presence of an imprudent market operator. An issue that will be discussed further below.

These two cases illustrate how past State aid intervention in the banking sector by Member States did encompass some of the same features of asset relief schemes. But in both the case of Credit Lyonnais and Bankgesellschaft the level of support provided remained substantial. Yet wider market considerations appeared to have trumped any competition distortion or moral hazard concerns. The value of asset relief schemes and the potential for any associated competition distortions would thus remain issues to address under the Impaired Assets Communication.

[64] *Ibid* at para.208.
[65] *Ibid* at para.307.
[66] *Ibid*.

7.3.1. Overview of Impaired Assets Communication

To fully assess how the Commission applied State aid rules to asset relief schemes during the financial crisis, one must examine the related provisions of the Impaired Assets Communication. In particular, the question of how this Communication addresses the costs of asset relief schemes. For instance, in the Irish case the transfer of property-related loans to a specialised asset management vehicle would entail a considerable cost for the Irish State and the Irish banking sector. The Impaired Assets Communication includes a series of provisions which address the question of cost.[67] These include the Commission assessing whether the scheme in question is indeed "appropriate" in identifying the problems facing the relevant banking sector.[68] An ancillary strand is that there is full disclosure in respect of the relief scheme.[69] Thus participating financial institutions must disclose the level of impairment effected by this measure and be subject to a long-term viability review.[70]

However, there are a number of flaws with the above disclosure and review conditions. Firstly, "disclosure" remains a vague term in respect of the banking sector. In a number of cases the nature of the asset relief scheme itself may be such that determining the value of the relevant assets or liabilities may not be easily achieved. Secondly, any review which aims to specifically assess the participant institution's long-term viability may remain contingent on the success of the asset relief scheme measure itself. Thus one problem with adopting a market wide asset relief scheme, as with the case of the NAMA, is while this form of intervention may benefit certain institutions it may actually undermine others. In effect some financial institutions may receive a substantial capital increase from the transfer of bad-loans while a more prudent competitor may in relative terms not receive as substantial a price premium due to having a lower number of bad loans on its books.

[67] Commission Communication (2009/C72/01) of 26/03/2009 on the treatment of impaired assets in the Community banking sector, [2009] OJ C72/01 at para.9 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0326(01)&from=EN[last accessed on 07/11/2018].
[68] *Ibid* at para.27.
[69] *Ibid* at para.19.
[70] *Ibid* at para.50.

Whether or not participating financial institutions volunteer or are involuntarily required to participate may also indicate whether the measure remains objectively beneficial or not for a financial institution. This will be discussed further blow in respect of the proposed cost-benefit analysis benchmark.

In a similar vein, whether the scheme aligns with the identified problems in the Member State's banking sector, may remain subject to wider market considerations. If one class of assets are adversely affecting a bank's balance sheet and solvency, then transferring such assets or providing some level of State insurance may seem a reasonable and "appropriate" counter-measure. But this presupposes that national authorities remain best placed to determine what support scheme should be adopted. The Impaired Assets Communication does state that "all possible alternatives" should be considered by the Member State in question.[71] In the case of NAMA the Irish authorities did undertake a detailed study of possible alternative measures but ultimately the effectiveness or otherwise of one scheme over another is difficult to ascertain from *ex-ante* perspective. Wider economic factors may affect whether a particular scheme is better tailored for engendering economic stability or not.

7.3.2.1. *Ex-ante* transparency and viability review

One of the key conditions under the IAC is the need for there to be full *ex-ante* transparency in respect of how much value the transferred assets have depreciated before transfer.[72] In this way some form of objective price floor can then be calculated and from this how much of a State aid subsidy may be required. The participating financial institutions must also be subject to a viability review in line with other pre-existing Commission Communications.[73] In most cases there should be some degree of symbiosis between the impairment a financial institution must account for on its balance sheet and the viability of the bank in question. Presumably, the greater the

[71] N.67.
[72] *Ibid* at para.20(a).
[73] *Ibid* at para.20(b).

financial loss generated by participation in the asset relief scheme the more material the question of viability becomes.

7.3.2.2. Burden-sharing under the Impaired Assets Communication

Under the Impaired Assets Communication, the burden-sharing objective should in theory be easier to meet as the underlying mechanism of an asset relief scheme is to divest impaired assets from a bank's balance sheet below book value. However, there are a number of different parties affected by an asset relief scheme. The financial institution itself does not exist in isolation but may remain subject to shareholder control. Thus if the transfer of assets from the financial institution undermines the financial position of the bank then this will also erode shareholder value. In cases where the transferring financial institution has already been nationalised or remains under majority State ownership then in effect the State may not only have to fund the costs of the scheme but also fund the costs of further recapitalisation. The Communication does allow for *ex-post* burden-sharing which entails the institution in question repaying the State some degree of compensation under a claw-back mechanism.[74] Another alternative is a loss-share policy whereby the institution agrees to discharge the first 10% of the loss generated by the asset relief scheme and a lower level of loss once this threshold has been met.[75] But of these reimbursement safeguards may only be applicable if the financial institution in question has the capacity to repay any claw-back amount or is in a position to meet the first 10% loss generated from the asset relief scheme.

7.3.2.3. Behavioural Constraints

In order to align the asset relief scheme with other banking sector State aid interventions, the Impaired Assets Communication also provides guidance on the behavioural conditions which may be imposed on the beneficiary institutions. These conditions may be either positive or negative, for instance, the institution in question may have to ensure that credit is advanced to the wider economy rather than used to pursue market share at the expense of

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[74] *Ibid* at para.24.
[75] *Ibid*.

competitors.[76] Alternatively, the participating financial institution may be required to implement a dividend ban or place a cap on executive compensation.[77] In effect these constraints mirror those also set out under previous crisis Communications and are not necessarily tailored to reflect the specific nuances of asset relief schemes.

7.3.2.4. Eligibly of assets

The Impaired Assets Communication does not establish a narrow definition for what constitutes an impaired asset in line with "Eurosystem guidance on asset support measures for banks."[78] A pan-EU definition for what constitutes an eligible asset may fail to address the problems in a specific Member State. For example, in Ireland the main grounds for an asset relief scheme were the level of non-performing loans related to the property sector.[79] In contrast, the German banking sector was overly exposed to the subprime securities and so in most cases the asset relief schemes employed by the German authorities revolved around isolating these liabilities from a financial institution's wider balance sheet via a risk shield.[80] Hence different categories of assets may require different forms of asset relief schemes and a wide range of discretion on a Member State's part.

7.3.2.5. Value of assets subject to transfer under asset relief scheme

A central aim of asset management programmes is to remove non-performing loans from a financial institution's balance sheet. When establishing an asset relief scheme policymakers have two conflicting aims to meet. Firstly, there is the need to disentangle a financial institution from any loans or assets which may act as a deterrent for future investors and depositors. Secondly, there is the need to ensure that the State does not by default over-compensate or under-compensate the relevant financial institution when ascertaining what compensation should be applied to the transfer in question. However, if the

[76] *Ibid* at para.30.
[77] *Ibid* at para.31.
[78] *Ibid* at Annex 1 at para.2.
[79] See Chapter 5 at p.114.
[80] Commission Decision NN25/2008 (ex CP15/08) of 30./09/2008 *WestLB risk shield Germany*, OJ C(2008)1628 at para.19 available at http://ec.europa.eu/competition/state_aid/cases/225266/225266_843256_6_1.pdf [last accessed on 09/102/107].

level of compensation is set at low level then this in turn may require the State having to engage in an additional recapitalisation programme in order to bolster the institution's balance sheet.[81] Conversely, where the level of compensation is excessive then the vehicle established to manage these assets may generate a loss.[82] Therefore the contingent liability posed by the asset management company for the Member State becomes an additional cost associated with supporting the wider banking sector. The Commission appears to have adopted a flexible solution for this particular problem by formulating a "real economic value" for the relevant liabilities designated for transfer.[83]

Yet whether an asset appreciates or depreciates in value is largely contingent on wider economic factors. In a volatile market environment establishing either a baseline or worst case scenario price benchmark may prove a difficult exercise. Even performing loans may lose value after being transferred to an asset management company due to failure on the part of the new vehicle to retain the underlying value of the loan.[84] In previous financial crises policymakers also had to address the issue of transfer price. If one examines asset relief schemes both within and outside of the EU, in general two contrasting positions were adopted by policymakers. For example, in Mexico the relevant loans "were transferred at book value as assets were not valued prior to transfer" and undertaking a new valuation process would have further slowed down the asset relief scheme.[85] This decision to transfer the loans at book value was perhaps due to time constraints rather than a concern over the capitalisation needs of the participating banks.

In both Finland and Sweden the loans in question were also transferred at book value to the relevant asset management companies.[86] There are associated benefits with transferring assets at book value under an asset relief scheme as the participating financial institutions do not have to immediately

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[81] N.67 at para.32.
[82] *Ibid*.
[83] *Ibid* at para.41.
[84] N.25 at p.7.
[85] *Ibid* at p.13.
[86] N.41.

crystallise any losses. Hence there is no immediate requirement of possible State recapitalisation for the participating banks in question. Furthermore, transferring assets at book value may allow for participating financial institutions to continue lending to the real economy rather than to immediately absorb the losses if the assets were moved at real market value prices.

However, a counter view may be advanced in that transferring the assets at book value undermines efforts to accurately ascertain the recapitalisation needs of the financial institution in question. In some cases, where the book value remains only marginally less than the actual current market value then the bank may not need to raise additional capital. But in times of financial crisis it seems unlikely that an impairment will be of marginal value. Another adverse consequence of transferring assets at book value is the moral hazard effect on the wider banking sector. This will be discussed further below, in summary though if an asset relief scheme simply places the financial institution in the financial position *ex-ante* the financial crisis then the internal failings of the relevant bank are not subject to market discipline. In effect the asset relief scheme becomes a *de facto* insurance policy against future asset price collapses for a Member State's banking sector.

In contrast, transferring the eligible assets at a price below book value resolves to some degree any associated moral hazard concerns. Yet if the transfer price is set below book value then this may engender further problems both for the relevant financial institution and the wider banking sector in question. For instance, if a financial institution records the actual loss of value arising from the transfer of assets to the asset management company then an immediate capital shortfall arises. Further, if this financial institution has a similar asset portfolio to other domestic banks then the latter may be left holding assets with a decreasing value. This becomes particularly evident in banking markets where property bubbles have formed and most banks have increased their exposure to property related assets. If the transfer price reflects current market values, then this may increase the capitalisation needs of the participating banks. But if external investment remains difficult to access then the Member State remains liable for providing additional aid to each of the participating banks in question.

The method of valuation will ultimately depend on a number of wider issues. In times of systemic crises transferring assets at market value may simply invoke further market instability. Conversely, a number of positives may be deduced if assets are subject to a realistic price benchmark. It may for example, help establish a floor price for the relevant assets and this may in turn attract investment from private market operators. Klingebiel notes that accelerating the sale of assets "rapidly establishes floor prices that will promote a speedier recovery from the economic crisis".[87] The same principle could be applied in respect of a transfer price set at current market values as this may also invoke further market activity.

7.4.1. Long-term Economic Value: NAMA Act 2009

As noted above under the 2009 Act a long-term economic value price was set for the eligible assets designated for transfer to NAMA. One of the central aims behind a long-term economic valuation is to alleviate the effect of the wider market environment prevailing at the time of the asset relief scheme. A number of valuation benchmarks are established under s.72(1) of the Act. "Market value of a property" is defined as "the estimated amount that would be paid by a willing buyer to a willing seller in an arm's length transaction" and "where both parties act knowledgably, prudently and without compulsion".[88] The same definition applies in relation to the "market value of a bank asset".[89] A more nuanced asset valuation measure is also set out, namely "the long-term economic value of property". In effect this valuation refers to what sale price an asset may make once the financial crisis had abated.[90] A parallel definition applies in respect of the "long-term economic value of a bank asset".[91]

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[87] *Ibid* at p. 8.
[88] N.10 at s.72(2)(a).
[89] *Ibid* at s.72(2)(b).
[90] *Ibid* at s.72(2)(c).
[91] *Ibid* at s.72(2)(d).

Establishing the long-term economic value of a bank asset is based on a series of factors, ranging from the market value of the property to long-term economic value of a "similar property or bank asset".[92] Further guidance on calculating the long-term economic value was provided for in Ministerial Regulations such as the price and value of land related to the loan or asset, between land prices and interest rates, and the price and value of the related asset class.[93]

7.4.2. Impaired Assets Communication and Long-term Economic Value

The Impaired Assets Communication also applies a long-term economic valuation for any assets transferred under an asset relief scheme. Under Annex 3 of the Impaired Assets Communication, the assets possibly subject to transfer, such as residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS) or credit default swaps (CDOs) indicate the complex nature to developing a transfer value.[94] To resolve these complexities the IAC places importance on using expert valuers to determine what constitutes a long-term economic value.[95] But even this dependency on a panel of experts has obvious limitations as certain assets may simply continue to lose value and have little if no long-term price uplift. Therefore, the Commission needs to strike the correct balance between the need for "counterbalancing current market exaggerations fuelled by current crisis conditions" via asset relief measures while also ensuring that these schemes do not act as *de facto* subsidies for imprudent financial institutions.[96] To determine whether such a balance has been struck one must examine the Commission's decisional practice when assessing State aid applications under the Impaired Assets Communication.

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[92] *Ibid* at 76(1)(d).

[93] S.I. *National Asset Management Agency (Determination of Long-term Economic Value of Property and Bank Assets) (Amendment) Regulations 2010* available at https://www.nama.ie/fileadmin/user_upload/documents/Legislation/SI504Of2010NAMADeterminationOfLEVofPropertyAndBankAssetsRegulations2010.pdf [last accessed on 07/11/2018].

[94] N.67 at Annex IV.

[95] *Ibid*.

[96] *Ibid*.

7.4.3. Commission Decision on NAMA and Long-term economic value

When assessing the State aid application for NAMA, the Commission accepted the long-term economic market valuation methodology formulated by the Irish authorities.[97] To determine the "real economic cash flow" of an asset, the Irish authorities developed three different categories of loans. The cash flow values for assets with a low recovery rate were subject to an uplift factor relevant to the current market value of 10% or less.[98] For assets with medium recovery prospects the uplift factor was set at between 10.0% and 15.0%, while the final category of assets was subject to an uplift in excess of 15%.[99] Each of these categories was then subject to a different time period for valuation. For example, assets with the lowest uplift were valued over a three year period while assets subject to the highest uplift were valued over an eight year timeframe.[100] Therefore, the Irish authorities had developed a nuance benchmark for establishing the different cash flows for different asset classes. The key failing with this approach however was the fact that the Irish authorities had adopted an asset focused approach to determining value as opposed to one that focused on both the positive and negative effects on the participating financial institutions.

7.4.4. Transfer process: From tranches one to three

The actual transfer of assets from the participating Irish financial institutions to NAMA was via a number of tranches. For instance, in the first tranche of assets removed from the participating Irish financial institutions loans valued at €15.284 billion were placed with NAMA. Portfolios from Anglo Irish Bank and Allied Irish Banks constituted more than half of the total transfer value.[101]

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[97]Commission Decision N725/2009 of 26/02/210 *Ireland Establishment of the National Assets Management Agency Asset Relief Scheme for Banks in Ireland* OJ C(2010) 1155 available at http://ec.europa.eu/competition/state_aid/cases/234489/234489_1086237_117_2.pdf [last accessed on 07/11/2018].

[98] *Ibid* at para.121(ii).

[99] *Ibid*.

[100] *Ibid*.

[101] Commission Decision N331/2010 of 03/08/2010 *Ireland Transfer of the first assets to NAMA*, OJ C(2010) 5425 at para.9 available at http://ec.europa.eu/competition/state_aid/cases/237101/237101_1177824_52_2.pdf [last accessed on 07/11/2018].

The current market value of the loans at the time of transfer was €5.856 billion while the actual transfer price subject to the long-term economic value uplift was €7.532 billion.[102] Therefore the discount applied to the first tranche equated to 49% of the original book value of the loans.[103] The values of the underlying properties were also set out, with a current market value of €7.454 billion and a long-term economic value of €8.275 billion.[104] This difference in consideration constituted an "average uplift of 11.01% above the market value", slightly above the projected 10% uplift under the IAC.[105] The breakdown of the properties transferred in tranche one mainly consisted of development land under different phases of construction and investment property.[106] Similarly, the geographical spread of the transferred properties remained concentrated in the Irish and UK market place rather than more diversified locations.[107]

In the second tranche of loans transferred to NAMA, the breakdown of loans again mirrored that of the first tranche. Both investment and development property constituted the largest segments of the tranche combined (47%).[108] Half of the property interests in Tranche 2 were located within Ireland.[109] The book value of the loans transferred in Tranche 2 was €11.93 billion while the current market value of the underlying property was €5.41 billion.[110] In the second tranche the long-term economic value for the relevant properties was calculated at €5.94 billion.[111] Thus the second tranche was subject to a total uplift of 9.8%, an increment below both the previous uplift under Tranche 1 and the recommended uplift under the IAC.[112]

[102] *Ibid* at paras.9-10.
[103] *Ibid* at para.10.
[104] *Ibid*.
[105] *Ibid* at para.11.
[106] *Ibid* at para.12.
[107] *Ibid* at para.13.
[108] Key Tranche Data 1 and 2, National Assets Management Agency, 23rd August 2010 at p.15.
[109] *Ibid* at p.13.
[110] *Ibid* at p.3.
[111] *Ibid*.
[112] *Ibid*.

The final tranches transferred to NAMA mainly consisted of either investment property or development land.[113] As in previous tranches, loans associated with development land were divided into two categories, land that was less than 30% developed and land that was at least 30% developed.[114] The book value of the transferred loans was €46.958 billion, with the current market value of the loans estimated to be €15.86 billion.[115] For the last loan tranches the long-term economic uplift constituted a State aid payment of €3.239 billion.[116] Clearly, the approach adopted by the Irish authorities was one that followed the previous rationale behind asset relief schemes and that was embraced under the IAC's criteria. But this approach was not it is submitted necessarily one that addresses the actual effects of the financial institutions participating in asset relief schemes. By adopting the same formula as when asset relief schemes were applied under the Rescue and Restructuring Guidelines, both the Commission and Member States fell for the same problems as those experienced during the Credit Lyonnais and Bankgesellschaft asset relief schemes. Namely, the substantial level of aid required and also the fact from a competition distortion perspective that in most of these cases, with the exception of Anglo Irish Bank, the participating financial institutions would remain active on the Irish market place.

Certain commentators such as Quigley remain sceptical of the long-term economic value concept in the context of a sector wide scheme such as NAMA.[117] According to Quigley the "toxicity of the impaired assets taken over by the State is such as to eliminate any realistic long-term valuation".[118]Thus the very "notion of 'real economic value' becomes merely

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[113] Commission Decision SA.38562 (2014/N) of 29/07/2014 *Ireland Transfer of the last tranches (tranches 3 to 9) of assets to NAMA*, OJ C(2014)5364 available at http://ec.europa.eu/competition/state_aid/cases/252347/252347_1584913_91_2.pdf [last accessed on 07/11/2018] .
[114] *Ibid* at para.15.
[115] *Ibid* at paras. 12-13.
[116] *Ibid* at Annex 1.
[117] C. Quigley, "Review of the Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis", (2012) Vol.3(3) Journal of European Competition Law and Practice pp.237-247 at p.244. See also F.C Laprévote and F. Coupe, "The State's toolkit for rescuing banks in difficulty", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.107 at p.149.
[118] *Ibid*.

aspirational, if not delusional".[119]NAMA has subsequently made profits from the disposal of the transferred distressed assets.[120] A profit which Medina Cas and Peresa link to the "factory approach" of NAMA that has helped increase the value of the agency's assets.[121] Quigley's point does remain however, as ultimately the accuracy or otherwise of a long-term economic value benchmark depends on a wide range of factors that neither the Commission nor Member State can adequately forecast. While this remains true of all economic forecasts, it may be possible to formulate a different valuation process which is not as dependent on unpredictable factors.

Further, the profit that NAMA has made must still be considered in the wider context of the total recapitalisation costs the Irish State had to meet after the transfer of assets to the agency. Therefore, unless NAMA generates a profit that at the very least matches these recapitalisation costs the benefits of applying a long-term economic benchmark remains open to criticism as indeed does NAMA's continued asset disposal programme rather than utilising these assets to resolve the current housing crisis. For instance, the projected surplus the agency seeks to return to the Irish State of some €3.5 billion is some way off the total costs of recapitalising the four core Irish financial institutions that has come to €39.9 billion.[122] The costs of asset relief schemes will obviously remain high for Member States, particularly so when most of the domestic financial institutions participate in such a scheme. However, there may be an alternative method to applying these schemes that is not necessarily linked with the value fluctuations of the underlying assets designated for possible transfer. But to determine whether this is necessary, one must next examine how other Member States applied asset relief schemes

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[119] *Ibid*.
[120] S. Medina Cas and I. Pereas, "What Makes a Good 'Bad Bank'? The Irish, Spanish and German Experience", European Economy Discussion Paper No.36 September 2016, at p. 23 available at http://ec.europa.eu/info/publications/what-makes-good-bad-bank-irish-spanish-and-german-experience_en [last accessed on 07/11/2018].
[121] *Ibid*.
[122] National Asset Management Agency, *Annual Report 2017*, May 2018, at p.5 available at [last accessed on 09/01/2018]; Comptroller and Auditor General, Report on the Accounts of Public Services 2016, September 2017, at p.36 available at http://www.audgen.gov.ie/documents/annualreports/2016/report/en/Report_Accounts_Public_Services_2016.pdf [last accessed on 09/01/2018].

to their domestic banking sectors and whether these schemes also raised the same problems as the Irish one.

7.5.1. Other asset relief schemes and assets values: From Spain to Germany

There were a number of different asset relief measures implemented by Member States during the financial crisis. Some of these interventions followed that of the Irish State via the establishment of a centralised "bad bank" to purchase assets from financial institutions. For example, the Spanish authorities created a specialised vehicle to purchase assets from Spanish banks as a form of recapitalisation tool.[123] However, unlike NAMA, the Fund for the Acquisition of Financial Assets [hereinafter FROB] was designed to purchase "high quality" assets from Spanish banks rather than distressed loans.[124] Another difference between NAMA and FROB was the process used to transfer assets from financial institutions. Unlike the tranche-transfer mechanism utilised by NAMA, the FROB performed a reverse auction whereby the participating financial institutions offered "pre-specified asset classes" for sale.[125] The assets subject to this "reverse" auction included both covered bonds and asset-backed securities.[126]

An interesting aspect to the Spanish asset relief scheme is that the Commission decision authorising this measure was prior to the introduction of the IAC. Hence the Commission applied the three principles as used when assessing State aid recapitalisations for banks under Article 107(3)(b) TFEU namely, "appropriateness, "necessity" and "proportionality".[127] The Commission found that FROB was an "appropriate measure" to remedy a serious disturbance in the Spanish economy. To alleviate the liquidity

[123] Commission Decision NN54/A/2008 (ex-CP 277/2008) of 4/11/2008 *Spain Fund for the Acquisition of Financial Assets*, OJ C(2008)6713 available at http://ec.europa.eu/competition/state_aid/cases/227830/227830_958064_2_1.pdf [last accessed on 07/11/2018]
[124] *Ibid* at para.8.
[125] *Ibid* at para.15.
[126] *Ibid* at para.20.
[127] *Ibid* at paras. 43-46.

constraints facing Spanish institutions some form of intervention was required.[128] Although at a later point during the crisis the Spanish authorities adopted a consolidation and recapitalisation plan for the Cajas savings institutions, the aim of FROB was similar to NAMA.[129] Participating institutions transferred assets in exchange for financial support rather than dilute the pre-existing equity by issuing new shares as a *quid pro quo* for State support.

The Commission also considered whether the Fund met the "minimum necessary" criterion.[130] As the assets subject to the FROB auction were high quality and not impaired this meant the "minimum necessary" criterion had been met.[131] Further, once the wider financial market stabilised these assets could then be resold for a profit.[132] Therefore in the case of the Spanish asset relief scheme it appears that the level of return generated under FROB would discharge any initial acquisition costs.

Following the same approach as both the Irish and Spanish Member States, the Lithuanian government adopted an asset relief scheme whereby certain assets from the Lithuanian banking sector would be exchanged for capital injections and government securities.[133] A number of assets subject to transfer were impaired loans and other financial instruments.[134] The level of discount imposed by the asset relief scheme was set at 20% but this could be lowered depending on certain factors.[135] These included the reliability of the collateral for the transferred assets, the financial position of either the borrower or the bank in question and "any other significant factor which may affect the value of the bank's assets".[136] As the Lithuanian scheme was submitted post the introduction of the Impaired Assets Communication, the Commission did not

[128] *Ibid* at paras. 48-49.
[129] See Chapter 6 at p.163.
[130] *Supra* 123 at paras. 51-53.
[131] *Ibid* at para.53.
[132] *Ibid* at para. 54.
[133] Commission Decision N 200/2009 and N47/2010 of 05/10/2010, *Lithuania Lithuanian bank support scheme* OJ C(2010) 5472 at para.7 available at http://ec.europa.eu/competition/state_aid/cases/235036/235036_1142508_34_2.pdf [last accessed on 07/11/2018].
[134] *Ibid* at para.16.
[135] *Ibid* at para. 23.
[136] *Ibid.*

assess the scheme via the "appropriate" and "necessity" criteria.[137] In this case the 20% discount and the possible decrease in the asset transfer price where necessary were both sufficient to meet the valuation benchmark under the Impaired Assets Communication.[138]

Similarly, the asset transfer scheme for the Danish bank FIH Group entailed an asset relief scheme whereby the Danish State would establish and provide financial support to a new bad- bank for the financial institution's non-performing loans.[139] Under this scheme FIH Group would provide a loan to the bad-bank which would only be recoverable if adequate resources were in place post the resolution of the bad-bank.[140] In addition a further loan would be provided by FIH Group which would finance the day-to-day operations of the bad-bank.[141] Further support from FIH Group included an "unlimited loss guarantee" to recompense the State authority with oversight for the bad-bank, the Financial Services Company.[142] The Commission adopted a critical stance when assessing this form of asset relief scheme as the process did not necessarily sever the financial link between the assets and liabilities of the new bad bank and the FIH Group.[143] In effect the Commission questioned whether a market investor would deem the bank in this case "relieved from its worst assets".[144]

The Commission also raised concerns about the level of aid provided to the FIH Group and whether this met the "minimum necessary" criterion.[145]Although the wider FIH Group remained financially liable via the "unlimited loss guarantee" for the possible costs associated with the new bad bank. The Danish State had to pay a guarantee fee was to the FIH

[137] *Ibid* at para.85.
[138] *Ibid* at para. 87.
[139] Commission Decision No. SA34445 (2012/C) (ex 2012/N) of 29/06/2012-*Denmark The transfer of property related assets from FIH to the FSC* OJ C(2012) 4427 available at http://ec.europa.eu/competition/state_aid/cases/245255/245255_1350980_822_2.pdf [last accessed on 07/11/2018].
[140] *Ibid* at para.18(i).
[141] *Ibid* at para.20(i).
[142] *Ibid*.
[143] *Ibid* at para. 60
[144] *Ibid*.
[145] *Ibid* at para. 66.

Group.[146]Furthermore the Commission noted how there was a strong possibility that the FSC would not receive any return from managing and finally winding down FIH's bad bank.[147] Despite these concerns the Commission did authorise the relief scheme temporarily for six months before issuing a final decision.[148] To resolve the Commission's concerns the Danish authorities applied a number of additional measures designed to increase the level of contribution from the FIH Group.[149] The latter now had to pay a new annual fee of "€1[.]61 million" to the Financial Services Company until the resolution of the bad bank, repay existing management fees back to the bad bank agreed under the previous proposals and adopt a number of behavioural constraints.[150]

In a similar response to the Irish authorities, the German State sought to transfer impaired assets from the balance sheet of Hypo Real Estate. This entailed the transfer of €30 billon of commercial property loans while the remainder encompassed financial instruments and public sector bonds.[151] The Commission found that the transfer price of these assets was in excess of the "real economic value" as established under the Impaired Assets Communication.[152] Therefore under this scheme, the level of restructuring in this case had to be substantial for Hypo Real Estate in order to constitute an effective *quid pro quo* measure against the over-valuation of the transferred assets.[153]

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[146] *Ibid* at para.68.
[147] *Ibid* at para. 71.
[148] *Ibid* at p.16.
[149] Commission Decision SA.34445(ex 2012/C) of 11/03/2014 *implemented by Denmark for the transfer of property related assets from FIH to the FSC*, OJ C(2014) 1280 available at http://ec.europa.eu/competition/state_aid/cases/245255/245255_1529876_1267_2.pdf [last accessed on 07/11/2018].
[150] *Ibid* at para. 56.
[151] Commission Decision n0 C15/2009 (ex 196/2009) and N380/2010 of 24/09/2010 *Extension of scope of formal investigation procedure, winding-up institution additional SoFFin guarantee for HRE; Hypo Real Estate Germany*, OJ C(2010) 6672 at para.52-53 available at http://ec.europa.eu/competition/state_aid/cases/237473/237473_1146889_56_1.pdf [last accessed on 07/11/2018].
[152] *Ibid* at para.83.
[153] *Ibid* at para.96.

7.5.2. Risk Shields

Another form of asset relief measure that some Member States adopted were risks shields. A risk shield in effect contains both a guarantee strand and a recapitalisation strand. Therefore, a Member State will agree to guarantee the first loss in a portfolio of assets in return for a fee while the financial institution itself will then meet the remaining losses. In most cases the Member State will also provide some level of recapitalisation to further strengthen the balance sheet of the bank in question. When assessing the asset relief measure adopted by the Belgian authorities for KBC Bank the key issue for the Commission was the transfer value of the assets in question. Under the restructuring plan for KBC, the bank's collateralised debt obligations would be guaranteed in a tiered process by the Belgian State up to a value of €20 billion.[154] For example, the first loss up to the value of €3.2 billion was solely met by KBC while the next tier of losses, a further loss of €2 billion, would then be met by the Belgian State in exchange for new equity in the bank or other market instruments.[155] Any loss from the remaining €13.3 billion would then be guaranteed up to 90% of its value by the Belgian State while KBC would cover the residual loss.[156] The Commission though was sceptical of the uplift in US residential property markets submitted by the Belgian authorities as part of the State aid application. As the assets in question were mortgage backed securities originating from the United States any price developments in this sector were likely to affect the value or otherwise of the transferred securities.[157]

Thus the challenge for both the Belgian authorities and the Commission was to find an accurate valuation for these securities. But this actually raises related questions about the internal management within KBC bank itself. When examining the subprime crisis in the United States, Lang and Jagtiani note how "irrational exuberance" on the part of management may have

[154] Commission Decision n0 C18/2009 (ex N360/2009) of 30.06.2009 *Second recapitalisation and asset relief for KBC, Belgium*, OJ C(2009) 5268 available at http://ec.europa.eu/competition/state_aid/cases/232156/232156_1079002_2_1.pdf [last accessed on 09/01/02017].
[155] *Ibid* at paras.30-31
[156] *Ibid* at para.31
[157] *Ibid* at para.83(c)

resulted in certain banks failing to appreciate any possible price depreciation.[158] This means that the market is perceived to be infallible and that value will continue to rise.[159] In a similar vein, Minsky discusses how during prolonged periods of economic growth markets tend to move from "hedge finance units", investments that can meet their financial liabilities from their own cash flow to "units engaged in speculative and Ponzi finance", investments that can only meet their financial liabilities by selling assets or borrowing capital.[160]

Although in some cases the downturn in the US property markets was considered by some banks, the emergence of the originator-to-distribute model meant that banks had a limited incentive to ensure borrowers would not default.[161] From a State aid perspective though one could question whether the concept of "irrational exuberance" could be tailored to reflect the final transfer price for mortgage backed securities. If banks such as KBC overpaid for securities and failed to appreciate the risks involved in these investments, then the transfer price should if anything encompass a penalty element that reflects this "irrational exuberance".

A similar challenge arose in respect of the risk shield put in place for the German lender LBBW.[162] This scheme mirrored the asset relief measure adopted by the Belgian authorities. Thus the financial institution's impaired

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158 W. Lang and J. Jagtiani, "The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance", (2010) Vol.38 Atlantic Economic Journal, pp.123-144 at p.133 available at http://download.springer.com/static/pdf/553/art%253A10.1007%252Fs11293-010-9221-7.pdf?originUrl=http%3A%2F%2Flink.springer.com%2Farticle%2F10.1007%2Fs11293-010-9221-7&token2=exp=1490355543~acl=%2Fstatic%2Fpdf%2F553%2Fart%25253A10.1007%25252Fs11293-010-9221-7.pdf%3ForiginUrl%3Dhttp%253A%252F%252Flink.springer.com%252Farticle%252F10.1007%252Fs11293-010-9221-7*~hmac=dc382da9bd2c586907628c5f2dc6b3dfd74187d8d7de07a3d8e4ba77a5b09d16 [last accessed on 07/11/2018].

159 *Ibid*.

160 H.P. Minsky, "The Financial Instability Hypothesis" Levy Economics Institute of Bard College", May 1992 at p.8 available at http://www.levyinstitute.org/pubs/wp74.pdf [last accessed on 07/11/2018].

161 N.158 at p.134.

162 Commission Decision C/17/2009 (ex N265/2009) 30/06/2009-*Germany Aid measures provided to LBBW* OJ C (2009) 5260 available at http://ec.europa.eu/competition/state_aid/cases/232152/232152_971719_69_1.pdf [last accessed on 07/11/2018].

assets would not be transferred to another undertaking but instead subject to a risk shield. Under this risk shield LBBW would meet the first loss of €1.9 billion of an overall asset-backed securities portfolio valued at €17.7 billion.[163] Any losses after this would then be guaranteed by the Württemberg-Baden State up to a value of €6.7 billion.[164] For the second portfolio of securities held by LBBW via a special purpose vehicle, the first and second losses met by the financial institution itself and the State were €2.75 billion and €6 billion respectively.[165] The description provided by the German authorities for both portfolios indicates the exposure of LBBW to both mortgage backed securities originating in the EU and the US.[166] Therefore the Commission had to determine two related questions. First, was the market forecast provided by the German authorities accurate, in other words would the underlying assets linked with these complex financial instruments increase or decrease in value? Second, were the loans and other debts linked with the transferred securities and credit obligations in default or likely to enter default?

In both the case of KBC Bank and LBBW, the Belgian and Württemberg-Baden authorities sought to address the questions raised by the Commission in respect of the valuation of the shielded asset portfolio. For KBC Bank this entailed the Belgian authorities providing evidence that the "real economic value" of the designated assets for transfer was greater than the transfer value of these assets.[167] Yet a more detailed study of the proposed LBBW asset relief scheme highlights how certain assets within the asset backed securities portfolio retained a high current market value while others did not.[168]In effect the Commission found that the baseline valuations provided by LBBW's own

[163] *Ibid* at para. 19.
[164] *Ibid*.
[165] *Ibid*.
[166] *Ibid* at paras. 22-26.
[167] Commission Decision n0 C18/2009 (ex N360/2009) of 18/11/2009 *State aid implemented by Belgium for KBC* OJ C(2009) 8980, at paras.123-126 available at http://ec.europa.eu/competition/state_aid/cases/232156/232156_1079006_91_1.pdf [last accessed 07/11/2018].
[168] Commission Decision (2010/395/EU) of 15/12/2009 *on State aid C17/09 (ex N 265/09) by Germany for the restructuring of Landesbank Baden-Württemberg* [2010] OJ L188/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010D0395&from=EN [last accessed on 07/11/2018].

assessment were considered inaccurate.[169] To resolve this concern the Commission proposed a claw-back condition so that adequate burden-sharing could offset any overvaluation applied by the domestic authorities in relation to the portfolio.[170]

WestLB was also subject to risk shield primarily designed to cover the losses arising from the bank's portfolio of non-performing securities and other non-core assets.[171]The initial risk shield for WestLB was to protect the financial institution from losses of the first €5 billion.[172] The Commission applied a hybrid approach when assessing this support as although Article 107(3)(b) TFEU was the exemption referenced, the framework used to assess the aid was the Rescue and Restructuring Guidelines. This was mainly due to the fact that when the initial State aid application was submitted the Germany authorities had failed to prove that the resolution of WestLB would trigger a "serious disturbance".[173] In this case the risk shield was initially construed as a temporary measure, a form a rescue aid designed to stabilise the financial institution on a temporary basis until a more permanent restructuring could take place.[174]

Unlike determining the value of an asset transfer programme, where some form of asset price can be determined and then used as a benchmark for extrapolating the long-term economic value. The market for WestLB's assets was illiquid thus the Commission held that the level of State aid provided under the risk shield was the full value of the loss guarantee.[175] This in turn raises another question in respect of asset relief schemes, namely if no market is actually in place for the assets subject to transfer then should the asset relief measure proceed? One possible solution to this question may include establishing a value that is not necessarily rooted in markets that may or may

[169] *Ibid* at para.53.
[170] *Ibid* at para.59.
[171] Commission Decision No C43/2008 (ex N390/2008) of 12/05/*2009 implemented by Germany for the restructuring of WestLB AG*, OJ C(2009) 3900 at para.11 available at http://ec.europa.eu/competition/state_aid/cases/227692/227692_980787_81_1.pdf [last accessed on 07/11/2018].
[172] *Ibid* at para.24.
[173] *Ibid* at para.61.
[174] *Ibid* at para.27.
[175] *Ibid* at para. 58.

not exist at transfer value but on the costs and benefits that affect the financial institution in question. This will be further examined below.

7.5.3. Asset Insurance

Asset protection schemes are another form of asset relief scheme although unlike an asset transfer the assets in question remain on the bank's balance sheet. However, the participating financial institutions agree to pay a fee to the relevant Member State in exchange for a sovereign guarantee over the assets in question. For example, the United Kingdom established an asset insurance scheme for the Royal Bank of Scotland whereby the former would guarantee the first loss up to £60 billion.[176] The Commission concluded that the scope of this guarantee was adequate given the fact that it was highly likely that this would cover "at least the long-term expected losses on the covered assets".[177]

7.6.1. Impaired Assets Communication and the level of State aid: Time for a new approach?

Unlike when assessing a recapitalisation or restructuring amount of State aid under the other crisis Communications, the Commission, has not applied the "appropriate" and "minimum necessary" principles when assessing the compatibility of support under the Impaired Assets Communication provisions. While one could argue that both these principles and the Impaired Assets Communication overlap to some degree, there are certain key considerations that this Communication has failed to address. For example, in a number of cases Member States have applied the long-term economic value when determining what level of compensation should be provided to a recipient financial institution. However, this particular benchmark remains flawed for a number of reasons.

[176] Commission Decision N 422/2009 and 620/2009 of 14/12/2009, *United Kingdom Restructuring the Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme*, OJ C(2009)10112 final at para.154 available at http://ec.europa.eu/competition/state_aid/cases/233798/233798_1093298_30_2.pdf [last accessed on 07/11/2018].
[177] *Ibid* at para.153.

Firstly, calculating the long-term economic value of any asset remains a fraught exercise as wider economic factors affecting this hypothetical price may or may not arise. From a State aid context this exercise may not only over-compensate imprudent financial institutions and raise moral hazard concerns, it may also distort competition within a Member State's banking sector. The asset class in question may not recover a base line value as the market for these assets may not actually be present post a financial crisis. This runs counter to the concept of "creative destruction" in markets where continuous product innovation will lead to market upheaval and the demise of uncompetitive undertakings.[178] However, there are certain impediments to creative destruction including regulation.[179] In this context the application of a hypothetical long-term economic value constitutes an impediment to creative destruction as instead of the European financial market innovating to overcome the losses associated with subprime loans. The State has intervened to provide an artificial market value for these loans. This also corresponds with the problem outlined above where the IAC and Member States place a focus on the value of the assets designated for transfer rather than focus on the characteristics of the individual participating financial institutions.

Secondly, applying a long-term economic benchmark presumes that there was a market rationale for the purchase of or investment in, the related securities or assets. But this rationale may have developed due to wider economic factors that were not necessarily conducive to market stability. In the case of subprime securities, imprudent behaviour on the part of US and European financial institutions resulted in a market gradually developing for these financial instruments. Yet applying some form of value to these financial instruments as a part of an asset relief scheme should not be based on applying a hypothetical benchmark that may not be applicable in a better regulated financial environment. Van den Hauwe refers to the investment boom under Minsky's market instability theory and how this had two key "drawbacks".[180]

[178] R. J. Caballero, "Creative Destruction", at p.4 available at https://economics.mit.edu/files/1785 [last accessed on 07/11/2018].
[179] *Ibid* at p.5.
[180] L. Van den Hauwe, "Understanding Financial Instability: Minsky Versus the Austrian", Munich Personal RePEc Archive 24th December 2014, at p.12 available at [last accessed on 07/11/2018].

One, as speculation increases in the market then a firm's debt will exceed profits.[181] Two, this speculation will eventually lead to market "bottlenecks" or "inflationary pressures" that will require monetary authorities to increase interest rates.[182] However, the imposition of a long-term economic benchmark is in contrast to an external authority attempting to resolve market failure via interest rate policies that may see a revaluation of a firm's assets related to actual current demand rather than developing a long-term economic value which suggests that market instability may arise again in future. By establishing a long-term economic value benchmark Member States, such as Ireland, were in effect designing a compensation level that again focused on the up turn on asset values without necessarily examining the benefits and costs of these price increases for the financial institutions in question.

Thirdly, circumstances may arise whereby financial institutions that have invested in these financial instruments or engaged in imprudent lending receive the most compensation under a long-term economic value benchmark. The long-term economic benchmark was applied by the Irish authorities in respect of NAMA however, where other asset relief schemes applied different transfer values questions remain as to what is or is not an "appropriate" scheme and indeed what level of aid is the "minimum necessary". For instance, should the threshold at which an asset shield is set be lowered or raised depending on the assets or liabilities covered? Should asset insurance be restricted in the range and value of assets subject to this scheme?

If one views other strands of State aid law, there are few if any direct comparisons with the State directly subsidising non-performing assets of an undertaking. One could argue that when a Member State seeks to support a manufacturing undertaking or airline that the aid is primarily focused on the failings within the firm rather than specifically a set of assets or liabilities on the recipient's balance sheet. However, as is evidenced in Chapter 6 the Market Economic Investor Principle may provide some form of benchmark for how best to determine the value of eligible assets or liabilities under an

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[181] *Ibid*.
[182] *Ibid* at p.13.

asset relief scheme. In Chapter 6, the suggested proposal was a tailored version of this test in the form of the rationale State actor for ascertaining the “minimum necessary” amount of aid to provide to a long-term viable financial institution.[183] But applying such a tailored approach for determining the transfer price or risk shield limit for distressed assets may blur the lines between the State as an investor and the State simply acting to resolve a market failure.

Despite the absence of a direct comparative from other State aid regimes there may be an equivalent form of State intervention under the Commission’s State aid and Environmental Guidelines.[184] Under these guidelines Member States may provide State aid to undertaking’s seeking to reduce their impact on the wider environment or to relocate to a different location where the environmental impact is reduced.[185] The minutiae of environmental protection safeguards is not the subject for discussion here however suffice to say that there is a parallel objective between both the transfer of distressed assets from a financial institution and the subsidies provided for an undertaking to meet environmental standards. This objective is to resolve wider market failings while also incentivising the undertaking in question to participate in the relevant scheme.

7.6.2. Market Failure and Asset Relief Schemes

Market failure has been discussed in detail in Chapter 6 including the different circumstances in which it may arise. However, in the context of asset relief schemes one could argue that such interventions are primarily designed to resolve a specific market failing with two particular dimensions. First, there is the internal dimension within the participating financial institution whereby management failed to assess the possible downside risks associated with the assets in question. Second, there is a wider macro failing whereby the conduct

[183] Chapter 6 at p.192-200.
[184] Commission Communication (2014/C/200/1) of 28/06/2014 Guidelines on State aid for environmental protection and energy 2014-2020 OJ [2014] OJ C200/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0628(01)&from=EN [last accessed on 07/11/2018].
[185] *Ibid* at paras.227-233.

of competing financial institutions resulted in these non-performing assets becoming prevalent within the financial system. This market behaviour on the part of financial institutions aligns with Minsky's theory as set out above that capital flows to high risk Ponzi units in times of market stability.[186] Therefore an asset relief scheme aims to resolve both of these dimensions from an institutional and market perspective. In a similar vein one could posit that State aid for environmental protection seeks to resolve an internal and external facing market failing. Internally, a firm may not appreciate the wider environmental damage it is causing while the wider market in which this firm operates as a whole adopts the same position.

Yet in both cases the recipient undertakings are in effect awarded for these internal and external failings. For instance, under the State aid and Environmental Guidelines an undertaking may be able to avail of substantial State assistance to finance the costs associated with relocation.[187] The Commission then applies a cost-benefit analysis of the proposed relocation aid. For example, it may be that the recipient undertaking incurs substantial costs related with the move but these costs are offset by the increased capacity the new site can facilitate.[188] Thus the relevant level of aid must reflect the balance between costs and opportunity. In contrast, under an asset relief scheme a cost-benefit analysis is not necessarily undertaken by either the Commission or the Member State. As noted above there are also wider market costs that arise with the application of a long-term economic value benchmark. These include the possibility of financial institutions failing to engage in product or service innovation due to subsidy associated with non-performing legacy assets and the possibility that imposing a long-term economic value may result in a future market distortion. Long-term economic value benchmarks in effect link the restructuring of the financial institution under an asset relief scheme with their past market operations. In contrast, a cost-benefit analysis method should not only seek to address current issues that may face the financial institution but also tie in with the other proposals

[186] N.160.
[187] N.184 at para.237.
[188] *Ibid* at para.240.

as set out in Chapters 4 through to 6 of this Thesis. For example, a long-term viability test should aid the application of a cost-benefit analysis as the possible adverse effects of a long-term viable financial institution may be clearer than if the financial institution remains subject to a blanket long-term economic value benchmark.

An obvious cost is the immediate crystallisation of losses on a financial institution's balance sheet thereby triggering the need for further capital. Further, the transfer of assets from a financial institution's portfolio may have longer-term costs for the undertaking such as a reduced market share, a knowledge drain within the institution related to the assets transferred and opportunity costs of any potential future returns from these assets. In contrast, participating in an asset relief scheme encompasses a number of benefits. These include a reduction on the capital the institution has to set aside to buffer against non-performing assets, a balance sheet that should attract new investors and also a freeing of resources to pursue other market activities. In addition, one of the central benefits for a financial institution to avail of an asset relief measure is the fact that the measure should facilitate the continued market presence of the financial institution in question. By applying a cost-benefit analysis for individual financial institutions this should then resolve the wider macro problems arising from applying a long-term economic value benchmark such as the risks to product innovation and the possible link that may be drawn from the causal factors from a past financial crisis to a future one.

7.6.3. Strands of the cost-benefit analysis: retaining market value as a benchmark

The level of aid a financial institution receives should not depend on a hypothetical market value but on the outcome of the cost-benefit analysis. As noted above in certain relief schemes the Member State in question applied a tiered guarantee scheme. Thus a proposed tiered benchmark will be a central component in determining the levels of aid provided to a financial institution under a future State Aid Crisis Framework. In effect a two tiered approach for aid provision is proposed for asset relief schemes depending on the outcome of the costs-benefit analysis undertaken by the Commission. For example, one of the core tenets of European State aid control is the question of incentive; that is, whether the proposed aid in question will alter the behaviour of the recipient undertaking. As noted above in the context of the State aid and environmental domain, the incentive in question should be designed to subsidise the costs of relocating production for an undertaking. In the research and development domain, the incentive effect refers to any additional research activity the undertaking in question performs due to the provision of State support.[189]

Similarly, when developing a tiered cost-benefit analysis the value of the assets or liabilities designated for transfer or protection should be contingent on the incentive effect on the recipient financial institution. For example, where a financial institution has an underlying internal objective to remove the assets or liabilities on its balance sheet, but not the resources in place to achieve this objective, then in this case access to an asset relief scheme should be permitted. But the value of the assets or liabilities in question will then be determined on the associated benefits of participation and whether these equal or over-compensate the costs. In this case the behaviour of the financial institution has not necessarily been altered via an incentive but rather facilitated. However, where a financial institution has no internal objective to remove non-performing assets then this bank may require an incentive to participate in an asset relief scheme. Where this arises the cost-benefit analysis may need to reflect the counterfactual where this financial institution did not engage in an asset relief scheme and determine whether or not the "incentive" of asset relief itself should constitute a benefit.

In the above two examples, the first financial institution has pre-existing incentive to establish some form of asset relief scheme. This factor should then determine whether this bank falls under the first or second tier when ascertaining what compensation, it may receive via the transfer price. For this

[189] Commission Communication (2014/C198/01) of 27/06/2014 Framework for State aid for research and development and innovation [2014] OJ C198/01 at paras.62-65 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0627(01)&from=EN [last accessed on 07/11/2018].

financial institution a State backed asset relief scheme is simply facilitating a restructuring process that the bank would have to have undertaken in any case. In contrast, the second financial institution may have adopted an alternative restructuring path but has altered this course to participate in the State backed asset relief scheme. Hence for the Commission and Member State the key question for determining which tier this bank falls under, is whether in this counterfactual scenario the alternative restructuring plan would have yielded a better outcome than the asset relief scheme. If not, then this financial institution will fall under the second tier.

The proposed two tiers are as follows. Under the first tier, where the Commission concludes that the benefits for the recipient financial institution considerably outweighs the costs the level of support for the transferred assets should then only correspond to the current market value of the assets in question. In effect this should neutralise the financial benefit the recipient financial institution receives as a *quid pro quo* measure for the fact that this bank will remain an active market participant in the banking market in question. Furthermore, where this financial institution had an internal objective to engage in an asset relief process then this should also be reflected in the cost-benefit analysis. Rather than having to finance its own asset relief programme this bank has benefitted from a sector wide or individual scheme, thereby reducing its own operational costs.

Where the outcome of the cost-benefit analysis suggests that the recipient financial institution will require further support and restructuring as the costs negate any benefits, then the level of aid should reflect the original pre-crisis market value of the assets in question but the scope of the actual assets transferred should remain restrictive. The pre-crisis value in effect is a mechanism to alleviate the underlying costs against the benefits. This proposal would reduce the associated costs of restructuring and recapitalisation facing the financial institution. In effect this proposal acts as an incentive for the financial institution to engage with the asset relief scheme. However, not all assets would be transferred at this pre-crisis value as the position of the financial institution within the Member State's market would remain the central criterion for determining what percentage of assets would be subject to this price uplift. If the financial institution is in "a position of dominant failure", such as Anglo Irish Bank, then the assets that constitute the cause of this position of dominant failure should be subject to the discount price threshold. Assets that are not causal to a financial institution's position of dominant failure can then be transferred at the pre-crisis value threshold. This also ensures that the Member State in question will not have to provide further State aid as part of a separate capitalisation programme as was the case in Ireland. As the scope of loans transferred will be reduced for financial institutions in these circumstances, applying a pre-crisis value for the loans that are transferred should also help this financial institution offset the costs associated with the loans that remain on its balance sheet.

7.7.1. Competition distortion: Implied asset relief schemes

As in previous Chapters, the final section of this Chapter will focus on the application of the "proportionately" criterion in respect of asset relief schemes. Possible competition distortions may arise in respect of both bank guarantee schemes and bank recapitalisations. However, there are a number of competition distortions that an asset relief scheme may pose. If financial institutions are free to pursue high risk investments or lending strategies with the ultimate loss being borne by the State, then this may cause prudent market rivals to pursue the same strategy. A future State Aid Crisis Framework will have to address these possible competition distortion issues. In the United States, research on the adverse competitive effects on financial institutions within the banking sector has been conducted. For example, how asset relief measures may impact on different financial institutions was examined in respect of the Troubled Asset Relief Programme [hereinafter TARP] in the United States. One study conducted by Black and Hazelwood found that in respect of TARP, the larger recipient financial institutions adopted a lending policy for commercial loans that increased on average their risk rating.[190] In contrast, smaller TARP recipients had a lower risk-rating for their

[190] L. Black and L. Hazelwood, "The Effect of TARP on Bank Risk-Taking", Board of Governors of the Federal Reserve System, International Finance Discussion, IFDP 1043, March 2012 available at https://www.federalreserve.gov/pubs/ifdp/2012/1043/ifdp1043.pdf [last accessed on 07/11/2018].

commercial lending.[191] The authors suggest that one possible reason as to the different effect TARP funding had on financial institutions of different sizes was perhaps due to the "conflicting social objectives" of TARP.[192] These objectives included, recapitalising the relevant financial institutions while also ensuring that these same banks provided lending to the wider US economy. But according to the findings of Black and Hazelwood, the effect of this funding saw smaller banks actually restrict their lending while larger banks increased their scope of lending thereby exposing the latter to further risks. This example illustrates how asset relief measures may facilitate larger banks to engage in imprudent behaviour and so fail to resolve the longer-term systemic threats posed by these financial institutions.

Other commentators found that financial institutions with less stable funding sources availed of more capital from TARP than those banks that relied on deposit based funding.[193] While Bayazotiva and Shivdasani also found that TARP funding was "directed toward large banks and those with greater derivatives exposures, a pattern consistent with an objective of lowering systemic risk".[194] There are two main points that can be extrapolated from the findings of both Black and Hazelwood and Bayazotiva and Shivdasani. First, in times of systemic crisis larger financial institutions are likely to require more substantial State support than smaller financial institutions. Second, in most cases these larger financial institutions are more likely to be engaged in high risk banking markets and business lines and thus will require access to a funding source that can provide the capital for engaging in these activities. This in turn raises considerable questions in respect of competition distortion and asset relief schemes. In effect, the level of support devised under an asset relief scheme will depend on the market size and funding requirements of the applicant institution.

Therefore, such schemes by their very nature will trigger possible competition distortion within a banking market as the larger market participants will avail

[191] *Ibid* at p.18
[192] *Ibid* at p.19.
[193] D. Bayazotiva and A. Shivdasani, "Assessing TARP", (2012) Vol.25(2) The Review of Financial Studies pp. 377-407 at p. 404.
[194] *Ibid*.

of more support than smaller and more prudent competitors. These possible competition distortions do not just arise between different categories of recipient financial institutions but also between recipient and non-recipient financial institutions. One study undertaken by Berger and Roman found that TARP recipients did receive competitive advantages over non-recipient market rivals.[195] By utilising TARP funds, these financial institutions were able to increase their market share and also their market power in comparison with non-recipient financial institutions.[196] Applying a number of hypotheses the authors conclude that although there was a "cost disadvantage" to availing of TARP funds, this particular negative was offset by the "safety channel" associated with an institution participating in TARP.[197] Where a recipient financial institution succeeded in repaying the TARP funds early then this accentuated the positive effect of this "safety channel".[198]

Yet comparing the effects of TARP on the US banking sector with the possible distortionary effect of asset relief schemes adopted by EU Member States may not reflect an accurate benchmark. One clear divergence between the two was the former's dual role in not just purchasing toxic assets from participating financial institutions but also purchasing equity holdings in these banks.[199] Hence in many ways TARP was more than a standalone asset relief scheme and if anything mirrored more of a bank recapitalisation fund. But a number of measures under TARP were similar to those adopted by Member States during the financial crisis. For example, an Asset Guarantee Programme was implemented for both Citigroup and Bank of America, while under the Public Private Investment Programme guarantees and funds were provided to any party seeking to purchase mortgage-related securities from participating financial institutions.[200] Therefore, the adverse competitive

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[195] A. N. Berger and R.A. Roman, "Did TARP banks get competitive advantage?", Research Paper November 2013, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2270811 [last accessed on 07/11/2018].
[196] *Ibid* at p.29.
[197] *Ibid*.
[198] *Ibid*.
[199] B. Webel, "Troubled Asset Relief Programme: Implementation and Status", Congressional Research Service June 27th 2013 at p.1 available at https://www.fas.org/sgp/crs/misc/R41427.pdf[last accessed on 07/11/2018].
[200] *Ibid* at pp.2-3.

impact of TARP on the US banking sector does provide an illustration of how subsidising banks for non-performing loans may possibly distort the wider banking sector. A future State Aid Crisis Framework will, like the IAC, have to address the possible competition distortion issues that may arise when an asset relief scheme is utilised as a crisis resolution tool by a Member State. In fact, such competition distortions may have arisen in cases of past asset relief schemes within Europe.

For instance, in past European banking crises the adverse competition effects of asset relief schemes have also been subject to examination and comment. For instance, Bergström et al. concede that the State support provided to Nordbanken, the bank that primarily benefitted from the Swedish asset relief scheme, may have exceeded the "minimum necessary" to save this financial institution from collapse.[201] However, this support arguably aligned with the interests of the State as a "rational investor" so that the recipient financial institution could in time generate sufficient value for the Swedish State.[202] Further, the support provided to Nordbanken meant that the Swedish banking sector did not become less competitive with the exit of a market actor.[203] Therefore, for Bergstöm et al. the asset relief scheme provided to Nordbanken and the related guarantee scheme, was not necessarily a threat to market competition. However, the authors do concede that a State owning a major bank may raise interesting questions in respect of a future financial crisis.[204] A question not directly applicable to Nordbanken as this bank was later merged with a Norwegian bank to form the Nordea Banking Group. According to a 2006 report published by Nordic Competition Authorities, Nordea Bank had a market share in Sweden of just 16 per cent.[205] Hence, one could argue that any adverse effect on competition within the Swedish

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[201] C. Bergström, P. Englund and P. Thorell, "Securum and the Way out of the Swedish Banking Crisis", Summary of Report, Centre for Business and Policy Studies, May 2003, at p.7 available at https://www.sns.se/wp-content/uploads/2016/11/securum_eng.pdf [last accessed on 07/11/2018].

[202] *Ibid*.

[203] *Ibid* at p.8.

[204] *Ibid*.

[205] *Competition in Nordic Retail Banking*, A Report from the Nordic Competition Authorities No1/2006 at p.15 available at http://www.kkv.fi/globalassets/kkv-suomi/julkaisut/pm-yhteisraportit/nordic_retail_banking.pdf [last accessed on 07/11/2018].

banking sector were minor as other non-aided financial institutions expanded their market share. For instance, the same report states how both Handelsbanken and SEB had as of 2006 market shares of 27 and 24 per cent respectively.[206] However, there may be cases where asset relief schemes trigger more substantial competition distortions such as a financial institution utilising its unburdened balance sheet to reduce customer fees or increase lending at the expense of a non-aided market rival.

Although there are few studies on the possible adverse competitive effects arising from Japanese asset relief schemes. The subsequent in-depth restructuring of the banking sector as whole may have acted as a sufficient counter to possible competition distortions. A number of financial institutions were merged with market rivals and in certain cases the banking sector itself established asset relief schemes without recourse to State support.[207] Any longer-term competition distortions within the market were likely to be alleviated due to the fact that multiple financial institutions were receiving State support.[208] A similar argument could be posited in respect of NAMA and other asset relief schemes where a Member State's core domestic financial institutions all participated under these schemes. But there will always be cases from a Union wide perspective where certain financial institutions will not have required access to an asset relief scheme. Therefore, there remains a strong possibility that competition distortions occur where a financial institution is no longer encumbered by non-performing assets and so is free to extend market share at the expense of prudent competitors. A similar issue already arises as noted in Chapter 3 in respect of restructuring plans where the new unit is in effect able to maintain the legacy financial institution's market share without having to finance the costs now borne by the bad-bank.[209] Implementing an asset relief scheme for financial institutions

[206] *Ibid* at p.19.
[207] T. Hoshi and A. K Kashyap, "Solutions to Japan's Banking Problems: What might work and will definitively fail", Paper prepared for the US-Japan Conference on the Solutions for the Japanese Economy" Draft November 2004, at pp.20-21 and pp.25-26 available at http://faculty.chicagobooth.edu/anil.kashyap/research/papers/solutionsnov2004.pdf[last accessed on 07/11/2018].
[208] Although there may competition distortions depending on the level of support provided to specific financial institutions. See Chapter 5 at p.153.
[209] See Chapter 3 at p.41.

mirrors the moral hazard concerns associated with deposit insurance in respect of financial stability as raised by Dowd.[210] For instance, where a "bad bank" takes excessive risks, attracts deposits via high interest rates and then subsequently collapses this represents a penalty for both the depositor and the financial institution itself.[211] However, Dowd argues that the introduction of deposit insurance results in depositors failing to withdraw their funds and therefore a "bad bank" is not penalised for its reckless business strategy.[212] For Dowd "[t]he introduction of deposit insurance thus subverts the competitive process and makes prudent banking uncompetitive".[213] One could easily come to the same conclusion in respect of asset relief schemes where a financial institution receives a price premium for non-performing loans, and further may have access to additional State support if required as part of any wider recapitalisation need. This in turn places greater import on the competition distortion safeguards as set out under the Impaired Assets Communication and applied by the Commission in its decisional practice. By examining these one can then determine whether a new State Aid Crisis Framework should follow the same approach or encompass tailored competition distortion safeguards that better mitigate asset relief scheme related competition distortions.

7.7.2. Competition Distortion Safeguards and Asset Relief Schemes: The Commission's approach from burden sharing to claw-back mechanisms

A financial institution that avails of an asset relief scheme remains subject to certain behavioural and structural competition safeguards. In most cases these safeguards mirror those applicable to financial institutions subject to guarantee schemes and recapitalisation programmes. But distinguishing between the competition distortion remedies applicable to a financial institution that avails of an asset relief scheme and those applied as part of a recapitalisation plan is not always clear. However, the Impaired Assets

[210] K. Dowd, "Moral Hazard and the Financial Crisis" (2009) Vol.1 Cato Journal pp.141-166, at p.159 available at http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2009/1/cj29n1-12.pdf [last accessed on 07/11/2018].
[211] *Ibid*.
[212] *Ibid*.
[213] *Ibid* at p.160.

Communication does refer to two specific forms of competition distortion safeguards. These include claw-back mechanisms and burden-sharing. Both of these safeguards will now be examined below so that the proposed future financial crisis framework addresses specific competition distortion concerns that may arise from the introduction of an asset relief scheme that are not it is submitted sufficiently addressed under the current Impaired Assets Communication competition distortion safeguards. Although the Commission has published an AMC Blueprint for Member States in 2018 this document fails to add anything new to the asset relief scheme landscape for Member States and policymakers.[214] The actual cost-benefits for the participating financial institutions are not examined in detail.[215] This Blueprint accompanies the Commission Communication on the progress made thus far by Member States on reducing the non-performing loans on European financial institutions.[216] Progress that seems to have stalled in recent years and further indicates the need for a new asset relief scheme framework for a future financial crisis.[217] It may also be that such a new asset relief scheme framework will need to incorporate new competition distortion measures. Before one can determine this however the current competition distortion safeguards under the IAC will need to be critically assess.

7.7.3. Claw-back mechanisms as competition distortion remedy

As noted above, one specific competition distortion safeguards that is encompassed within the IAC is a claw-back mechanism. A claw-back

[214] Commission Staff Working Document, AMC Blueprint, Accompanying the document, Communication from the Commission to the European Parliament, to the European Council, the Council and the European Central Bank, Second Progress Report on the Reduction of Non-performing Loans in Europe, (COM(2018)133 final), Brussels 14/03/2018, SWD(2018)72 final at p.44 available at http://ec.europa.eu/finance/docs/policy/180314-staff-working-document-non-performing-loans_en.pdf [last accessed on 07/11/2018]: If anything the blueprint seems to endorse the structure of AMCs as established by Ireland and other Member States that is a centralised process.

[215] See pp.49-50 where the focus is again on long-term economic value of the transferred assets.

[216] Communication from the Commission to the European Parliament, to the European Council, the Council and the European Central Bank, Second Progress Report on the Reduction of Non-performing Loans in Europe, (SWD(2018) 72 final), Brussels 14/3/2018, COM(2018)133 final, at p.5 available at http://ec.europa.eu/finance/docs/policy/180314-communication-non-performing-loans_en.pdf [last accessed on 07/11/2018].

[217] *Ibid* at p.7, note there remains some €910 billion non-performing loans within the EU.

mechanism in effect allows for a Member State to seek some form of additional repayment or compensation for the aid provided at some future point in time. In the context of an asset relief scheme this mechanism allows for a Member State to seek compensation from a financial institution where the value of the transferred assets decreases further in value. From a competition distortion perspective this "remedy" has most to recommend it. On the one hand, not only does it provide some form of additional repayment for the Member State in question it also ensures that the recipient financial institution retains some financial liability for past imprudent behaviour. On the other though, one could posit that a claw-back mechanism does not necessarily act as an effective competition distortion remedy. By the time a Member State may seek to invoke a claw-back mechanism the initial distortive effect of the scheme will presumably have already either lapsed or become ingrained within the wider market. This ingrained effect may take the form of the recipient financial institution engaging in new business lines or simply maintaining its position as a direct competitor to unaided banks. For example, by the time the financial institution has the resources to meet the costs of the claw-back mechanism, without this adversely affecting its wider financial position, then the Member State may be repaid but the position of competitors may not necessarily be improved. A legacy form of moral hazard may remain in place whereby the aided financial institution remains operating in the market place. A new State Aid Crisis Framework will have to address this challenge as otherwise imprudent behaviour may generate benefits for certain financial institutions at the expense of not only market rivals but also taxpayers.

7.7.4. Burden-Sharing and Recapitalisation

Another aspect of asset relief schemes that raises interesting competition distortion issues is the level of burden-sharing imposed by the transfer price for the assets transferred. But the level of burden-sharing between financial institutions even under the same asset relief scheme may vary substantially. For example, in an Irish context loans transferred from Anglo Irish Bank were subject to a higher discount than the loans transferred from Allied Irish Banks and Bank of Ireland.[218] Therefore due to the nature of the Irish asset relief scheme, imprudent financial institutions, such as Anglo Irish Bank, were subject to more substantial burden-sharing and so there was a related competition distortion safeguard. However, the second strand of restructuring for Anglo Irish Bank entailed the Irish State recapitalising the bank for an amount far greater than that provided to either Allied Irish Banks or Bank of Ireland.[219] Thus a conflict arises where a participating financial institution is able to avail of a State funded recapitalisation that compensates for the burden-sharing strand of the scheme. The current IAC does not address this particular double-effect of asset relief schemes and recapitalisations that both derive their funding from State support and where a financial institution benefits from both forms of interventions. A future State Aid Crisis Framework must seek to resolve the possible competition distortion effects that may arise from this double-effect of asset relief schemes and recapitalisations.

7.7.5. Behavioural and Structural Constraints on Asset Relief Schemes under a new State Aid Crisis Framework

As noted above the two primary conditions the Commission imposes on financial institutions seeking to avail of the asset relief scheme, claw-back mechanisms and burden-sharing, are not necessarily effective competition distortion safeguards. Behavioural and structural measures may not necessarily constitute an effective remedy either depending on how these are applied. Curtailing the market behaviour of a financial institution may simply result in this recipient taking a specific course of action that in the absence of State support would have occurred in any case. Structural measures in a banking sector experiencing a systemic crisis meanwhile may not be possible due to the possible adverse consequences for the financial institution in

[218] Comptroller and Auditor General Special Report, National Asset Management Agency, Progress Report 2010-2012, April 2014 at p.21 available at https://www.nama.ie/fileadmin/user_upload/NAMAProgressReport_2010-2012.pdf [last accessed on 07/11/2018].

[219] Commission Decision SA.32057 (2010/NN) of 21/12/2010 *Temporary approval of the fourth recapitalisation and guarantee in respect of certain liabilities in favour Anglo Irish Bank*, OJ C(2010) 9503, at para.16 available at http://ec.europa.eu/competition/state_aid/cases/239758/239758_1187960_26_2.pdf [last accessed on the 07/11/2018].

question arising from these. For example, Ahlborn and Piccinin note how Commerzbank was required to exit a specialised lending market via the disposal of its Euro-loan division.[220] However, as this unit was sold off as a single undertaking the purchasing institution would still have a strong market position in this business line. Thus while the exit of Commerzbank from this market may have off-set any competition distortions arising from the aid provided to the financial institution, from a macro perspective the competition environment within this market as a whole did not alter. Other commentators have questioned the Commission's stance of imposing behavioural restrictions on recipient financial institutions that may ultimately undermine wider competition.[221] If one financial institution is restricted from becoming a price leader than there may be little appetite among other market participants to take this position thus adversely affecting the interests of consumers.[222] Therefore new proposed structural and behavioural constraints on asset relief scheme participants should not necessarily seek to mirror those as applied for recapitalisation aid. Rather any new proposals will need to directly address the specific competition distortions that may arise from an asset relief scheme.

If one considers the primary reasons behind an asset relief scheme, the removal of non-performing loans from a financial institution's balance sheet, then a number of related competition distortion safeguards can then be considered. For example, one proposed behavioural constraint that should be applied to a financial institution availing of an asset relief scheme should include this beneficiary agreeing to a future exit from the loan/asset market necessitating the asset relief intervention for the bank. Yet even this proposal may not represent the best way to effectively safeguard against competition distortion. For example, imposing such a constraint on banks such as Allied Irish Banks and Bank of Ireland may not necessarily affect their long-term

[220] C. Ahlborn and D. Piccinin, "The Great Recession and Other Mishaps: The Commission's Policy of Restructuring in Times of Crisis", in Erika Szyszczak ed., in *Research Handbook on European State aid Law*, (Cheltenham; Edward Elgar Publishing; 2011) p.124 at p.155.
[221] U. Soltësz and C. Von Köckritz, "From State aid control to the regulation of the European Banking System-DG Comp and the Restructuring of Banks", (2010) Vol.6(1) ECJ pp.285-307 at p.306.
[222] *Ibid*.

viability as both financial institutions were overly exposed to property-development related loans and financing. In effect, this constraint may merely align with how management within these financial institutions have responded post the crisis. Conversely, there may be cases where a financial institution has transferred assets to a bad bank under an asset relief scheme, but this related market may still remain a key area for future growth.[223]

Hence a financial institution may then need to alter its long-term business strategy if barred from engaging in this market segment. Post the 2008 financial crisis, it remains unlikely that any financial institution would develop a long-term business strategy that would encompass the purchase and holding of certain securitised products. However, there may be some cases where a specific market constraint could still constitute an effective competition distortion remedy if the market in question stabilises. In the case of Irish financial institutions such as Allied Irish Banks and Bank of Ireland, property development may in time become a profitable business line both within Ireland and in other jurisdictions. Therefore, a cap on the level of lending to this market may not only prevent a relapse of the past problems facing these financial institutions but also ensure that these banks will not require access to a future asset relief scheme for these very same assets.[224]

From a wider market perspective this market constraint should ensure that non-aided financial institutions could enter the market in question without having to compete against the pre-existing barrier to entry posed by the incumbent financial institutions. Further, a new market entrant may develop more efficient and innovative lending techniques and therefore drive now costs for the final consumer. This proposal would also meet wider macro

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[223] Bank of Ireland Annual Report 2017 at p.13 available at https://investorrelations.bankofireland.com/app/uploads/BOI-Annual-Report-2017.pdf [last accessed on 07/11/2018].

[224] A similar constraint to that applied to the mortgage lending currently enforced by the Central Bank of Ireland could be used as a basis for this proposed constraint. See *Review of residential mortgage lending requirements, Mortgage Measures 2017*, Central Bank of Ireland, at p.6 available at https://www.centralbank.ie/docs/default-source/financial-system/financial-stability/macroprudential-policy/policy-documents/2017-review-of-mortgage-market-measures5485cb134644629bacc1ff0000269695.pdf?sfvrsn=2 [last accessed on 09/01/2018].

banking objectives such as reducing possible market footprint of a Member State's domestic banks thereby also reducing the possible financial commitment these banks may require in a future financial crisis. Another wider macro banking objective that this proposal may also help meet is by ensuring that financial institutions may not fall under the position of dominant failure category as examined and set out in Chapter 6. For example, if financial institutions are restricted from lending to one particular sector such as property related lending then these financial institutions may then diversify their business models and thereby not become overly exposed to one specific economic activity. However, the possible competition distortion strands that derive from burden-sharing and recapitalisation when these two interventions are combined will still need to be addressed.

7.7.6. Burden-sharing and resolution funds

As noted above, in most cases when implementing an asset relief scheme, a Member State was also acting as the primary source for recapitalisation. A future Impaired Assets Communications should seek to align the objectives of stabilising a banking sector with those of bank resolution. How the proposed future State Aid Crisis Framework interacts with developments in banking resolution such as the Bank Resolution and Recovery Directive and the Single Resolution Mechanism will be discussed further in Chapter 9. But for the purposes of this Chapter the focus is on how to develop a new form of burden-sharing on financial institutions participating in an asset relief scheme other than a form of burden-sharing that results in the relevant Member State then reimbursing the bank in question. One possible option may be for a bank that receives State recapitalisation post any impaired asset relief scheme to remain liable for an increased bank resolution fund contribution as an additional form of burden-sharing.

Under this proposal participating financial institutions that remain active in a Member State's banking sector would still be subject to a form of claw-back mechanism once the wider financial sector has stabilised. Adler et al. when discussing the Commission's response to the financial crisis note how initially this body adopted a more flexible approach to addressing competition distortion in the initial phases of the 2008 crisis.[225] But “in the long-run a number of competitive distortions would arise, which must take some priority over other objectives” mainly financial stability.[226] In many ways this proposed competition distortion safeguard mirrors the graduated approach to financial crisis State aid enforcement set out Adler et al.. The initial objective of stability that an asset relief scheme is designed to achieve can still be pursued but longer-term competition distortions should then be addressed where possible. In effect the above proposal ensures that once stability has returned to a Member State’s banking sector, that any financial institutions that have not only received a price premium on their distressed assets but also received State recapitalisation post the asset relief scheme, discharge an additional contribution for this double-form of State support. There though does remain one other area of possible competition distortion that a new State Aid Crisis Framework may also have to address. That is the possible competition distortion that an asset management company itself may pose in its primary business lines of asset support and disposal.

7.7.7. Constraints on Asset Management Agencies

Although this may be considered a slightly different issue to address, a future State Aid Crisis Framework will have to encompass specific competition distortion safeguards that relate to the operation of asset management companies.

In certain cases, the management company in question may have a dominant position within a certain market for assets or loans. For example, if one management company holds a substantial number of distressed property related loans then this may distort the market position of non-State owned undertakings also engaged in the disposal of non-performing loans. Where this management company seeks to engage in a fire-sale of assets then this may undermine the financial position of competing market operators. Similarly, the various functions of an asset management company may

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[225] E. Adler, J. Kavanagh and A. Ugryumov, “State aid to Banks in the Financial Crisis: The Past and the Future”, (2010) Vol.(1)(1) Journal of Competition Law and Practice pp.66-71 at p.69.
[226] *Ibid*.

overlap with the market activities of financial institutions. For example, from an Irish perspective the role of NAMA is not simply that of a disposal vehicle but also encompasses a number of quasi-banking functions as set out under the *National Asset Management Agency Act 2009*.[227] These quasi-banking functions have raised competition issues when NAMA seeks to fund property development schemes within the Irish market with certain NAMA-borrowers or indeed directly which may undermine the position of non-NAMA based property developers. The financial resources of NAMA in effect constitute a competition distortion as private sector developers may not be able to compete.[228]

In January, 2018, the Commission found that NAMA did not pose a competition distortion on the Irish property market.[229] The Commission appears to have based this position on three central grounds. First, the agency only extends new loans to property developers when there is an underlying commercial rationale for doing so.[230] In effect the Commission found that when it comes to operating as a property investment actor, NAMA does so in line with how other private market operators would operate.[231] Second, the pre-existing support provided to NAMA had already been authorised by the Commission and the applicable conditions then established met by the agency.[232] Thus the Commission was not willing it seems to retrospectively reconsider its 2010 decision on NAMA. Third, the Commission found that NAMA's decision to extend credit to new property developments was in line with its mandate to receive the best possible financial return for the Irish State.[233]

[227] N.10 at ss.138-146.
[228] J. Brennan, "Vestager says Government must prod EU over to prioritise NAMA complaint", Irish Times (January 31st 2017) available at http://www.irishtimes.com/business/economy/vestager-says-government-must-prod-eu-to-prioritise-nama-complaint-1.2958420 [last accessed on 01//09/2017].
[229] Commission Decision, State Aid SA.43791, *Ireland, Alleged aid to and through the National Asset Management Agency*, Brussels, 25.01.2018, OJ C(2018)464 final, available at http://ec.europa.eu/competition/state_aid/cases/272163/272163_1964479_141_2.pdf [last accessed on 09/102/107].
[230] *Ibid* at para.102.
[231] *Ibid* at para.97.
[232] *Ibid* at para.79.
[233] *Ibid* at para.92.

Despite the Commission’s findings in this case, there remains a failure on the part of the Impaired Assets Communication to establish competition distortion measures on asset management companies such as NAMA. Therefore, any future Impaired Assets Communication should contain specific competitive constraints in cases where a bad-bank may seek to engage in activities that undermine non-aided competitors. These constraints should include a hypothetical asset-management company test, whereby if a private asset management company provides support on similar terms to a borrower then no State aid concerns arise. In effect this test mirrors the market economic investor principle but with an additional social objective strand so that if a common good, such as increasing the provision of housing in a constricted market place, is part of this support then the aid should be considered compatible with the internal market provided this aid is not excessive. Under these proposals the onus would be on both the Member State and relevant asset management company to prove that there is a social objective so that any market activities by this asset management company remain compatible with any future Impaired Assets Communication under a new State Aid Crisis Framework.

Conclusion

A future financial crisis is likely to entail a number of different responses from Member States and the Commission. Asset relief schemes will play a key role in future financial crisis along with bank guarantee schemes and recapitalisation programmes. Past financial crises in the Nordic countries, United States and Japan, saw the emergence of bad-bank programmes as a possible crisis response. However, in these past cases the question of State aid was not a factor that had to be assessed as these jurisdictions did not have equivalent controls in place. The 2008 financial crisis saw policymakers in Member States seek to leverage past financial crisis responses and so in some cases bad-bank schemes or similar were adopted. The Commission’s response was then to formulate a specific Communication setting out the restrictions and conditions these schemes would have to adhere to. But the resultant Impaired Assets Communication, while it did set down parameters for the transfer price of impaired assets and the scope of risk-guarantee schemes, failed to contextualise this for specific participating financial institutions. The actual underlying cost-benefit analysis of participation in an asset relief scheme should be examined to determine the final transfer price a financial institution should then receive. In this way, the level of aid provided should not be subject to an open-ended concept such as long-term economic value but instead based on the underlying benefits and costs for each participating financial institution.

In a similar vein, the competition distortion safeguards under the current Impaired Assets Communication do not effectively counter the possible distortions arising from asset relief schemes. Although, applying a cost-benefit test to the transfer price of impaired assets should to some degree address any possible competition distortions related to this strand of the scheme. The fact remains that in some cases, such as in the case of the Irish banking sector, the participating financial institutions will then avail of State recapitalisation schemes. Therefore, new competition distortion safeguards will need to be established that specifically address this dual State aid aspect of State asset relief and recapitalisation intervention. These new safeguards should restrict the participating financial institutions from engaging in future with the market segment in question that required the introduction of an asset relief scheme during the financial crisis. Further, financial institutions that have participated in an asset relief scheme should then be liable for an additional contribution to any future bank resolution fund. This particular safeguard should ensure that these financial institutions are subject to a claw-back mechanism that ties in to the current bank resolution regime but also provides a cross-subsidy for the wider banking sector. Finally, although not directly related to the State aid provided to financial institutions, there may be certain cases where a State established asset management company may itself pose a threat to competition. To ensure that any future Impaired Assets Communication also resolves this potential competition threat, a hypothetical asset management test should apply whereby if the acts of the State asset management company mirror those of a private undertaking, then no State aid concerns arise. Further, if the State asset management company does have a legitimate social objective then this should constitute an exemption from the hypothetical asset management test.

This Chapter has sought to examine the current Impaired Assets Communication and from this examination identify areas of possible improvements for a new State Aid Crisis Framework. In this way Member States and the Commission will not only be able to apply the proposed tests for guarantee and blanket guarantee schemes under Chapter 4, the systemic importance and long-term viability tests set-out in Chapters 5 and 6, but also now apply a new test for asset relief schemes. However, the question remains how a new State Aid Crisis Framework will interact with developments in the bank resolution domain. This will be examined in Chapter 8.

Chapter Eight: European Developments in the Bank Resolution and Supervision Domain

Introduction

The aim of this Chapter is to set out the bank resolution regimes that were adopted by EU Member States in order to address the 2008 financial crisis and subsequent developments. What becomes clear is that in most cases the bank resolution tools and procedures established usually mirrored each other from one jurisdiction to the next. However, post the 2008 crisis there was a drive towards establishing a uniform bank resolution process via the introduction of a Bank Recovery and Resolution Directive and a Single Resolution Authority. Other pan-EU financial supervision and bank recapitalisation developments are also critically assessed such as the Single Supervisory Mechanism and the European Stability Mechanism.

After evaluating these developments one can then seek to propose possible future solutions designed to resolve future financial crises. Further, these proposals should dovetail with the proposed future State Aid Crisis Framework for banks that has been set out in the preceding Chapters and that will be summarised in Chapter 9. A future State Aid Crisis Framework cannot function in isolation from developments in the bank resolution domain. This Chapter will seek to illustrate how both domains can be utilised in conjunction so that the interests of both Member States and taxpayers are preserved in any future crisis environment.

8.1.1. Member State Bank Resolution Legislation: Ireland, the United Kingdom and others

The absence of a centralised bank supervisory and resolution authority during the 2008 financial crisis meant that Member States developed their own bank resolution legislation tailored to address the problems facing their own domestic institutions. From an Irish perspective, the introduction of the 2008 blanket guarantee scheme limited the scope of any possible bank resolution legislation. Therefore the Irish authorities first introduced the *Credit*

Institutions (Financial Stabilisation) Act 2010 so that some form of direct control could be exercised over Irish financial institutions that had received State support.[1] For example, under a Special Management Order, the Minister of Finance could appoint a Special Manager to exercise day-to-day management over a financial institution on behalf of the State.[2] This order was exercised under the preceding *Central Bank and Credit Institutions (Bank Resolution) Act 2011*, in relation to an Irish Credit Union but not in respect of an Irish bank.[3] However, the Minister of Finance did utilise a Direction Order under the 2010 Act, whereby the relevant bank had to comply with the course of action set out in this order.[4] Examples of Direction Orders under the 2010 Act usually related to the respondent institution, such as Allied Irish Banks, issuing new shares to the Irish State at the expense of existing shareholders.[5]

Despite the wide ranging scope of the Irish guarantee scheme the 2010 Act did include a specific intervention tool that enabled the Minister for Finance to impose losses of subordinated creditors. These Subordinated Liabilities Orders were frequently used in respect of Allied Irish Banks creditors whereby the original terms of the bonds purchased by these parties were unilaterally altered.[6] In this way the amount of debt outstanding to these subordinated creditors could be reduced substantially via extending the date for repayment or altering the level of interest payments.[7] Although it may be difficult to make a distinction between bank stabilisation and resolution legislation, in an Irish context there was also a separate *Central Bank and*

[1] *Credit Institutions (Financial Stabilisation) Act 2010* at s. available at http://www.irishstatutebook.ie/eli/2010/act/36/enacted/en/html [last accessed on 09/10/2017].
[2] *Ibid* at s.14(1)-(7).
[3] Memorandum on the intervention conditions and other matters relevant to seeking a Transfer Order for Newbridge Credit Union ("NCU") under the Central Bank and Credit Institutions (Resolution) Act 2011 (the "2011 Act"), para.5, available at *http://static.rasset.ie/documents/news/resolution-report.pdf* [last accessed on 07/11/2018].
[4] N.1 at s.9(1)-(8).
[5] Department of Finance, "Direction order in relation to Allied Irish Bank under the Credit Institutions (Stabilisation) Act 2010" (Press release, December 23, 2010), available at *http://www.finance.gov.ie/news-centre/press-releases/direction-order-relation-allied-irish-banks-under-credit-institutions* [last accessed on 07/11/2018].
[6] *Allied Irish Banks plc, -Subordinated Liabilities Order*, April 14th 2011, available at ttps://group.aib.ie/content/dam/aib/group/Docs/Press Releases/2011/14-04-2011-aib-subordinated-liabilities-order.pdf [last accessed on 07/11/2018].
[7] *Ibid* at p.3.

Credit Institutions (Resolution) Act 2011.[8] This Act would establish a specific bank liquidation process and a resolution fund for Irish banks.[9] Further, a number of resolution tools were also introduced which mirrored those of the 2010 *Stabilisation Act* such as transfer orders.[10]In the United Kingdom, a hybrid approach was adopted initially; for instance, the *Banking (Special Provisions) Act 2008* was used to transfer deposits from Kaupthing Singer, but the remaining residual entity fell under the auspices of the *Insolvency Act 1986*.[11] Other Member States introduced banking legislation with a contemporary focus, legislation designed to address the market instability triggered by the sub-prime crisis. A number of parallel provisions arise in the various national regimes adopted throughout the EU. For instance, the *Dutch Intervention Act of 2013* contains provisions which mirror those found in the Irish resolution and stabilisation Acts.[12] Although certain nuances do arise; for instance, the UK *Financial Services (Banking Reform) Act 2013* contains a "ring-fencing" provision which has no direct parallel under the Irish Acts.[13] While under the initial German legislation, the *Bank Restructuring Act 2009* which enacted the related *Credit Institutions Re-organisation Act*, included a specific provision whereby third parties could not execute their termination rights against a bank that had entered the reorganisation process or was party to a transfer order.[14]

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[8] *Central Bank and Credit Institutions (Resolution) Act 2011* available at http://www.irishstatutebook.ie/eli/2011/act/27/enacted/en/html [last accessed on 07/11/2018].
[9] *Ibid* at ss.75-90 and ss.10-16.
[10] *Ibid* at ss.20-30.
[11] Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008 (S.I. No. 2674 of 2008) art.20 available at **http://www.ksfiomdepositors.org/sites/www.ksfiomdepositors.org/files/uksi_20082674_en.pdf** [last accessed on 07/11/2018].
[12] "Unofficial translation dated 11 July 2013 of the Explanatory Memorandum to the Act on Special Measures for Financial Corporations (Intervention Act)", p.10, available at http://www.toezicht.dnb.nl/en/binaries/51-228545.PDF [last accessed on 07/11/2018].
[13] *Financial Services Market Abuse Act 2000* s.142B(2), *as inserted by s.4(1) of the Financial Services (Banking Reform) Act 2013* available at http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf [last accessed on 07/11/2018].
[14] *Fundamental features of the Bank Restructuring Act*, German Bundesbank, Monthly Report June 2011, at p.66 available at https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2011/2011_06_%20fundamental_features_german_bank_restructuring_act.pdf?__blob=publicationFile [last accessed on 07/11/2018].

8.1.2. The drive towards uniformity: The Bank Resolution and Recovery Directive and the Single Resolution Mechanism

Therefore at a supranational level, particularly in light of the Financial Stability Board's key attributes of bank resolution,[15] Member States have now, post-crisis, implemented bank resolution regimes in most cases with shared common features. This drive towards harmonisation across EU Member States has continued with the introduction of the Bank Resolution and Recovery Directive.[16] This effort among Member State governments and EU policymakers was part of a wider objective to form a European Banking Union. Thus instead of Member States acting in an unilateral manner to resolve a domestic banking crisis there would be a pan-EU bank recovery and resolution architecture in place whereby the Union as a whole rather than individual Member States would be liable for the costs related to bank bail-outs. Certain commentators have also stressed the advantages that may arise from having a single resolution authority. For instance, Goyal et al. state that a "single resolution authority would support market discipline and should minimise the costs of individual failing banks".[17] But with a single resolution authority there is a need for a single supervisory authority and set rules on how banks should be resolved or subject to recovery procedures.

The Commission's Communication on a Roadmap to a Banking Union also focuses on the multi-facetted nature of any proposed consolidation and centralisation of the bank supervision and resolution process.[18] Thus the three

[15] "Key Attributes for Effective Resolution Regimes for Financial Institutions" Financial Stability Board (October 2014 version), available at http://www.fsb.org/wp-content/uploads/r_141015.pdf [last accessed on 07/11/2018].
[16] Directive 2014/59 of May 15, 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Directive 82/891, and Directives 2001/24, 2002/47, 2004/25, 2005/56, 2007/36, 2011/35, 2012/30 and 2013/36, and Regulations 1093/2010 and 648/2012 [2014] OJ L173/190 available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014L0059 [last accessed on 07/11/2018].
[17] R. Goyal, P.K. Brooks, M. Pradhan, T. Tressel, G. Dell'Ariccia, R. Leckow, C. Pazarbasioglu, and IMF Staff Team, "A Banking Union for the Euro Area" IMF Staff Discussion Note, February 13th 2013, at p.8 available at https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf [last accessed on 07/11/2018].
[18] Commission Communication, A Roadmap towards a Banking Union, of 12/09/2012, COM(2012)510, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0510&from=EN [last accessed on 07/11/2018].

areas initially referred to in the Roadmap include a new Capital Requirements Directive, (CRDIV), so that banks would have to hold sufficient capital to meet any future crisis scenario, greater harmonisation between Member State deposit protection schemes and a new set of recovery and resolution tools for European banks.[19] The Roadmap also sets out the proposal for a Single Supervisory Mechanism, whereby a new hybrid approach to banking supervision would be established encompassing not just national regulators but also the European Central Bank.[20] The next strand of the Banking Union, the Single Resolution Mechanism, was considered to be a key "underpin[ing]" for the Single Supervisory Mechanism although this would require transitional financing before sufficient bank levies could be generated.[21]

Therefore, post the 2008 crisis there has been a consistent drive among EU policymakers to establish a new banking supervision and resolution response so that Member States do not become isolated in times of financial crises. Yet whether the above proposals can indeed resolve the bank-sovereign debt loop evident during the 2008 crisis remains open to question. The specific tents of the post-crisis resolution process will now be examined below.

8.1.3. Resolution Triggers under the Bank Resolution and Recovery Directive

The resolution and recovery process as envisaged by the Bank Recovery and Resolution Directive [hereinafter the BRRD] can be best described as two-pronged. First, there is the planning element setting out the proposed resolution process. Followed by the second prong, the actual exercise of the resolution or recovery powers as established under the BRRD. Under the planning element, the relevant resolution authorities must develop resolution plans.[22] The central objective of a resolution plan is to establish, in essence, a map for the resolution authority to follow. A resolution plan may entail the

[19] *Ibid* at p.5.
[20] *Ibid* at p.7.
[21] Statement of Eurogroup and ECOFIN Ministers on the SRM Backstop, 18th December 2013 available at www.consilium.europa.eu/.../Statement-of-Eurogroup-and-ECOFIN-Ministers-on-the-... [last accessed on 09/10/2017].
[22] N.16 at art.10(1).

division of assets and the bail-in of certain liabilities.[23] Under the BRRD, the trigger for executing a resolution plan arises once the resolution conditions are satisfied.[24] In summary, these conditions detail the erosion in an institution's financial position to a point where the institution will "fail or is likely to fail", no alternative rescue scheme will work, and it is in the public interest to resolve the institution.[25] However, it is not difficult to foresee Member States in times of systemic crisis adopting some form of pre-emptory measures to ensure that an institution offsets these resolution conditions. Such measures are likely to involve recourse to State resources. Alternatively, a Member State may seek to ensure that an institution falls under the recovery strand of the BRRD rather than risk further instability by invoking resolution.[26] Yet this institution may have no actual long-term prospects.[27]

8.1.4. Resolution Tools

Under the BRRD, the resolution tools must comply with the resolution principles as set out in art.34 of the Directive such as imposing losses on shareholders and creditors while precluding depositors from any loss in line with deposit protection schemes.[28] Depending on the circumstances at the time of the resolution, different tools or combination of tools may be deployed. A sale-of-business tool may ensure that the profitable divisions of a financial institution may be transferred to a viable undertaking, thereby ensuring the continuation of critical functions.[29] Alternatively, an interim response may be more effective on stability grounds and so a bridge-bank tool may be required to hold certain assets or liabilities until a more permanent solution can be implemented.[30] The question does remain however, as indeed it does in relation to resolution tools under national resolution regimes, whether these asset transfer tools are exercisable in times of systemic crisis when, realistically, asset values may be depressed. Such a problem may also

[23] *Ibid* at art.10(7)(p) and (q).
[24] *Ibid* at art.32(1)(a)–(c).
[25] *Ibid*.
[26] *Ibid* at art.5(1).
[27] See further below at p.
[28] N.16 at art.34(1)(a),(b) and (h).
[29] *Ibid* at art.38(1)(a) and (b).
[30] *Ibid* at art.40(1)(a) and (b).

impact on any efforts to apply an asset separation tool. At first glance, this may appear as another term for a transfer order, but the specific aim of this tool is to transfer assets or liabilities to various asset management vehicles.[31] Therefore, the BRRD appears to envision a resolution process where asset management vehicles perform a central role. To ensure that certain creditors do not receive a subsidy from the resolution process, a bail-in tool may also be used in conjunction with other resolution tools.[32]

However, the BRRD expressly precludes certain liabilities from the effects of the bail-in tool, but other liabilities may also, at the discretion of the resolution authority, remain immune from any "bail-in".[33] This exception, which narrows the range of liabilities subject to bail-in, undercuts the effect of the bail-in tool if certain subordinated creditors receive full repayment. Such an exception may raise moral hazard concerns and entail a Member State providing additional funds to the institution subject to resolution.

A number of these resolution tools have already been applied in practice across different Member States. For example, in Greece the sale-of-business tool was used to facilitate the transfer the deposits of Bank of Peloponnese to another financial institution without imposing losses on the affected depositors.[34] In Italy, the authorities decided to utilise the bridge-bank tool in order to wind-down four regional banks, and replace them with new financial institutions.[35] While the authorities in Denmark applied both the bail-in tool and bridge-bank tool to allow for the resolution of Andelskassen.[36]

8.2.1. Single Resolution Mechanism and Single Resolution Fund

With the introduction of the Single Resolution Mechanism [hereinafter SRM], domestic resolution funds will gradually be merged to form one single

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[31] *Ibid* at art.42(1).
[32] *Ibid* at art.43(2)(a) and (b).
[33] *Ibid* at art.44(2)(a)–(g) and art.44(3)(a)–(d).
[34] *Bank Resolution and "Bail-in" in the EU: Selected Case Studies Pre and Post BRRD*, World Bank Group, Finance and Markets, Financial Sector Advisory Group (FinSAC), at p.33-34 available at http://pubdocs.worldbank.org/en/120651482806846750/FinSAC-BRRD-and-Bail-In-CaseStudies.pdf [last accessed on 07/11/2018].
[35] L. Stanghellini, "The Implementation of the BRRD in Italy and its First Test: Policy Implications", (2016) Vol.(2)(1) Journal of Financial Regulation pp.154-161 at p. 159.
[36] N.34 at p.26.

resolution fund hereinafter SRF].[37] There are some positives to this—a future EU banking crisis may require funds which no individual domestic resolution fund has the scope to provide. But disadvantages also persist. Firstly, certain banks such as BNP Paribus may pay more than other institutions into the SRF but still remain "too big to fail".[38] The SRF may simply become an internal banking industry subsidy where certain financial institutions outside of the "too-big to fail" remit provide support to competing institutions with a "too big to fail" shield. Secondly, the bank-sovereign link may be initially severed but any erosion in the SRF's resources in a systemic crisis may make participating institutions reluctant to commit emergency funding without some form of guarantee from Member States. Thirdly, the SRF may cause further contagion as, if one institution triggers SRM intervention, then investors and depositors may presume that an institution with a similar business model in a different jurisdiction may follow the same path. Some of these issues are also relevant when one considers the flaws of domestic resolution funds. However, centralising the costs of resolution at a supranational level may concentrate risk, whereas a more fragmented approach may actually prove more efficient and also constitute a more effective counter against a pan-EU crisis arising again.

8.2.2. General Principles and the Role of the Board

The actual management and oversight exercised over the SRM will be retained by the Single Resolution Board [hereinafter the Board]. Any decision made by the Board must correspond to certain principles as set out under Article 6 of the Regulation.[39] Thus the Board cannot "discriminate" between financial institutions and parties located within the common market or

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[37] Article 67(4) of Regulation 806/2014 of July 15, 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation 1093/2010 [2014] OJ L225/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN [last accessed on 09/10/2017].

[38] Current market capitalisation of BNP Paribus as of December 31 2017 is €77 billion, see Annual Report available at https://invest.bnpparibas.com/sites/default/files/documents/ddr2017-gb-bnp_paribas-160317.pdf [07/11/2018].

[39] N.37 at art.6(1).

between financial institutions and parties within and out the EU.[40] When performing this role the Board must give due weight to the resolution objectives under Article 14 and a number of other factors. These other factors include the "interests of Member States where the group operates" and the possible effects the decisions of the Board may have on Member States' "financial stability", economies or any bank fund protection schemes.[41] How exactly the Board can weigh up each of these objectives remains unclear. The aim of the SRM is to facilitate the orderly wind up of a bank without triggering further instability yet the issues the Board must have regard to seem to cast a contradictory light. One of the key failings of the 2008 crisis was the hesitancy of Member States to liquidate insolvent institutions due to the potential adverse consequences this reaction may generate. Therefore, a policy of containment was adopted as the default mechanism where State aid was advanced to prop up ailing institutions. Unfortunately, the same grounds for containment must now be considered by the Board. Therefore, the question must be asked whether the Board will adopt a conservative position whereby once these factors are assessed containment rather than resolution is favoured. A problem Beck et al. describe as the "'post-Lehman' syndrome" where resolution is by-passed due to the potential for further instability.[42]

In a recent decision, the Board considered the acquisition of the failing financial institution Banco Popular Espanol by Banco Santander to comply with the resolution objectives.[43] However, the macro economic climate in 2017 was not that of 2008 and so any resolution process would presumably be considered adequate to meet the public interest grounds of the SRM regulation. On closer examination the acquisition of Banco Santander of Banco Popular Espanol hardly constitutes a resolution action in line with the

[40] *Ibid* at art.6(3)(a)-(c).
[41] *Ibid* at art.6(3)(a).
[42] T. Beck, D. Gros, D. Schoenmaker, "On the Design for a Single Resolution Mechanism" in Directorate General for Internal Policies *Banking Union Single Resolution Mechanism* Monetary Dialogue February 2013 p.29 at p.35 available at http://www.europarl.europa.eu/document/activities/cont/201304/20130422ATT64861/20130422ATT64861EN.pdf [last accessed on 07/11/2018].
[43] Notice summarising the effects of the resolution action taken in respect of Banco Popular Espanol pursuant to Article 29(5) SRMR, Single Resolution Board, 7th June 2017, available at https://srb.europa.eu/sites/srbsite/files/note_summarising_effects_07062017.pdf [last accessed on 07/11/2018].

actual winding-down of the failing financial institution. One must question whether in times of systemic upheaval and the absence of a willing purchaser would the Board have come to the conclusion if the resolution action in question resulted in the actual closure of the bank.[44] Therefore, the Board's position in respect of Banco Popular Espanol does not necessarily provide any real insights as to whether it will or will not fall prey to the "Lehman syndrome".

8.2.2.1. The Interests of Member States

Any efforts the Board must undertake to satisfy the "objective of balancing the interests of the various Member States involved" may also be impractical in financial instability.[45] During the last crisis another supranational European body, the ECB was considered by some commentators to be influenced heavily by German considerations.[46] This power imbalance is also likely to arise in the work of the Board. Thus despite the sentiment behind this "balancing of interest" clause the reality is that Member States with the largest banks and the largest economies are likely to dictate the intricacies of any resolution response regardless of the adverse effects on other Member States.

In a similar vein the Board must also be cognisant of the "need to minimize a negative impact" for a wider group entity if one subsidiary is placed into resolution and consider the "possible negative effects on non-participating Member States" and other institutions in that locale if the institution earmarked for resolution straddles both participating and non-participating jurisdictions.[47] Politically the Board has a difficult tightrope to thread in respect of any decision which may impact on a "non-participating Member State" as such an outcome may be seen as penalising these Member States and in effect driving a wedge between SRM and non-SRM Members.

[44] *Ibid*.
[45] N.37 at art.6(3)(b).
[46] D. Beckworth, Is There Really A German Bias at the ECB? available at http://macromarketmusings.blogspot.ie/2012/01/is-there-really-german-bias-at-ecb.html [last accessed on 07/11/2018].
[47] N.37 at art.6(3)(c) and 6(4).

The Board when striving to balance the resolution objectives with all these other caveats must do so "as appropriate to the nature and circumstances of each case" and adhere to any Commission decision under Article 107 TFEU.[48] Article 6(6) also precludes any decision of the Board placing an obligation on a Member State to provide "extraordinary public financial support".[49] This clause highlights the constraints of how the Board can only utilise Single Resolution Fund [hereinafter the Fund] resources to execute a resolution rather than availing of an open recourse to Member State resources.

8.2.3. The role of the Board: resolution plans and the question of resolvability

When exercising the powers of a national resolution authority as established in the Recovery and Resolution Directive the Board automatically co-opts the position of the latter.[50] It remains difficult to ascertain the exact reasoning behind Article 5(1). Does it for instance allow for the Board to step in and perform a dual role as a central decision making body but also perform the role of a particular national resolution authority during this process? In any case, the Regulation also envisions the Board working in conjunction with national resolution authorities on certain tasks including adopting resolution plans and assessing the resolvability of a financial institution.[51] One commentator succinctly conveys what a resolution plan should strive to achieve namely to ensure "the effective use of the resolution authority's powers" and "achieve an orderly resolution in the event that recovery measures are not feasible".[52]

For the Board the central question when producing a resolution plan is whether a financial institution remains "resolvable". A financial institution remains "resolvable if it is feasible and credible" to utilise the "normal insolvency proceedings" or the resolution powers and tools under the

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48 *Ibid* at art.(6)(5).
49 *Ibid* at art.(6)(6).
50 *Ibid* at art.5(1).
51 *Ibid* at art.7(3)(a).
52 E. Hüpkes, ""Living Wills"-An International Perspective" in Andreas Drombret and Patrick S. Kenadjian, ed. *The Bank Recovery and Resolution Directive* (Berlin: Walter de Gruyter, 2013) p.71at p.82.

Regulation without triggering systemic instability in a Member State or the wider Union.[53] It seems somewhat contradictory that this “resolvability” test contains an element rooted to whether the pre-existing “insolvency proceedings” are actually deployable or not considering that one of the reasons for the SRM is to replace inadequate domestic resolution legislation. If certain resolution plans contain “impediments to resolvability” then the Board may propose how such obstacles can be surmounted.[54] Alternatively a sharper approach may be adopted where the Board instructs the national resolution authority to coral a financial institution to address these “impediments”.[55]

It remains unclear whether the Board should assess “resolvability” by examining the potential internal problems which may arise in a financial institution or by examining whether the same financial institution could be resolved in times of a systemic crisis. Thus if the Board examines “resolvability” solely on the individual merits of a firm during times of financial stability the “resolvability” criterion may be met yet in an acute market environment the same financial institution may pose a systemic risk thereby failing the “resolvability” condition. Therefore, for the Board determining whether or not a financial institution is resolvable may ultimately depend the question of whether a financial institution is systemically important or not in times of financial crisis.

8.3.1. Single Resolution Mechanism, State aid and the problem of systemic importance

As noted above it remains to be seen how exactly the establishment of the SRM will resolve the problem of systemic importance. Even in cases where the “impediments of resolvability” are removed there still remains the underlying problem posed by contagion. Determining whether or not a financial institution actually meets the resolvability criteria, focuses the question of resolution solely within the confines of one particular bank. The

[53] N.37 at art.10(3).
[54] *Ibid* at art.10(7).
[55] *Ibid* at art.10(10).

inter-dependency this same financial institution may have with other banks and financial service firms is not one of the factors the SRM must consider when examining the question of "resolvability". In an isolated market disruption, a financial institution may be easily resolved but the question of "resolvability" becomes far more complex during a systemic crisis. Even financial institutions with specialised or limited business lines may fall under the systemically important remit in cases where they provide some infrastructural support to other market participants.

The SRM Regulation regularly refers to the problems posed by contagion but fails to provide any solution as to how this issue may be overcome. Under Article 2 of the Regulation, the resolution objectives include the need for "preventing contagion".[56] But the only way in which this contagion may be "prevented" is by the exclusion of certain liabilities from the scope of the "bail-in" tool. Yet such a response to the threat posed by contagion fails to adequately address the underlying issue of systemic importance. Although the Regulation does refer to "impediments to resolvability" this is not necessarily the same as addressing the problems posed by "systemic importance".[57] Even where a National Resolution Authority and the SRM successfully remove such impediments, the fact remains that a financial institution may not be "resolvable" in times of a systemic crisis. This in turn raises issues in respect of how the SRM process will interact with State aid measures where "resolvability" tools may prove inadequate.

For instance, a "bridge-institution tool" may entail some form of State support in order to be successfully applied, while an "asset-separation tool" may also require State aid so that certain assets may be transferred to a viable financial institution. "Extraordinary public support" may be required in certain cases to restore the long-term viability of a financial institution.[58] Presumably, any recourse to State aid would only arise where the resources of the SRF no longer suffice to finance the resolution or restructuring of a failing financial institution. Both the relevant Member State and the Board will perform a role

[56] *Ibid* at art.14(2)(b).
[57] *Ibid* at art.10(3)-(4).
[58] N.16 at art.56(1).

in submitting a State aid application to the Commission.[59] Hence the Commission will reprise its role as a State aid monitoring body determining whether any aid application remains compatible under Article 107(1) TFEU.

The Regulation fails to expressly state which subsection of Article 107TFEU an application involving SRF aid may fall under. There may be occasions where a financial institution falls into difficulty during a period of relative economic calm and the wider threat of contagion, while present, does not actually qualify under the "serious economic disturbance" exemption under Article 107(3)(b)TFEU. If such a situation arises then what framework does the Commission apply when assessing an SRF aid application? The Commission arguably adopted a relatively low threshold for State aid compatibility during the financial crisis. Therefore, will a similarly low benchmark be applied for SRF aid applications? The establishment of the SRF does to some degree resolve the problems associated with the sovereign-bank link where a Member State must provide continuous State aid to an ailing financial institution. Contributions from the banking sector should be utilised to fund the resolution of an insolvent bank. However, under the BRRD Member States may still exercise "extraordinary financial stabilisation support" after the resolution tools have already been utilised, the opposite of pre-cautionary capitalisation if you will.[60] This financial support may encompass a "public support equity tool" while the other is the "temporary public ownership tool".[61]

Therefore, if the resolution tools under the BBRD fail to resolve the financial institution in question then the Member State may invoke State support tools. But one must question how exactly, in effect, State aid tools can be utilised in the event that the resolution tools are deemed to be ineffective. Does a scenario arise whereby a financial institution is initially earmarked for resolution but then due to the limited scope of the applicable resolution tools the financial institution is later deemed to have a long-term future as a viable bank? This particular issue illustrates one of the main failings with both the

[59] N.37 at art.19.
[60] N.58 at 56(3).
[61] *Ibid* at arts.57-58.

BRRD and the SRM Regulation. Both policy responses have not actually added anything new to the bank resolution architecture within the EU other than to establish an *ex ante* mechanism for bank insolvency. The effectiveness or otherwise of resolution tools ultimately depends on the wider financial context prevailing at the time of the bank insolvency and the actual market position the financial institution in question performs in the Member State's domestic economy.

8.4.1. State aid and Pre-cautionary Recapitalisations

Related to the above point, a Member State may be more willing to commit public funds in order to engender immediate stabilisation rather than to exercise resolution and recovery steps in a systemic crisis scenario. This undermines the central principle of the BRRD, namely to ensure that viable financial institutions are rescued while non-viable ones, such as Anglo Irish Bank, are resolved in a controlled manner and without cost to the State.

Already two Member States have sought to avail of the precautionary recapitalisation exemption in order to prevent the resolution of two regional financial institutions. Instead of the Italian authorities allowing both Banco Popolare di Vicenza and Veneto Banco to enter liquidation a State aid solution was applied.[62] Thus both banks were placed in a form of controlled insolvency whereby both senior bondholders and depositors would be exempt from burden-sharing. Both the Commission and the SRB came to the conclusion that any application of the new resolution rules could trigger an economic disturbance within the Veneto region.[63]The State aid in question encompassed a capital injection of €4.785 billion and a State guarantee with a maximum threshold of €12 billion.[64] Both the capitalisation and the guarantee were aimed at facilitating the transfer of the viable parts of both banks into the wider Intesa Sanpaolo banking group. However, on closer inspection this intervention if anything seeks to evade the scope of the new

[62] European Commission Press Release: Commission approves State aid for market exit of Banco Popolare di Vicenza and Veneto Banco under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo, Brussels 25th June 2017, available at http://europa.eu/rapid/press-release_IP-17-1791_en.htm [last accessed on 07/11/2018].
[63] *Ibid*.
[64] *Ibid*.

European resolution architecture and instead utilises a domestic insolvency framework with State aid support. Further, both the SRB and the Commission accepted the positon of the Italian authorities that any resolution action under the SRM and BRRD frameworks would likely trigger a regional economic disturbance.[65] Yet surely such a position runs counter to the very objective behind the introduction of a specific bank resolution framework, namely that a bank regardless of size could be resolved in a controlled manner without recourse to State resources.

From a State aid perspective it is also surprising that certain aspects of the Banking Communication were applied under Article 107(3)(b)TFEU even though a regional disturbance was considered a likely event from the demise of these banks rather than one of national disturbance. During the initial phases of the financial crisis the Commission was unwilling to apply Article 107(3)(b)TFEU in certain cases as the collapse of the bank in question may not have triggered "a serious economic disturbance". However, it now seems that even a regional disturbance is sufficient for the application of State aid intervention. This despite the fact that the SRB itself found that these financial institutions did not pose a systemic threat to the wider Italian economy.[66] While one may categorise the above intervention as in effect a State aided liquidation rather than a clear example of a "precautionary recapitalisation", the Italian State has exercised the latter option in respect of Monte dei Paschi Siena.[67] A financial institution that had already received State aid in 2013 from the Italian State and as Gray and de Cecco note had excessive exposure

[65] *Ibid*.
[66] Notice summarising the effects of the decision taken in respect of Banca Poplare di Vicenza S.p.A., 23/05/2017 available at https://srb.europa.eu/sites/srbsite/files/23.6.2017_summary_notice_banca_popolare_di_vicenza_s.p.a._20.00.pdf [last accessed on 07/11/2018].
[67] Commission Statement: Statement on agreement in principle between Commission Vestager and Italian authorities on Monte dei Paschi Siena, Brussels 1st June 2017, available at http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm [last accessed on 07/11/2018]. Commission Decision n0 SA.47677(2017/N) of 04/07/2017, *Italy-New aid and amended restructuring plan of Banco Montei dei Paschi di Siena*, OJ C(2017) 4690 final, at para.73 available at http://ec.europa.eu/competition/state_aid/cases/270037/270037_1951496_149_2.pdf [last accessed on 18/01/2019].

to Italian sovereign bonds in comparison with other Italian financial institutions.[68]

In effect this support was designed to circumvent the triggering of the resolution tools under the BRRD framework. The preamble of the BRRD specifically sets out how a Member State has discretion to inject capital into a bank in exchange for equity if certain scenarios arise such as a negative stress test.[69] In a similar vein the Greek authorities also invoked "precautionary recapitalisations" for Piraeus Bank and the National Bank of Greece.[70] Although not to subject to a "precautionary recapitalisation" the Irish financial institution Permanent Trusty Savings Bank had to be provided with further State aid to meet future European Banking Authority stress tests.[71] Clearly there is wider market and economic grounds for the Irish State to support Permanent Trusty Savings Bank in light of the current two pillar bank market currently in place as discussed in Chapter 6. A third banking force may curtail the market dominance of both Allied Irish Banks and Bank of Ireland. However, if one considers the fact that both Monte dei Paschi Siena and Permanent Trusty Savings Bank failed European Banking Authority stress tests then a related question must be asked in respect of long-term viability and bank resolution.[72]

If one of the central objectives of the new bank resolution architecture is to allow for the controlled resolution of a failing financial institution, then the

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[68] J. Gray and F. de Cecco, "Competition, stability and moral hazard: the tension between financial regulation and State aid control", in Francois Laprévote, Joanna Gray and Francesco di Cecco, ed., *Research Handbook on State Aid in the Banking Sector* (Cheltenham: Edward Elgar Publishing, 2017) p.20 at p.36: Commission Decision SA.36175 (2013/N) of 27/11/2013 *Italy-MPS-Restructuring*, OJ C(2013) 8427 final available at http://ec.europa.eu/competition/state_aid/cases/249091/249091_1518538_162_2.pdf [last accessed on 18/01/2019].
[69] N.16 at para.41.
[70] N.67.
[71] Commission Decision SA.33442 (2011/N) of 09/04/2015, *Ireland Restructuring of Irish Life and Permanent Group Holdings ltd*, OJ C(2015)2353 at paras.23-26 available at http://ec.europa.eu/competition/state_aid/cases/241557/241557_1662492_396_2.pdf [last accessed on 07/11/2018].
[72] Results of EU-wide stress test, European Banking Authority, 26th October 2014, at p.38 available at http://www.eba.europa.eu/documents/10180/669262/2014+EU-wide+ST-aggregate+results.pdf [last accessed on 07/11/2018].

"precautionary capitalisation" principle appears to undermine this objective. Perhaps the utilisation of the precautionary principle by the Italian authorities indicates that the resolution tools under the BRRD are simply not adequate to either prevent a systemic crisis from arising or to apply during a systemic crisis. This is not to say that Permanent Trusty Savings Bank or Monte dei Paschi Siena do not have underlying business models that may provide a basis for restoring these financial institutions to long-term viability. However, if private market investors are not willing to invest in these financial institutions as standalone entities and both financial institutions require additional capital buffers then this may point to the need for a new test. Therefore, instead of Member States falling into the same trap as 2008, a three step approach could be established under a future State Aid Crisis Framework to augment the existing "precautionary recapitalisation" principle under the BRRD. Under this proposal a failing financial institution would not be subject to precautionary support but would instead be subject to the proposed systemic resolution tools proposed below. If there, then remains a residual financial institution in place this should then be merged with a long-term viable competing financial institution. In effect this proposal follows a parallel path to the one taken by the Italian authorities in respect of Banco Popolare di Vicenza and Veneto Banco, whereby parts of a financial institution are liquidated in a controlled manner, which may in line with the systemic bank "minimum necessary" test in Chapter 4 require "operational aid".

Before the question of whether systemic resolution tools should apply, the question of long-term viability should first be addressed. Thus, in the above case of Permanent Trusty Savings Bank and Monte dei Paschi Siena, before any precautionary support could be provided, the Commission would have to determine whether external factors adversely affected these financial institutions and whether in the absence of these factors both banks would not require State aid. However, if either financial institution was in a position of "dominant failure" the resolution option should then be pursued as the bank in question was likely to enter a period of difficulty even in the absence of a systemic event. In this way, the possibility of Member States in future continually exercising a precautionary recapitalisation scheme would be greatly reduced and allow for non-viable undertakings to exit the market without triggering further instability.

8.4.2. Systemic Resolution Tools

One possible way to resolve these complex issues related to precautionary recapitalisations is for a number of new resolution tools to be developed which should be specifically invoked in times of systemic crisis. The Board of the International Organisation of Securities Commissions has set out specific recovery tools for financial infrastructure providers and these tools provide a theoretical benchmark for proposing future systemic resolution tools.[73] There are in fact a number of overlaps between a financial infrastructure provider and a systemically important financial institution albeit one operates at wholesale level while the other may operate at both wholesale and retail level. First, both are at the nexus of financial transactions and as Jenny states a financial institution may also be a facilitator for the wider economy by processing payments and extending credit.[74] Second, it remains difficult to isolate the role of both financial infrastructure providers and financial institutions from the macro functioning of the market places both operate in due to the central role played in transaction processing. A systemically important financial institution may for instance provide a clearing facility for other financial institutions and so any disruption may adversely impact these correspondent banks. Third, although a financial market infrastructure provider will not have a direct presence at a retail level, a systemically important financial institution will in most cases have a direct interface with depositors thus any form of systemic resolution tool most also provide some form of support to this class of creditors. Similarly, when a market infrastructure provider enters difficulty the relevant counterparties

[73] Recovery and Resolution of financial market infrastructures, Consultative Report July 2012, Committee on Payment and Settlements, Board of International Organisation of Securities Commissions, available at http://www.bis.org/cpmi/publ/d103.pdf [last accessed on 07/11/2018].
[74] F. Jenny, The Economic and Financial Crisis, Regulation and Competition" (2009) Vol.32(4) World Competition pp.449-464.

will need some form of support so that the crisis does not spread to other financial infrastructures and their customers.

When designing resolution tools specific to market infrastructure providers the International Organisation of Securities Commissions tailored the FSB Key attributes for bank resolution to reflect the nuances of the market infrastructure provider.[75] However, a reverse process could be adopted whereby these tailored tools may apply for a systemically important financial institution. Due to the overlap between both market infrastructure providers and systemically important financial institutions as set out above and the fact both constitute possible sources of financial contagion, there will also be an overlap between the applicable resolution tools in question. For example, any moratorium imposed as part of the resolution of a market infrastructure provider is deemed to be an option best avoided as this may cause further instability if counter-party claims cannot be processed.[76] An alternative option would be to facilitate the transfer of any critical functions of the market infrastructure provider to a solvent market operator.[77] Although the proposals recognise the possible adverse consequences that may arise should a moratorium apply in the processing of claims, other claims, such as termination rights are considered malleable to a delay measure.[78] In respect of funding the resolution process and the functions of the market infrastructure provider, the proposals encompass raising the required resources from bail-ins where this is possible.[79] Therefore, despite the overlap between both a market infrastructure provider and a systemically important financial institution, the proposed resolution tools for the former do appear to leverage bail-ins as a central part of the process. Further, the IOSC's proposals are not necessarily tailored to reflect possible wider market instability already present if a market infrastructure provider enters financial difficulty. However, there are three primary strands one can see in the above proposed resolution steps. First, there is the payment objective, ensuring that

[75] N.73 at p.10.
[76] *Ibid* at p.11.
[77] *Ibid* at p.12.
[78] *Ibid* at p.14.
[79] *Ibid* at p.13.

certain creditors are repaid in a timely manner. Second, there are the wider operational objectives, this includes the clearing of inter-institutional transactions and currency exchange systems, for the market as whole; this is evident in the proposal to transfer the critical functions of a market infrastructure provider to a solvent third party, Third, there is the containment objective, for example the delaying of any termination clauses so that there is not an immediate cash-call on the failing market infrastructure provider. Although, there is somewhat of a contradiction between objective one and three, from these strands one can then formulate a number of systemic bank resolution tools that are designed to achieve the same underlying objectives.

For instance, an emergency transaction tool may be required to ensure that certain transfers can be completed in cases where an institution has entered bank resolution proceedings. In this way a bank may be subject to bank resolution in times of systemic crisis but certain key transactions could still be processed in order to prevent any adverse contagion effect. A deposit protection tool should also be adopted as part of the wider pan-EU bank resolution architecture. Under this tool the deposits of the institution would be ring-fenced from the wider institution up to the level of protection provided under the applicable deposit protection scheme. However, in exceptional circumstances the deposit protection tool may ring-fence additional deposits not covered by the deposit protection scheme in order to stabilise the wider financial sector. Both of these tools may be considered “initial” safeguard tools which mainly aim to stabilise the initial market tremors affecting the institution in question.

An emergency merger tool could also be an additional option in times of systemic crisis. Under this tool a failing institution would be merged with an institution provided that a number of conditions are met. Firstly, the acquiring institution must be viable and have sufficient resources in place to assimilate the failing institution. The problems associated with the Halifax Bank of Scotland and Lloyds group merger should be avoided whereby the new combined entity required further State support from UK taxpayers.[80] Secondly, the newly amalgamated institution must dispose of certain business units once the crisis has abated in order to enable new market entrants and to prevent the establishment of new "too-big-to-fail" institution. Finally, the acquiring institution should provide some form of recompense to the resolution authorities for organising and helping to implement the merger. This payment could then be used to resolve the other business units of the failing institution not subject to the emergency merger tool.[81] Although this may not necessarily at first seem different to the merger policies adopted during the financial crisis, this tool would it is posited differ in that not only would it seek to align with the new proposed State aid conditions as set out under the new State Aid Crisis Framework it would also seek to ensure that merger policy remains a complement to State aid based crisis intervention measures. The ad hoc nature of merging banks during the last financial crisis would be replaced by a specific systemic resolution tool that addresses the systemic risk of a failing financial institution while also ensuring that the new combined entity does not pose a systemic threat or requires further State aid from a Member State.

Two other systemic resolution tools should also be added to the tool-kit under the BRRD and aid the SRM in the resolution process. A credit-provision tool ensures that a failing institution is still able to provide credit to its customer base including large-scale corporations. This particular tool would only apply for a relatively short period of time but would at least alleviate the initial market shock should a systemically important institution enter the resolution process. A tool should also be introduced to transfer complex market liabilities from the failing institution to a holding-bank where these can then be unwound gradually over time rather than immediately triggered.[82] The current array of resolution tools include an asset-separation tool, a business

[80] Commission Decision N428/2009 of 18/11/2009 *United Kingdom Restructuring of Lloyds Banking Group* C(2009)9087final at para.8 available at http://ec.europa.eu/competition/state_aid/cases/232373/232373_1069315_136_2.pdf [last accessed on 07/11/2018].

[81] See liquidation surcharge in Chapter Five.

[82] N.78. This tool could also complement the existing Art.68 measure that seeks to preclude certain securities and derivatives from automatic termination on the part of a bank's counterparties.

sale tool and a bridge institution tool, but these tools may prove insufficient for financial institutions engaged in credit default agreements and contract for difference agreements. By establishing specific resolution tools designed to maintain critical financial transactions and banking infrastructure, the resolution process should then be better tailored to resolve systemically important financial institutions.

8.5.1. Significant Criteria for Single Supervision Mechanism and Systemic Importance Test; conflict or conflate?

A critical analysis of the Single Supervisory Mechanism [hereinafter SSM] will be discussed below, but for now the focus remains on the criteria used to determine the supervisory scope of this new body. Thus the number of financial institutions falling within the supervisory remit of the SSM only includes 127 "significant" banks within the participating countries. A significant bank is one that meets one of the following criteria, (1) has total assets in excess of €30 billion, (2) has an economic importance for the country in question or the EU economy as a whole, (3) meets a threshold for cross-border activities, or (4) the institution has accessed or sought to access funding from the European Stability Mechanism or the European Financial Stability Facility.[83] An additional criterion that may place an institution under the "significant" category includes whether the bank "is one of the three most significant banks" within a participating country.[84]

These criteria suggest that there is now at a pan-EU level a *de facto* systemic importance test for financial institutions. However, an examination of the above criteria makes it clear that this new test may not be sufficient to capture the nuances of the global and European banking sector. First, whether an institution has total assets in excess of €30 billion or not may not necessarily indicate systemic importance. A financial institution with less than €30 billion could still pose a systemic threat within a Member State. Thus the second

[83] European Central Bank, Banking Supervision, "What makes a bank significant?" available at https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html [last accessed on 07/11/2018].
[84] *Ibid*.

criterion covers this scenario as a bank may very well not meet the assets threshold but retain an economic importance within the relevant Member State. Further, the catchall provision, that a financial institution may be "one of the three most significant banks" within a Member State lowers the qualifying criteria as to whether an institution satisfies this condition depends on the domestic banking sector in question.

The third criterion refers to whether the institution has a cross-border presence, but cross-border activities may not necessarily indicate that a financial institution is actually "significant". In most cases, if an institution falls within one of the preceding criteria then this factor may essentially be an ancillary matter. The basis of the fourth criterion must also be questioned as this may actually defeat the primary purpose of establishing some form of a significant importance test in the first place. If a financial institution simply seeks to apply for pan-EU funding, then one would presume that the alternative criteria are also in some way met. An institution with a substantial pan-EU presence would presumably require European Stability Mechanism [hereinafter ESM] funding but a case may arise where a relatively minor market actor may seek to avail of this funding. This may occur due to the constrained financial resources of the domestic Member State the financial institution is located in or simply because there are no alternative sources of private funding open to the institution in question. However, there may be cases where even a minor financial institution may require ESM funding due to the systemic threat it poses to a Member State's internal banking sector.[85]

In Chapter 5 a systemic importance test for financial institutions was proposed in respect of any State aid application under Article 107(3)(b)TFEU. This proposed test sought to strike a balance between the need to maintain wider economic stability while also restricting the scope of the term systemic importance so that not every financial institution would in effect require State aid. Under this proposed new test the key question remains whether there are overlapping determinants between a Member State's financial institutions and whether this "relatedness" is such that the

[85] See for example Max Bank in Chapter 5.

collapse of one acts as a domino effect for the "related" other financial institutions.[86] One could therefore posit that the above significant criteria overlap with this proposed systemic importance test. While some of the above conditions mainly refer to the size or market span of a financial institution, there is also recognition that smaller market operators may pose a systemic threat. Further, these criteria do not seek to apply one objective interpretation of what may or may not be a significant important financial institution. In a similar vein, the proposed systemic importance test ultimately seeks to ground any future question of what is or is not a systemic important financial institution in a wider banking and economic context. In contrast with the proposed systemic importance test, the Commission's response during the financial crisis was to determine systemic importance based primarily on the wider environment prevailing at the time of a Member State's application. In this way the question of systemic importance does not necessarily refer to the actual linkages of the financial institution in question to other institutions but on the possible linkages that may or may not exist.

8.6.1. Single Supervisory Mechanism: A new departure for EU financial supervision?

One cannot discuss the introduction of the SRM without also commenting on the SSM and the new drive towards greater co-operation among EU financial regulators. Under this new architecture the ECB now in effect sits at the top of the supervisory tree for significant financial institutions.[87] Thus the ECB will now have the final say on matters related to the authorisation of a financial institution to operate within the Union, to ensure that financial institutions remain complaint with the applicable Acts and regulations, to perform supervisory reviews of financial institutions and to perform any tasks related to the recovery and resolution of a financial institution.[88] Certain commentators however, have questioned the new financial supervisory landscape within the EU. For instance, Dammann, comments how national

[86] See Chapter 5 at p.271
[87] Council Regulation (No1024/2013/EU) of 15/10/2013 conferring specific tasks on European Central Bank concerning policies relating to the prudential supervision of credit institutions, [2013] OJ L287/63 at art.4(1)(a)-(i) available at http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex%3A32013R1024 [last accessed on 07/11/2018].
[88] *Ibid*.

supervisors retain a large role in the day –to-day oversight of "significant" financial institutions.[89] Although in theory the ECB is now the primary financial supervisory body for these institutions in respect of prudential matters, there will remain a reliance on national regulators to aid this process.[90] The European Court of Auditors has also raised concerns over the resources available to the Single Supervisory Board [hereinafter the SSB] and whether this may impede its effectiveness. [91] Other aspects of the SSM also point to possible future complexities and competency conflicts. Barbu and Boitan comment how a number of industry actors remain sceptical of how the ECB will perform its new supervisory role.[92] According to Deutsche Bank a more effective solution would have been empowering the European Banking Authority as a pan-EU financial supervisory body working in conjunction with the ECB.[93] In this way the new supervisory mechanism would have automatically included all 27 EU Member State. [94] Further, Dammann also questions whether national supervisors will not be influenced by national considerations if a domestic institution subject to SSM oversight has underlying weaknesses.[95] Monti and Petit address this particular question via the prism of principal and agency relationships.[96] They note how the national supervisory bodies, as the agents of the SSM, may not have any real incentive to comply with the objectives of the principal.[97] While all of these concerns remain valid the underlying problem remains that any future crisis scenario is

[89] J. Dammann, "The Banking Union: Flawed By Design", (2014) Vol.45. Georgetown Journal of International Law at pp. 1058-1090, at p.1089 available at https://www.law.georgetown.edu/academics/law-journals/gjil/recent/upload/zsx00414001057.PDF [last accessed on 07/11/2018].
[90] *Ibid* at p.1090.
[91] European Court of Auditors, Special Report, "Single Supervisory Mechanism-Good Start but further improvements needed", at para.27 available at http://www.eca.europa.eu/Lists/ECADocuments/SR16_29/SR_SSM_EN.pdf [last accessed on 07/11/2018].
[92] T.C. Barbu and I.A. Boitan, "Implications of the single supervisory mechanism on ECB's functions and on credit institution's activity", (2013) Vol.XX Theoretical and Applied Economics pp.103-120, available at http://store.ectap.ro/articole/843.pdf [last accessed on 09/09/2017].
[93] *Ibid* at p.106.
[94] *Ibid*.
[95] N.89 at p.1090.
[96] G. Monti and A. Petit, "The Single Supervisory Mechanism: legal frailties and possible solutions", ADEMU Working Paper Series May 2016, WP 2016/016 at p.5 available at https://repositori.upf.edu/bitstream/handle/10230/27288/Ademu-WP-016-2016%20The%20single%20supervisory.pdf?sequence=1 [last accessed on 09/102/107].
[97] *Ibid*.

likely to need a coherent and centralised response and at the very least the SSM is a step in this direction.

8.7.1. European Stability Mechanism: Indirect and Direct Recapitalisation and future challenges

In order to finally break the link between sovereign and financial institutions, a supranational fund was proposed whereby recapitalisation funds could then be accessed without recourse to Member State funds.[98] However, the ESM falls short of this proposal as ultimately the link between a sovereign and its financial institutions remains in situ. This is particularly evident if one examines the ESM assistance provided to the Spanish banking sector in 2012. In theory, the recipient Spanish institutions remain liable for repaying this financial assistance, in effect though the Spanish State remains liable as the State owned and financed FROB is the guarantor for these ESM funds.[99]

Direct recapitalisation is also possible and this is where the ESM support mirrors to some degree that of the State aid authorisation regime as exercised by the Commission. A direct recapitalisation will only occur if the proposed recipient has first sought to impose losses on bondholders as per the BRRD or tried to access private market support first.[100] In addition to this condition, the financial institution in question must also pose a "threat to the financial stability of the euro area as a whole or the requesting ESM Member".[101] If these conditions are met then the recipient financial institution, ESM and relevant Member State, must then submit a joint restructuring plan to the Commission in line with existing State aid rules as ESM funding constitutes State resources.[102] However, there are other wider consequences of this

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[98] Treaty Establishing the European Stability Mechanism, 6th April 2011, [2011] OJ L91 available at https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf last accessed on 07/11/2018].
[99] European Stability Mechanism, Frequently asked questions on the ESM financial assistance programme for Spain and the country' successful exit, 31st December 2013 at p.2 available at https://www.esm.europa.eu/sites/default/files/faq-financialassistanceforspain.pdf[last accessed on 07/11/2018].
[100] Guideline on Financial Assistance for Direct Recapitalisation of Institutions, ESM December 8th 2014, at art. 8(2), available at https://www.esm.europa.eu/sites/default/files/20141208_guideline_on_financial_assistance_for_the_direct_recapitalisation_of_institutions.pdf[last accessed on 07/11/2018].
[101] *Ibid* at art.3(2)(b).
[102] *Ibid* at art.4(4).

"direct" support via the ESM, as the sovereign is not removed from the recapitalisation process. For instance, under a direct recapitalisation, any initial shortfall an institution has in its Common Equity Tier 1 capital ratio must be met by the ESM Member.[103] Even where an institution has the required equity capital ratio, the ESM Member is still required to provide 20% of the public intervention costs within the first two years of the ESM recapitalisation.[104] Once these two years have lapsed then the ESM Member will then be liable for 10% of the total intervention costs.[105]

In cases where an ESM Member is unable to provide this contribution to the bank recapitalisation then the Governors of the ESM Board have discretion to partially or fully suspend this contribution.[106] Presumably there is some rationale in ensuring that the ESM Member where the recipient institution is based provides some support as part of any supranational recapitalisation plan. After all the financial position of the financial institution in question could be as a result of an inadequate regulatory regime of the Member State and thus there should be some penalty for this failing. However, one of the central objectives of the ESM, namely to break the sovereign-bank link that formed during the 2008 financial crisis seems to be undermined by this recourse to Member State resources. Further, the "home" contributing Member State may also have to enter into a "Memorandum of Understanding" with the ESM as a condition for any support provided to a domestic institution.[107] The scope of this Memorandum remains unclear and if anything further entwines the financial position of the recipient institution with that of the ESM Member.

8.7.2. Bail-in and ESM Recapitalisation

The direct recapitalisation option is considered to be the "last-resort" funding option for any distressed financial institution within the ESM umbrella. Private market investors and the bail-in of existing creditors should all be

[103] *Ibid* at art.9(1)(a).
[104] *Ibid* at art.9(1)(b).
[105] *Ibid*.
[106] *Ibid* at art.9(3).
[107] *Ibid* at art.4(7)(a).

undertaken first before ESM funding can then be accessed.[108] In effect direct ESM recapitalisation can only occur after a three-tiered bail-in process has been followed by the relevant policymakers. Thus the first party to finance the restructuring of the institution are shareholders, followed by a contribution from a resolution fund while subordinated and junior creditors are then subject to a write-down or equity conversion.[109] Yet, as noted above implementing bail-ins during systemic crisis may not be conducive to stability. This in turn may trigger further adverse consequences. First, the initial bail-in may undermine other financial institutions within the same market place. Second, this bail-in may also further erode the financial position of the recipient institution as depositors and other creditors withdraw their funds in order to avoid the possible effects of bail-in.

8.8.1 Depositor Protection and the Banking Union: Time for a pan-EU deposit protection scheme?

If a new post-crisis banking union is to resolve the problems evident from the 2008 financial crisis, then some form of pan-EU deposit protection scheme may need to be established as individual deposit schemes in different Member States may not have the required resources to meet the demands of depositors. A Member State may still seek to invoke a bank guarantee scheme in a future crisis as set out in Chapter 4 as the actual domestic deposit protection fund may not be sufficient to meet the claims of depositors in the event of a bank collapse. This leads to the rather contradictory scenario of a Member State introducing a guarantee scheme that in actual fact not only undermines existing deposit protection schemes. But this intervention is also unlikely to meet the claims of depositors in the event of a bank liquidation. If Member States are willing to pool their resources together to fund bank resolution and recapitalisation needs in future, then a similar approach could be beneficial to deposit guarantee schemes. A number of commentators have also proposed a pan-EU deposit scheme, for example Schoenmaker and Gross proposed, prior to the establishment of the SRM, a joint European Deposit Insurance and

[108] *Ibid* at art.8(2)(i)-(ii).
[109] *Ibid.*

Resolution Fund.[110] But the level of *ex-ante* funds for this, some €55 billion, would still need to be backstopped by the ESM. Therefore the funds within the proposed pan-deposit and resolution fund would only constitute "a first line of defence".[111] Yet the Commission's proposed scheme for a pan-EU-deposit scheme also has the same funding obstacles to surmount. For instance, in the event of a short-fall extraordinary *ex-post* contributions were proposed, but how feasible would such levies be in times of a Union-wide systemic crisis?[112] Another proposed source of additional funding was a loan from a non-participating Member State deposit guarantee scheme.[113]

The Commission's proposal has thus far been left untouched as the main focus has been on establishing an effective uniform supervision and resolution architecture for EU financial institutions. Perhaps one of the reasons this proposal has fallen by the wayside are the operational challenges that would arise in the event of trying to achieve a common deposit protection scheme. Eijffinger comments how although a common scheme may reduce competition distortions between Member States so far "the leap" to such a system "is not feasible at this moment or the near future".[114] An incremental harmonisation process is best achieved first before a full-scale pan-EU deposit scheme can be established effectively.[115]This aligns with the Commission's proposed pan-EU scheme whereby entailed domestic deposit protection schemes would retain their positions.[116]

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[110] D. Schoenmaker and D. Gross, "A European Deposit Insurance and Resolution Fund", CEP Working Document, No.364/2012, May 2012, available at https://www.ceps.eu/system/files/WD364%20European%20Deposit%20Insurance.pdf [last accessed on 07/11/2018].

[111] *Ibid* at p.7.

[112] Commission Proposal for a Regulation of the European Parliament and Council for amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, 2015/COD, 24/11/2015, COM(2015) 586, at p1.5 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015PC0586&from=EN[last accessed on 09/10/2017].

[113] *Ibid* at p.16.

[114] S. C.W. Eijffinger, "Deposit Guarantee Schemes" in Common Deposit Guarantee Schemes Monetary Dialogue, July 2013, Compilation of Notes, Directorate General for Internal Affairs, Policy Department, pp.43-53 at p.47 available at http://www.europarl.europa.eu/RegData/etudes/note/join/2013/507468/IPOL-ECON_NT(2013)507468_EN.pdf [last accessed on 07/11/2018].

[115] *Ibid*.

[116] N.112 at p.14.

Therefore the success or otherwise of the proposed scheme would still depend on the efficiency or otherwise of domestic deposit protection authorities conveying information to the central European Board and effectively interacting with customers in a pay-out scenario.[117] This in turn touches on an issue raised by both Gerhardt and Lannoo that the exact role deposit protection authorities should play in times of crises may need to be reconsidered. One option would be to equip these authorities with resolution powers as well.[118] But this may further blur the line between deposit protection and resolution objectives, for example resolution may be the best response to an inherently insolvent bank, but from a deposit protection perspective resolution may place pressure on the financial resources of the fund. Another possible problem that impact on the willingness of Member States to pool their domestic deposit protection schemes together at an EU level is the political dimension of consumers in one corner of the Union subsidising those from another. German and French depositors and indeed policymakers may not wish to see their banking sector utilising its resources indirectly to bail-out Irish or Dutch depositors if this results in German and French banks then increasing their fees and lowering deposit interest rates. Overcoming this particular political obstacle may require some form of bank specific limits to what each participating financial institution can access from the pan-EU deposit protection scheme. In this way the level of pan-EU deposit scheme funds depositors from certain Member States could draw down would be to some degree limited to the funds paid in not just by the failing financial institution but also domestic rivals of this bank. Only then would further funds be drawn down from the pan-EU deposit scheme's other segmented national accounts with these further funds been based on the capacity of other Member State financial institutions to commit replacement funds for those used.

[117] *Ibid*.
[118] M. Gerhardt and K. Lannoo, "Options for reforming deposit protection protections in the EU", ECRI Policy Brief No.4 (March 2011) at p. 12 available at http://aei.pitt.edu/30828/1/ECRI_Policy_Brief_4.pdf [last accessed on 07/11/2018].

8.8.2. Future Fund: Combining the ESM and SRM

Since the crisis, efforts to establish a banking union have arguably not come to fruition. Although the SRM and SSM have to some degree centralised the European bank resolution and supervision process, as noted above there remain considerable failings with both of these developments. Similarly, the ESM has not broken the bank-sovereign link as was initially envisaged by policy makers at both Union and Member State level. Direct and indirect recapitalisation in effect still exposes individual Member States to the losses that derive within their domestic banking systems. Further, any effective Banking Union should have some pan-EU deposit protection scheme in place but this objective has yet to be realised. The proposal to consolidated bank recapitalisation and resolution funding at a pan-EU level follows a similar proposal to restructure Member State financing at a pan-EU level. This would be done so via the issuance of Eurobonds.[119] Under this proposal the weakest Member States would in effect be guaranteed by financially stronger Member States.[120]

Currently the resolution and supervision architecture remains inadequate to address the failings uncovered by the 2008 crisis. The resolution tools available under the BRRD and the SRM remain limited in scope and while perhaps sufficient for an isolated occurrence of a failing institution, are not sufficiently tailored to resolve banks during times of systemic crisis. It seems that policymakers in the United States have fallen foul of the same failure as the Orderly Liquidation Authority established under the *Dodd-Frank Act* may still trigger financial instability as there may be time for market actors to pre-empt any orderly liquidation steps taken by the Federal Deposit Insurance Corporation.[121] What is actually required in a European context is the creation of new bank recapitalisation and resolution fund adequately resourced with

[119] Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policies, Economic and Monetary Affairs, EU Public Debt Management and Eurobonds, September 2010, at p.17 available at http://www.europarl.europa.eu/document/activities/cont/201106/20110607ATT20897/20110607ATT20897EN.pdf [last accessed on 07/11/2018].
[120] *Ibid*.
[121] Edwards J.M., "FDICA versus Dodd-Frank: Unlearned Lessons About Regulatory Forbearance", (2011-2012) Vol1.Harvard Business Law Review pp.280-301 at p.294.

both public and private contributions from both Member States and each financial institution within the Union, even those currently not under the scope of the SSM. This fund could be managed under the auspices of the current EBA, which has input from all the key financial institutions within the EU.[122] The contribution level of each participating institution can be determined by the "significance" criteria already used to determine the remit of the SSM. For financial institutions that fall outside these criteria a flat fee should apply. For Member States the level of funding provided would depend on the potential threat their domestic financial institutions pose to the internal market as a whole. Thus funding from this new proposed body could be allocated in a more cost effective and efficient manner.

Although systemically important institutions would be able to contribute to this fund, in order for the intervention scope of the fund to be effective, these institutions may be subject to certain structural or behavioural measures. While these terms may have competitive connotations, in this context it relates to how banks with large market footprints such as Deutsch Bank and Santander in Spain, would have to agree to reduce their balance sheets and possibly alter their funding models before joining this new pan-EU fund. In this way a number of positive outcomes would arise.

Firstly, the problem posed by "too-big-to-fail" would be resolved to some degree, if one central recapitalisation and resolution fund is in place that European banks are incentivised to contribute to, then balance sheet reductions and developing more stable funding sources, such as retail deposits or covered bonds, should ensure that banks are both easier to resolve and are unable to leverage short-term funding sources for excessive growth.[123] Secondly, these measures should ensure that the proposed central funds resources can be utilised in a parallel manner for different banks that may face recapitalisation or resolution costs. Thirdly, this approach would also ensure that institutions in effect regulate each other and ensure that their behaviour

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[122] N.92 at pp.106-107.

[123] S.L. Schwarz, "The Conundrum of Covered Bonds", (2011) Vol.66 *The Business Lawyer*, pp. at p.561-586 at pp.566-567 available at https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2954&context=faculty_scholarship [last accessed on 07/11/2018].

does not jeopardise the viability of the fund in times of a future systemic crisis.

However, while this proposed pan-EU recapitalisation and resolution fund with financing from European financial institutions, may suggest a post-Sate aid intervention response, realistically Member States may remain on hoc to finance some aspects of a bank's restructuring or resolution. This is particularly the case where the resources of the fund may not be sufficient to meet the different needs of different banks in times of multiple bank failings. But these costs could also be centralised with each Member State contributing a set levy each year that would be used solely for a future recapitalisation programme either for one domestic institution or for the sector as a whole. Thus the proposed State aid rules as set out in this Thesis would then apply. For instance, the level of aid to recapitalise a financial institution that meets the long-term viable test will then be based on the level of support a rational State would provide in these circumstances. However, where a financial institution is deemed not to be a long-term viable financial institution but is systemically important then "minimum necessary" operational aid could be drawn from this centralised fund to finance this process in conjunction with the application of the newly proposed bank resolution tools. Further, while there may be no drive towards a pan-EU deposit protection system for the medium term, the above proposed fund could encompass a specific ring-fenced fund that could be used to backstop domestic deposit protection schemes. This deposit-backstop fund could be financially supported from both the resolution side of the newly proposed pan-EU bank fund and if required Member State's recapitalisation Member States' funds. Kokkoris and Olivares-Caminal suggest that assessing State aid applications under the current SRM regime will still see financial stability as the central objective for policymakers and in this case, a resolution scheme requiring aid in a systemic crisis will likely still be endorsed by the Commission.[124] But the

[124] I. Kokkoris and R. Olivares-Caminal, "The Operation of the Single Resolution Mechanism in the Context of the EU State Aid Regime", in J.R. Binder and D. Singh, ed., "Bank Resolution the EU Regime", (Oxford: Oxford University Press, 2016) p.299 at pp.316-317.

above proposals should ensure that the recourse to individual Member State's resources is greatly reduced.

A new proposed central resolution and recapitalisation fund will need a decision-making authority and process much like the current SRM and SRB. It should also have direct communication with the SSM and with national regulators. While expanding this proposed fund's remit to also encompass banking supervision may have merits, a separate regulatory body such as the SSM would be preferred albeit one greater resources and input from the EBA. Instead, the proposed centralised fund would fall under the control and remit of the Commission, with both the Directorate Generals of Economic and Financial Affairs and Competition have dominant roles due to their areas of expertise and the need for quick State aid determinations related to the interventions of this fund. In many ways this proposal for the Commission to exercise a more central role in bank recovery and resolution follows the initial draft regulation of the SRM where the SRB's role was held by the former.[125] Although Nicolaides states that the Commission retains a significant role under the current process, this centralisation of decision-making authority should ensure that there is a coherent and consistent strategy and that the contradictory positions adopted by the SRB and Commission in respect of regional Italian banks are not repeated.[126]

Conclusion

The 2008 financial crisis illustrated the legislative vacuum in EU Member States when it came to the bank resolution domain. Systemically important financial institutions could not be subject to normal insolvency proceedings due to the threat of wider banking sector contagion and economic instability. In time, as the initial upheaval of the 2008 crisis abated Member States drafted and enacted specific bank resolution and recovery legislation. However, in most cases the resolution tools established under this legislation lacked specific features to address a failing financial institution in systemic crisis

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[125] P. Nicolaides, "Exceptions to the Exceptional Nature for State aid for Banks", State aid hub blog posted 15th August 2017 available at http://stateaidhub.eu/blogs/stateaiduncovered/post/8974 [last accessed on 07/11/2018]/

[126] *Ibid*.

environment. In effect, while legislation such as the Irish *Credit Institutions (Stabilisation) Act 2010* did serve a useful purpose in imposing losses on subordinated creditors, this Act was only introduced post the introduction of the blanket guarantee scheme in September 2008. What Member States such as Ireland required was to utilise a specific bank resolution architecture designed for application during the teeth of a systemic crisis.

Unfortunately, efforts to harmonise and centralise the bank resolution process within a pan-EU context have also failed to address this need. The resolution tools under the BRRD add nothing new to the pre-existing bank resolution environment but merely restate domestic measures already in place. Further, the "pre-cautionary recapitalisation" exemption in effect allows for Member States to circumvent the primary objective of the BRRD namely, the controlled liquidation of a failing financial institution. Although the long-term viable bank test as proposed under Chapter 6 should act as an effective counter-measure to the blanket use of this exemption by Member States. The fact remains, that if specific systemic resolution tools were in place the need for the pre-cautionary recapitalisation principle would not be required. Thus this Chapter has proposed a number of new systemic resolution tools that are designed for application during a future systemic crisis. These include an emergency transaction tool to facilitate essential transactions that the failing financial institution is party to, a deposit-protection tool in order to prevent an unorderly withdrawal of deposits, and an emergency merger tool to facilitate the possible merge of a failing institution with a viable competitor. A credit-provision tool is also proposed so that the controlled resolution of a bank does not immediately result in wider economic credit squeeze in the Member State in question. The final systemic resolution tool proposed is one for complex financial instruments so that these can be unwound over an elongated timeframe without triggering further systemic contagion.

These tools should ensure that Member States and the Board are able to apply resolution actions even in times of systemic crisis without engendering further contagion. Further, the above tools overlap with the proposed State aid measures set out in previous chapters. For example, for an insolvent financial institution the financing of either a deposit-protection tool or a credit-provision tool could be available under the provision of operationally necessary aid as proposed under Chapter 5. Similarly, these tools may require some form of State guarantee support and so the proposals under Chapter 4 would then come into play.

To further improve the European bank resolution architecture for any future systemic crisis a new pan-EU bank recapitalisation and resolution fund should be established. Under this fund financial institutions of a certain size would only be able to participate so those with exceptionally large balance sheets would then have some incentive to reduce their market footprint. Both Member States and financial institutions would contribute to this fund with the level of contribution dependent on the financial risk the former's domestic banking sector poses to the pan-EU market and the latter's balance sheet size. Member State levies could then be utilised the recapitalisation needs of their domestic financial institutions or sector as whole. In certain cases resolution costs may also be borne by these funds. For both cases the new State aid rules proposed under this Thesis will then apply. To ensure an effective overlap between the management of this new centralised recapitalisation and resolution fund with State aid control, it is envisioned that the overarching SRB in effect be subsumed by the Commission. Members of the Board could be drawn from the ECB but also DG Competition and the Directorate for Economic Affairs.

The next Chapter will seek to tie together the proposals in this Chapter with those proposed in the preceding Chapters. Establishing a new State Aid Crisis Framework will not only have to address questions of systemic importance and long-term viability but will also have to interact with bank resolution and recovery measures. However, what this Chapter has illustrated is that despite the introduction of the BRRD, new resolution tools will need to be introduced to reflect the proposed rules for financial institutions and wider banking sector schemes set out in the preceding Chapters.

Chapter Nine: Time for a new State Aid Crisis Framework for the European Banking Sector

Introduction

Throughout this Thesis the objective has been to pinpoint the current shortfalls of the State aid framework established as a response to the 2008 financial crisis. From Chapters 3 to 7, specific aspects of the Commission's and Member States' responses have been critically evaluated and possible solutions proposed so that the adverse consequences of State support to a banking sector in times of financial crisis can be avoided in the future. One of the key aims of this Thesis has been to establish a new State Aid Crisis Framework that will meet short-term and long-term stability objectives. During the financial crisis, Member States and the Commission were in effect left in a policy vacuum whereby there was little if any pre-existing State aid or indeed bank resolution architecture to leverage. Instead State aid rules designed for individual undertakings, such as the Rescue and Restructuring Guidelines of 2004 were applied to financial institutions such as Northern Rock and WestLB during the initial stages of the crisis.[1] However, the continued instability meant that a different response was required entailing the application of Article 107(3)(b)TEFU.

As set out in Chapter 2 this particular Treaty provision has been utilised by certain Member States in the past that have faced considerable economic challenges. The unique circumstances of the Greek State at that time warranted a response far more wide-ranging then merely applying State support in a piecemeal fashion. Rather, these "exceptional circumstances" were sufficient grounds for triggering the then Article 87(3)(b)EC exemption. State aid in a European Union context has always been rooted in a social context rather than what could be termed a corporatist one. State aid provided

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[1] Commission Decision NN 70/2007 (ex CP269/07) of 05/12/2007 *United Kingdom Rescue Aid to Northern Rock*, OJ C(2007) 6127 available at http://ec.europa.eu/competition/state_aid/cases/223064/223064_782466_33_2.pdf [last accessed on 07/11/2018]: Commission Decision NN25/2008 (ex CP 15/08) of 30.09.2008 *WestLB Risk Shield, Germany* OJ C(2008) 1628 available at http://ec.europa.eu/competition/state_aid/cases/225266/225266_843256_6_1.pdf [last accessed on 09/12/2016].

to an undertaking may have a direct effect of ensuring this firm maintains a market presence and while this may benefit the firm as a standalone entity, the reality is that there are wider communitarian benefits from this State intervention. Employment is maintained, the skillset of current or future workers is retained and even competitors may also benefit as an additional market rival may drive their own efficiency and productivity. Furthermore, the final consumer of any goods or services provided may also benefit as they have more possible purchase options than if the undertaking in question had exited the market. Thus there are a number of different factors that arise in the context of State aid provision that both the Member State in question and the Commission have to assess. These factors become amplified in times of a systemic banking crisis.

The possible adverse social and economic effects were a financial institution to collapse requires a response that meets short-term stability objectives but may not meet the longer-term interests of consumers, taxpayers or Member States. The central research question of this Thesis was to formulate a future crisis State aid framework that not only ensures the immediate stability needs of Member States but also seeks to resolve the long-term consequences affecting Member States from adopting a State aid solution to a banking crisis.

9.1.1. Guarantee Schemes under a Future Crisis Framework

As set out in Chapter 4 of this Thesis the State guarantees implemented during the 2008 financial crisis varied in scope and duration. In the case of Ireland this response entailed the introduction of a blanket guarantee scheme for Irish bank liabilities. For the Commission this response was considered both "appropriate" and "proportionate" to resolve the funding problems facing Irish financial institutions. Yet clearly authorising State aid of this scope and magnitude exposed the Irish State to a substantial contingent liability and conflated the resources of taxpayers with those of private banks. The conflation caused "a link between financial sector distress and public sector bailout" in turn adversely impacting on the market perception of the Irish sovereign as its default risk premium spreads increased post the blanket guarantee.[2] Despite past banking crises where the introduction of a sovereign guarantee had an adverse impact on the State in question, the Commission in effect conceded Ireland's position that such a scheme was "appropriate" for the crisis at hand.[3] Pisani-Ferry and Sapir comment how the Commission's response to the financial crisis, namely, its tailoring of the Rescue and Restructuring Guidelines, to the suit the problems posed by the crisis, "probably prevent[ed] the worst excess in terms of negative spillovers".[4] However, the lax interpretation of the term "appropriate" in the context of the Irish blanket guarantee scheme in effect had the same result as if no State aid restriction had been applied.

State bank guarantees are affected by different factors include macroeconomic conditions pertaining at the time of the proposed withdrawal of the guarantee and the banking structure and stability conditions.[5] If one was to apply these factors to the decision of introducing a blanket guarantee scheme then in the case of Ireland some form of immediate and wide ranging form of intervention was required. However, a more robust State aid and competition supervisory authority should have a set of measures in place to determine whether or not a bank guarantee scheme, let alone a blanket scheme, is an "appropriate" response in times of financial crises. One way to achieve this objective is to establish a specific counter-factual test that Member States would have to satisfy before the Commission would authorise the introduction of any bank guarantee scheme. This proposed counterfactual test encompasses three inter-related conditions. These are first whether there are possible viable alternatives the Member State in question may pursue as a crisis response rather than the application of bank guarantee scheme. Second, the precise objectives of the scheme should be set out clearly with

[2] S. Sigherri and E. Zoli, "Euro-Area Sovereign Risk During the Crisis", IMF Working Paper, October 2009, at p.8 available at https://www.imf.org/external/pubs/ft/wp/2009/wp09222.pdf [last accessed on 07/11/2018].
[3] Commission Decision
[4] J. Pisani-Ferry and A. Sapir, "EU banking policies", (2010) Vol.25(62) Economic Policy pp.343-373 at p.359.
[5] Transitioning from a blanket guarantee or extended coverage to limited coverage, International Association of Deposit Insurers, Discussion Paper, March 2012, at p.11 available at http://www.iadi.org/en/assets/File/Papers/Approved%20Research%20-%20Discussion%20Papers/Transitioning_Paper_29March2012_Final_for_Publication_1.pdf [last accessed on 09/10/2017].

the Commission adopting a negative position if the circumstances suggest that regulatory forbearance remains the primary objective rather than engendering short-term stability for long-term viability. Third, the Commission should determine whether a realistic exit plan is in place to ensure that those financial institutions availing of this support do not become financial entwined with the Member State in question.

To determine whether under the above test the guarantee scheme under consideration remains the only viable option the Commission should apply a similar three-step test as that applied in the context of operating aid for undertakings in areas of economic underdevelopment. Under this test the Commission would examine whether the proposed guarantee meets the wider economic needs of the Member State, the measure is appropriate to resolve the instability in question and the intervention will be withdrawn overtime. Any possible alternative forms of interventions should also be subject this three-step test so as to determine whether there is any actual alternative response that can meet these three inter-linked criteria.

The second strand should encompass the Commission imposing a number of market and institutional focused restrictions on any participating financial institutions. Under the second test to ensure that the proposed guarantee is not utilised as a *de facto* shield so that imprudent banks simply continue to behave in a pre-crisis manner, there should be a number of conditions these financial institutions must meet. These may include placing caps on the lending any participating bank may engage in, ensuring that these banks set aside additional capital where possible and a long-term plan in certain cases to ensure that these banks re-position their funding base from less volatile sources.

How the proposed guarantee scheme is revoked should also determine the Commission's final determination on whether or not to authorise this intervention. Revoking a guarantee scheme remains a difficult process as a balance needs to be struck between insulating the resources of the State from the domestic banking sector and also ensuring that this sector will stabilise without recourse to a guarantee scheme. On this basis leveraging existing

Commission practice related to competition safeguards could be availed of so that certain behavioural or structural conditions are placed on participating financial institutions so as to incentivise withdrawal from the scheme. These, what one could term penalties, would apply to long-term viable financial institutions as insolvent institutions would be subject to specific systemic resolution tools as proposed in Chapter 8.

While there is a degree of overlap between using a guarantee to restructure a banking sector and the revocation incentives for individual financial institutions, both tests have different objectives. The former seeks to ensure that any bank guarantee scheme is not simply used as a delaying tactic by Member States against taking any market-wide restructuring that is required. The question though whether such revocation incentives are practical in times of crisis remains and it may be that a graduated form of guarantee penalty fees or indeed any behavioural or structural conditions are applied as a last resort so that these restrictions do not result in short-term savings for the Member State but at the expense of longer-term costs.

These conditions should not only relate to the particular funding obstacles facing the relevant domestic banks but also wider economic concerns, such as a possible bank run or a sharp constriction in credit supply. If an alternative option may resolve these issues, then a guarantee scheme should not be introduced or gradually unwound if retroactive authorisation is required. During a crisis it may be difficult to ascertain whether one alternative actually meets the short-term stability requirements of Member States. However, this does not mean that a counterfactual test should be dismissed. By applying this "alternative-to-guarantee" test the Commission would ensure that Member State resources are not allocated in an inefficient manner.

While in theory blanket bank guarantees should simply fall outside of any future application of the term "appropriate" in practice this may not be possible. There may be cases where a Member State has to introduce a blanket guarantee scheme as the domestic banking sector is particularly vulnerable. If such a case does arise then the Commission should apply a separate criterion for determining whether or not this form of intervention is required.

If one draws a parallel from the specific characteristics of industrial decline as set out by the London School of Economics and tailors these for a specific banking sector context then a qualifying criterion for blanket guarantees could be formulated.[6] This criterion would be based on whether a Member State's banking sector has entered into a sector wide decline so severe that the above three conditions for a non-blanket scheme would remain impractical to apply. Thus where a Member State's banking sector experiences a continued and accelerated outflow of funding, either of depositors or bondholders, which triggers a credit squeeze affecting the wider economy and there is a sharp depreciation in share value, then such circumstances may warrant the introduction of a blanket guarantee scheme. The effectiveness of this scheme may though still remain dependent on the actual credibility of the guarantor Member State.[7]

9.1.2. Minimum necessary and bank guarantee schemes: restricting the coverage of both deposit protection and bondholder bail-out

Closely related to the question of whether or not a guarantee scheme is the appropriate form of State aid intervention in times of financial crisis is the question of what the minimum parameters of any scheme should be. In some cases, this question may simply be an extension of the "appropriateness" test, particularly in cases where the Commission has authorised a blanket guarantee scheme then the question of "minimum necessary" may be redundant. However, there are certain safeguards that could apply in any future State Aid Crisis Framework that not only ring-fence the limited resources of Member States but also constitutes some form of moral hazard control. Clearly there are limits to a proposed "minimum necessary"

[6] London School of Economics, "Study on the Methodology for Identifying Sectors with Serious Structural Problems", Report to the European Commission Competition DG, December 2002 at vii, available at http://ec.europa.eu/competition/state_aid/studies_reports/report_en.pdf [last accessed on 07/11/2018].

[7] Commission Decision State aid N 255/2009 of 12/05/2009-Belguim and N 274/2009- of 12/05/2009 *Luxembourg, Additional aid for Fortis Banque, Fortis Banque Luxembourg and Fortis Holding* OJ C(2009) 3907 at para.44 available at http://ec.europa.eu/competition/state_aid/cases/231240/231240_1040772_26_1.pdf [last accessed on 07/11/2018].

safeguards as the core objective of any guarantee scheme is to refrain from imposing losses on creditors such as depositors.

The effectiveness or otherwise of deposit protection schemes is a complex question in its own right, but for the purposes of this Thesis the focus remains on developing some form of State aid criterion in a scheme that seeks to extend the statutory protection threshold. One possible option could be to adopt a policy of co-insurance that would apply so that although a Member State could extend the threshold of deposit protection beyond the statutory minimum, depositors would still be liable for some loss above that threshold. For example, if a Member State seeks to extend a deposit protection scheme from €100,000 to €200,000 then the depositors would be subject to some loss within this higher range.

Already under the BRRD there is a "water-fall" effect applied whereby creditors, bondholders and unprotected depositors, are bailed-in before any State aid is advanced to the financial institution in question.[8] In the case where a guarantee has been introduced in line with the new proposed State Aid Crisis Framework this bail-in tool would still apply to existing creditors so long as this intervention does not trigger further instability. Any subsequent debt issued or deposits raised post this bail-in would then fall under the extended guarantee scheme with the co-insurance limitation applicable in the case of the latter. Following a parallel path, the Commission should apply a tailored "essential facility doctrine" to determine how extensive guarantee coverage should be for wholesale funding. Under this proposal the Member State in question would have to satisfy three inter-related questions based on the primary objective of the essential facilities doctrine namely access to market infrastructure.

In this case the "facility" in question is access to wholesale funding and thus the key question is whether a Member State's domestic banking sector

[8] "Systemic implications of the European bail-in tool: a multi-layered network analysis", Financial Stability Review, May 2016−Special features, at p.122 available at https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfbfinancialstabilityreview201605.en.pdf?ba65e03fbfd38b61314915e65a9133ce [last accessed on 07/11/2018].

requires some form of subsidised access to inter-bank markets. If financial institutions are able to access alternative funding without the need for State intervention, then clearly the “minimum necessary” criterion in this case will not be met. In effect there are then no actual grounds for a guarantee scheme to encompass inter-bank funding. The second question mainly seeks to align any State guarantee intervention with wider competition concerns. If a Member State’s domestic banking sector has to compete against other market competitors that are availing of some form of State support to access inter-bank funds, then this may place the former in a position of competitive disadvantage. The key objective of applying this criterion is to ensure that specific strands of a bank guarantee scheme are subject to benchmarks that are tailored to reflect the balance between intervention and State aid costs. This also aligns with the final proposed condition.

One could describe the above proposals as raising the conceptual thresholds for Member States seeking to introduce guarantee schemes in times of systemic crisis. However, what is also proposed is a “structural safeguard” to further reinforce this new threshold. In line with subsequent developments in the bank resolution field, the introduction of a State-backed guarantee scheme should entail the establishment of a specific undertaking to perform the role of guarantor. This structural condition should further align the objectives of the Commission and Member States in developing a future resolution framework that reduces the need for recourse to State aid. Thus in order to satisfy the “minimum necessary” criterion under any future State Crisis Framework Member States would under establish a guarantee fund.

In addition to the establishment of a guarantee fund the new State Aid Crisis Framework should also encompass guarantee entry and exit fees. Under this proposal not only would the participating financial institutions pay a fee for participating in this scheme these two fees would be based on the level of liabilities each bank has issued under the scheme. These fees would not be discharged to the relevant Member State until the crisis environment has alleviated. In this way a claw-back provision will form an intrinsic part of the “minimum necessary” criterion. Determining the level of these fees would be based on a similar principle to how the question of market dominance is assessed in the competition field. In this way the fees can reflect the level of risk a financial institution poses to the wider financial sector and indeed the guarantor Member State.

9.1.3. Competition Safeguards and Wholesale Funding

Research by Grande et al. and Schich highlights how the actual key determinant during the financial crisis for pricing guaranteed bank debt was not the underlying financial strength of the issuing institution but rather the financial strength of the guarantor sovereign.[9] Conversely, a bank with a stable and long-term viable position may be penalised where this institution falls under the guarantee scheme of a "weak" sovereign. Grande et al. use the example of one Spanish bank with a higher credit rating than a German financial institution yet it was the former that had to discharge a higher interest rate than the latter.[10]

Therefore, while one may have initially argued that the level of competition-distortion arising from Member States introducing guarantee schemes may not have been a considerable risk due to most banks falling under one scheme or another, distortions did arise linked with the jurisdiction in which an institution was established. Estrella and Schich make a number of proposals as to how these distortions could potentially be addressed ranging from stronger sovereigns, such as Germany, imposing an increased guarantee fee on their domestic financial institutions, to these Member States opening their schemes up to international institutions.[11] But these measures also have their drawbacks. In some cases, the sovereign will simply not be in a position to extend any guarantee scheme to a wider category of financial institutions.

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[9] G. Grande, A. Levy, F. Panetta, A. Zaghini, "Public Guarantees on Bank Bonds Effectiveness and Distortions" (2011) Vol.(2) OECD Journal: Financial Market Trends at p.11, available at http://www.oecd.org/finance/financial-markets/49200208.pdf [last accessed on the 07/11/2018]:S. Schich, "Expanded Guarantees for Banks: Benefits, Costs and Exit Issues", (2010) Vol.2009(2) OECD Journal: Financial Market Trends, at p.15 available at http://www.oecd.org/finance/financial-markets/44260489.pdf [last accessed on 09/01/02017].

[10] *Ibid* at Grande et al.

[11] A. Estrella and S. Schich, "Sovereign and Banking Sector Debt: Interconnectedness Through Guarantees", (2012) Vol.2011(2) OECD Journal: Financial Market Trends, at p.37 available at http://www.oecd.org/finance/financial-markets/48963986.pdf [last accessed on 07/11/2018].

Further, Estrella and Schich also note how politically it may not be possible for a strong sovereign to extend their guarantee scheme to financial institutions from weaker sovereigns such as Greece.[12]

One possible solution to resolving the competition distortion caused by this sovereign premium would be to apply a claw-back penalty charge. Under this proposed safeguard the Commission would apply a retrospective assessment of whether a financial institution availed of any additional price reduction in the cost of debt raised. Once this assessment has been completed the relevant financial institution would then be liable to discharge the value of this premium to the relevant Member State. This new safeguard would not only ensure that financial institutions benefitting under a sovereign premium are in effect on notice not to utilise this premium in their day-to-day operations thus countering contemporary concerns. It would also ensure that the Member State in question is actually compensated fully for the support provided to their domestic financial institutions.

9.1.4. Competition Distortion and Deposit Protection

Guarantee schemes in most cases are designed with a dual objective not only to ensure access to inter-bank funding but also to stem the outflow of deposits at a retail level. In some cases, financial institutions may abuse their participation within a statutory deposit protection scheme, although from a competition perspective possible distortions are limited as other banks will also be subject to this scheme. In times of financial crisis however, as was evident in 2008, different Member States may extend the remit of deposit protection for both defensive and offensive purposes. Defensive in the sense of incentivising existing depositors to refrain from withdrawing their funds and offensive as this extended scheme may act as a pull factor for depositors from other jurisdictions.

One possible competition distortion safeguard against the "offensive" aspect of a newly expanded deposit protection scheme would be via an *ex-post* penalty fee imposed on domestic financial institutions post the crisis. This fee

[12] *Ibid* at p.38.

would then ensure that these institutions are restricted from engaging in price leadership or market expansion based on the increased deposit inflows that may have been generated from the extended deposit scheme. Foreign financial institutions would be exempt from this *ex-post* fee even where they have availed of the domestic scheme due to their own home jurisdiction not establishing an equivalent scheme. This exemption would serve two purposes. First it would ensure that domestic financial institutions retain some form of financial obligation for acting in such a manner that an extended deposit scheme was required. Second, by exempting the subsidiaries of foreign banks that may have availed of the extended domestic scheme, this allows for these institutions to utilise their funds within this particular market and so should to some degree lead to market fragmentation. This in turn should reduce the threat of too-big-to-fail recurring among the domestic financial institutions within the Member State in question.

9.2.1. Systemic Importance and State aid in times of financial crises: A new State aid test

As noted in Chapter 5, Sjöberg opines that there are in effect three different forms of systemic crisis depending on which particular financial institutions are affected during the initial phases. Ascertaining what is or is not a systemically important financial institution may require a test that not only examines the size of an institution but also other macro related characteristics.[13] In effect the very nature of the globalised financial system is such that any minor interruption within this system may trigger a complete collapse. A financial institution may very well constitute an essential facility for wider market participants and thus fall within the systemic importance category. In these circumstances the demise of this essential "facilitator" may directly undermine the financial position of other institutions.[14] In other industries such as the airline and energy sectors, there may be what Blair terms a "network externalities" where if one link in the chain fails then this

[13] G. Sjöberg, "Banking Special Resolution Regimes as a Governance Tool", in Wolf-Georg Rinke and Peter M. Huber, ed., *Legal Challenges in the Global Financial Crisis,* (Oxford: Hart Publishing, 2014) pp.187 at p.190.
[14] C. Savvides and D. Antoniou, "Ailing Financial Institutions: EC State Aid Policy Revised" (2009) Vol. 32(3) World Competition pp. 347-366 at p.358.

will undermine the performance of the other links even those not directly connected.[15] However, there are cases where even a regional financial institution may pose a systemic threat and this threat arises due to certain “indirect” factors that are inherent within the banking sector. When examining the key factors behind the entry and exit of firms in different markets, Cinera and Galgau found a number of determinants across both individual firms and industries.[16] Firm specific determinants mainly relate to the internal business model and funding structure of the firm in question. There are also wider macro determinants that cross whole industries or indeed countries. For instance, in some industries high rates of firm entry and exits may be due to the underlying economic activities related to this industry. In other cases, the jurisdiction a firm operates in may pose a key determinant if this State is subject to economic shocks.

Other commentators such as Lee et al. have examined how firms expand into new business lines and conclude that the more similar the new market line is to existing business activity the higher the chances of retrenchment.[17] In effect exiting a new business line is less costly as production techniques can be easily redeployed in the original markets of the firm in question. These studies provide a key basis for formulating a new systemic importance test for financial institutions in times of financial crisis. If one recasts the determinants of market entry and exit as a comparative tool to compare the similarities between financial institutions within the same domestic banking sector, then the concept of “indirect” systemic effect becomes clearer. In some cases, financial institutions within a Member State may share the same determinants with each other such as market and jurisdiction. However, even

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[15] M.M. Blair, “The Economics of Post-September 11th Financial Aid to Airlines”, (2003) Vol.37 Indiana Law Review, pp.366-395 at p.377 available at https://mckinneylaw.iu.edu/ilr/pdf/vol36p367.pdf [last accessed on 07/11/2018].

[16] M. Cinera and O. Galgau, “Impact of Market Entry and Exit on EU Productivity and Growth Performance”, Directorate General for Economic and Financial Affairs, Feb 2005, at p.14 available at http://ec.europa.eu/economy_finance/publications/pages/publication712_en.pdf [last accessed on 07/11/2018].

[17] G. Lee, T.B. Folta and M/ Liberman, “Relatedness and Market Exit”, Working Paper January 2010, at p.3 available at **http://www.anderson.ucla.edu/faculty/marvin.lieberman/docs/LiebermanLee_Relatedness.pdf** [last accessed on 07/11/2018].

firm specific determinants may engender a form of inter-connectedness. This is where the relatedness across firms may become a key aspect in ascertaining systemic importance from a wider market perspective.

9.2.2. Minimum aid necessary for an insolvent bank

During the 2008 crisis Member States became the primary source of recapitalisations for both long-term viable and insolvent financial institutions. From an Irish perspective the continued support provided to Anglo Irish Bank resulted in the Irish State injecting some €30 billion into a failing financial institution with no real opportunity of repayment. Although the same issue may also arise in respect of long-term viable financial institutions this particular question is addressed below via the proposed rational State actor test. However, for insolvent financial institutions such as Anglo Irish Bank and Hypo Real Estate the problem of repetitive State aid results in the parameters of the minimum necessary criterion constantly expanding. As Schütte comments in relation to the French State's financial support provided to both Credit Lyonnaise and the GAN Group, "the higher the amounts concerned are, the easier it is to overrule the principle".[18] For example, when assessing the initial State aid applications for Hypo Real Estate, the Commission appeared to place over emphasis on the wider market role of the lender in the municipal bond sector rather than assessing the level of support on the question of viability. Thus, a loan of €35 billion from the Federal Government in Germany was not just considered a minimum necessary sum but even further support measures were also considered to fall within the new threshold for "minimum necessary".[19]

If a bank does fall under the remit of the systemic importance test, then operational aid may be required so that the recipient bank can continue to

[18] M. Schütte, "The Rescue and Restructuring of Banks: Loans and Guarantees to Banks", in Claus Dieter Ehlermann, and Michelle Everson, ed., *European Competition Law Annual 1999, Selected Issues in the Fields of State Aids*, (Oxford Portland-Oregon: Hart Publishing, 2001) at p.375 at .p.383.

[19] Commission Decision Nn17/2009 of 21/01/2009, *SoFFIN guarantee for Sicherungseinrichtungsgesellschaft deutscher Banker-Germany*, OJ C(2009) 440 final available at http://ec.europa.eu/competition/state_aid/cases/229209/229209_1016043_31_1.pdf [last accessed on 07/11/2018].

function until the opportune time for an orderly liquidation can arise. In this way the minimum amount of aid is provided to ensure that the operations of the recipient institution can continue to operate. Certain behavioural and structural restrictions should apply to a bank that is subject to "operational aid" so that prudent and long-term viable banks are not subject to competition distortion. Further, whereby the provision of this operational aid is conditional on the disposal of the recipient financial institution's business units, the acquiring financial institution should then be liable for a liquidation surcharge so that additional funds external to the State can finance the gradual wind down of the insolvent financial institution. Although this proposal overlaps somewhat with the provision of liquidation aid as set out under the Banking Communication, the key difference is that the level of aid provided is specifically based on the costs of meeting the different liabilities of the bank. Also the aim of this support is not necessarily to liquidate the bank in question but to facilitate its continuing operation until either its acquisition by another financial institution or may be liquidated without triggering a systemic crisis.

9.2.3. State aid to Insolvent Banks and Competition Distortions

There will remain some form of competition distortion in place where an insolvent financial institution remains in situ and may divert funds and market share from more prudent rivals. Therefore, when a financial institution fails the long-term viability test as set out in Chapter 6, certain measures should apply so as to minimise where possible the competition distortions that arise when an insolvent financial institution remains at least partially active in the market place. These measures should not diverge from the pre-existing competition distortion controls but should encompass certain customer and business transfer steps. Where possible the insolvent financial institution should promote the business lines of solvent rivals. In this way the level of operational necessary aid should be reduced; however an additional measure may also be required. Considering the cross-market subsidy solvent financial institutions gain from the "bailing out" of an insolvent rival, in cases where the former acquires business units from the latter then the purchase price should contain a liquidation premium as noted in Chapter 4. This premium should then be used to further fund the graduated liquidation process of the insolvent financial institution. In this way an effective balance should be struck between ensuring that wider financial stability is met but that possible longer-term competition distortions do not arise and become structurally entwined in a Member State's banking sector.

9.3.1. Long-term viability: A new test for determining long-term viability in a State aid context

Yet once this test for systemic importance has been applied by the Commission and the Member States the next step is to determine whether this same institution can be considered a long-term viable bank. This requires the need for another test, one designed so that long-term viability is not simply determined post any State aid injection, so that capital ratio requirements can be met, an issue that is further discussed in Chapter 8. Thus any long-term viability test should be applied *ex-ante* any recapitalisation to determine whether these funds are better utilised for liquidation purposes.

This test should aim to divorce external factors that may have impacted the business of the financial institution under examination from the actual internal efficiencies and strategies of the undertaking. Therefore, the Commission and Member State should apply a counterfactual test whereby the performance of this institution is considered in an environment where these external factors are absent. If these external factors, which may include regulators and specific policy developments promoted by these regulators, the demise of competitors or infrastructure failing, are absent then a long-term viable undertaking should have sufficient resources in place to continue operations. In contrast, there may be certain factors at play within a financial institution that may suggest even the absence of these external factors that the bank in question would still have entered financial difficulty. This may especially be the case if an institution has achieved a dominant market position but has done so not by virtue of product innovation or efficiency but rather due to imprudent high risk business strategies. This depends on whether a financial institution may have adopted the role of the “guru” within a Member State’s banking sector.[20] This particular market position may be evident prior to a financial crisis due to the make-up of the balance sheet and how other market participants react to this financial institution’s business activities. In effect a bank in this case adopts via its role of “guru”, a position of dominant failure, that is the presence of this firm in the market is itself a possible external factor that may adversely impact on competitors were it to enter financial difficulty.[21] The financial institution that performs this “guru” role helps in engendering a “status quo bias” within the market whereby other financial institutions follow the “guru’s” market movements and activities.[22]

Past State aid support may also be an indication that the institution in question is simply not in a position to operate in a continuing viable manner. However, this factor may not remain a crucial criterion if the institution currently has a diversified business model and the key grounds for intervention remain current external factors rather than a continuous link to this past support.

9.3.2. Minimum Necessary and Long-term Viable Banks

If a bank qualifies as a long-term viable financial institution, then a new “minimum necessary” level of aid should be established. Under this test the level of support provided would be grounded on an objective benchmark so that Member States would not have to provide continuing financial support to financial institutions with excessive amounts of aid even if these institutions are considered to be long-term viable. The central objective of this test would be to insulate State resources from having to continually inject capital into a financial institution beyond the actual a Member State’s resource requirements. Nicolaides and KeKelekis when critically evaluating

[20] I. Filiz, T. Nahmer, M. Spiwoks and K. Bizer, “Portfolio diversification: the influence of herding, status quo bias, and the gambler’s fallacy”, (2018) Vol.32 Financ Mark Portf Manag pp.167-205 at p.171 available at https://link.springer.com/content/pdf/10.1007%2Fs11408-018-0311-x.pdf [last accessed on 07/11/2018].

[21] M. Rubinstin, “Rational Markets: Yes or No? The Affirmative Case”, Institute of Business and Economic Research, Research Program in Finance Working Papers RPF-294, 2000 at p.5 available at http://www.nyu.edu/econ/user/bisina/rubinstein.pdf[last accessed on 07/11/2018].

[22] *Ibid*.

the Rescue and Restructuring Guidelines, discuss how two inconsistencies are evident under the objectives of these guidelines.[23] On a related note there is also the question of why private investors do not provide funds for the restructuring of a failing firm if both the Member State and Commission are of the view that future viability is possible?[24] Such a question in effect mirrors the statement by Lykotrafiti in Chapter 6 about the exact relationship between rescue aid from public resources and any subsequent restructuring costs met by the undertaking.[25]

For instance, in times of crisis private market investors may not simply have the funds to capitalise even fundamentally viable financial institutions. However, if the State must then become the primary source of recapitalisation then how far this level of support extends must be objectively determined. In a modern society the State plays a key role not just as a regulator but also as the provider for certain public goods, in terms of the latter this may encompass the provision of subsidies for public transport or infrastructure. Therefore the State cannot be said to be a passive actor, with both Tanzi and Reinert setting out how a State may promote economic growth and development.[26] Alongside this economic concept of what a State may do there is also Hardin's work whereby the State's role as a co-ordinator is set out.[27]

[23] P. Nicolaides and M. Kekelekis, "An Economic Analysis of EC State aid Guidelines on State Aid for the Rescue and Restructuring of Companies in Difficulty", (2004) Vol.39(4) Intereconomics pp.204-212 at p.207 available at https://webcache.googleusercontent.com/search?q=cache:7fmNBrisUR0J:https://archive.intereconomics.eu/downloads/getfile.php%3Fid%3D363+&cd=2&hl=en&ct=clnk&gl=ie&client=firefox-b[last accessed on 07/11/2018].
[24] *Ibid*.
[25] Chapter 6 at p.175.
[26] V. Tanzi, "The Changing role of the State in the Economy: An Economic Perspective", a Working Paper of the International Monetary Fund, September 1997, at p.11 available at https://www.imf.org/external/pubs/ft/wp/wp97114.pdf [last accessed on 07/11/2018]: E.S. Reinert, "The role of the state in economic growth", (1999) Vol.26(4) Journal of Economic Studies pp.268-326 available at at http://www.othercanon.org/uploads/state-paper-pdf.pdf [last accessed on 07/11/2018].
[27] R. Hardin, "Economic Theories of the State" in Dennis C. Mueller's (eds.) *Perspectives on Public Choice a Handbook*, (Cambridge University Press, 1997) pp.21-34 at p. 25 available at http://www.nyu.edu/gsas/dept/politics/faculty/hardin/research/EcoTheorState.pdf [last accessed on 07/11/2018].

Thus the multi-faceted role of the State is such that one may be able to ascertain where a State may utilise its resources for the common good in times of financial crisis. If one applies a rational State aid model, similar to the Market Economic Investor Principle criterion, then the level of funding provided to a long-term viable financial institution could be objectively established.

9.3.3. Competition policy as Stability policy

A future State Aid Crisis Framework should set out specific compensatory measures that not only address what could be termed routine competition concerns from a traditional State aid perspective but also wider macro banking sector factors as discussed above. One possible way in which to meet this objective is to impose a divestment policy on financial institutions not with the objective of penalising these institutions but with the aim of removing any future impediments to resolution. Thus under this proposal a State aid recipient would have to dispose of a part of their retail branch network or other primary business domain to a new market entrant. The extent of this divestment will ultimately depend on the overall size and market position of the recipient in question. In some cases, such as Allied Irish Banks in Ireland, this may entail the disposal of a regional branch network but in the case of financial institution such as BayernLB, this may mean the disposal of a specific unit of its corporate lending division to a foreign competitor.[28]

Two key benefits would arise from basing divestment on specifically promoting market entry. First, there will be more options for consumers, although if done on the basis of regional divestment, this might remain somewhat limited. Second, it ensures that financial institutions such as Allied Irish Banks and Bank of Ireland, while still dominant market operators, have seceded some market share to a new entrant thus countering the "too-big-to-fail" threat both pose.

[28] Commission Decision State aid N615/2008 of 18/12/2008 *Germany State aid to BayernLB* K(2008)8839 final at para.4 available at http://ec.europa.eu/competition/state_aid/cases/228700/228700_1022048_47_1.pdf [last accessed on 07/11/2018].

9.3.4. Market Concentration from a Pan-EU Perspective

As noted above imposing a divestment policy on recipient institutions may have positive effects in respect of one domestic or regional market but from a pan-EU perspective divestment could accentuate the problems posed by "too-big-to-fail". One possible solution to this problem is to apply a divestment control criterion whereby if a foreign branch network or business unit is subject to disposal then the purchasing institution must adhere to certain agreed business entry measures. In effect this criterion would impose further downstream divestment on the part of the purchasing financial institution. Thus this institution would then have to agree to further divide and resale some of the purchased business unit to other market entrants or engage in certain behavioural restrictions. Such a criterion would only apply where the Commission has undertaken a detailed study of the affected markets and the balance sheet of the purchasing institution before imposing any such downstream conditions on this institution. This proposal would ensure that any acquisition activity generated by State aid divestment policy does not in effect become the causal factor behind future "too-big-fail" financial institutions.

9.3.5. Compensatory Measures and Consumer Interests

The final strand that the Commission will need to address when formulating competition distortion safeguards for long-term viable banks is the possible effect these measures may have on the final consumer. As stated above, imposing divestments on certain State aid recipients may result in a positive externality for consumers as such a measure may see the emergence of a new market entrant. However, there may also be cases where divestment engenders further market consolidation and entrenches the dominant position of market operators in the market in question.

In the parallel field of merger, control enforcement bodies apply a consumer welfare standard to determine whether the proposed merger or acquisition will adversely impact on the consumer segment in question or market rivals. Certain commentators have questioned whether the EU's anti-trust enforcement regime should be recast as be applied in a manner where only if harm arises to the consumer from an undertaking's market activities should action be taken.[29] If a consumer-welfare standard becomes a key aspect of any future State Aid Crisis Framework so that the pre-existing structure of a Member State's banking sector remains in place, this may deter further market entry or indeed further competition among the existing market operators. Thus in these cases the State aid recipients will need to be subject to behavioural safeguards that, while the may not initially benefit consumers, such as a price leadership ban, and allowing new entrants access to financial services infrastructure so that barriers to entry are lowered for new entrants.[30]

9.4.1. Asset Relief Schemes and State aid

Under the current Impaired Assets Relief Communication, there was an effort by the Commission to develop a framework so that Member States could not over-subsidise financial institutions via asset relief schemes. Thus the concept of "real economic value" was formulated so that any sharp depreciation in asset values due to the 2008 crisis could be alleviated by adopting a longer-term market valuation that would not be subject to the prevailing economic downturn. Yet there are two key problems with applying a long-term economic valuation to assets subject to a relief scheme. First, in certain cases the asset class in question may not actually have a long-term economic value as no market operator may have any appetite to purchase these assets once the crisis environment has lapsed. In this case the long-term economic value should be zero rather than subject to some hypothetical value uplift. Second, a long-term economic value is not easy to reconcile with moral hazard considerations if the participating institution will in any case be immediately recapitalised by a Member State should any shortfall arise. Even where the asset management company retains responsibility for calculating long-term economic value, this measurement remains subject to a number of external factors which may not be easy to reconcile with the conflicting objectives of the asset management-company seeking to maximise profits from lowering

[29] V. Daskalova, "Consumer Welfare in EU Competition Law: What Is It (Not) About?", (2015) Vol.11(1) CompLRev pp.133-162 at p.158 available at http://clasf.org/browse-the-complrev/ [last accessed on 07/11/2018].
[30] Chapter 6 at p.200-201.

the transfer value and the recapitalisation needs of the participating financial institutions.[31]

Thus any future crisis framework must strike a balance between providing some form of effective asset relief programme for financial institutions while also ensuring that such schemes do not in effect constitute a "double bail-out" of the financial institution in question. This "double bail-out" arises where a financial institution receives an economic uplift under the long-term economic value benchmark that may not be based on market realities and then also receive a recapitalisation from State resources to make up any residual shortfall after the transfer process. One possible way to strike a balance is to establish a new benchmark whereby the value of the assets subject to transfer is replaced with a new form of redress based on a cost-benefit analysis. Under EU State aid and Environmental Guidelines an undertaking may qualify for relocation aid if this relocation ultimately reduces the firm's environmental impact.[32] There is a cost-benefit analysis undertaken as to whether the benefits of relocation outweigh the costs from the perspective of environmental protection. In a similar vein, the transfer of toxic assets from a bank under an asset relief scheme follows a parallel cost-benefit analysis. Where the benefits of transfer outweigh the costs then the level of State support should only correspond to the market value of the assets designated for transfer. However, where the costs of the scheme are greater than the benefits then the transfer price of the assets should reflect the pre-crisis value of these assets so that the Member State is not then subject to having to provide recapitalisation funds.

9.4.2. Asset Relief Schemes and Competition Distortion Safeguards

In Chapter 7 it was established how the competition distortion safeguards set out under the Impaired Assets Communication, are not necessarily tailored to

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[31] S. Ingves, S.A. Seelig and D. He, "Issues in the Establishment of Asset Management Companies", (2004) IMF Policy Discussion Paper 04/3, at p.9 available at https://www.imf.org/external/pubs/ft/pdp/2004/pdp03.pdf [last accessed on 07/11/2018].

[32] Commission Communication (2014/C/200/1) of 28/06/2014 Guidelines on State aid for environmental protection and energy 2014-2020 OJ [2014] OJ C200/1 available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0628(01)&from=EN [last accessed on 07/11/2018].

reflect the actual reasons behind the introduction of an asset relief scheme. Under any proposed future State Aid Crisis Framework, the competition distortion safeguards should not only be confined to a claw-back mechanism but to specific behavioural and structural measures that directly relate to the grounds for participating in an asset relief scheme. Thus in the case of Irish banks such as Allied Irish Banks and Bank of Ireland, this may entail these financial institutions limiting their exposure to the property development sector in future. In this way the possible moral hazard associated with an implied asset relief scheme should be sufficiently countered. Furthermore, by imposing these constraints on participating financial institutions, this should indirectly act as a market opening opportunity for other financial institutions.

Another proposed competition distortion safeguard set out in Chapter 7, relates to the problems posed by the duality of State support under certain asset relief schemes. If a scheme is designed in such a way that a financial institution not only receives an asset uplift from the transfer of non-performing loans but also then State recapitalisation, then an additional constraint should then be imposed. Although, the above cost-benefit test may resolve certain strands of this duality problem, an additional counter would be to impose an increased bank resolution contribution on financial institutions benefitting from this dual advantage.

In cases where a State owned and supported asset management-company poses a threat to competition in a particular market sector, a new hypothetical test has been proposed. Under this proposal the actions of an asset management company should be compared to where a hypothetical asset management company charged with the disposal of loans would engage in the manner subject to review. Therefore, in cases where an asset management company has an additional social objective, this should provide for a wider range of discretion to pursue its activities so long as these remain directly related to achieving this social objective.

9.5.1. State aid and Bank Resolution: A new supranational approach

There is a clear overlap between State aid intervention for financial institutions and bank resolution regimes. While from one perspective the objectives of the former may conflict with the aims of the latter, in truth there are a number of cases in which both strands may become entwined. In cases where State aid is designed to ensure that a bank maintains its market presence, bank resolution may initially remain a secondary consideration but depending on long-term factors, resolution may be the only viable solution. As noted above and Chapter 8, there have been a number of developments in the bank resolution and recovery domain within the EU since the 2008 crisis. The implementation of the BRRD and the SRM have to some degree seen a move towards a consolidated and uniform approach to bank resolution within the EU. Competences and resources are now centralised across the participating Member States while the risk of financial fragmentation due to national financial supervisors responding unilaterally to a crisis has also been "tackle[d]".[33] However, these developments have not been without fault, Alexander for instance cites the *Meroni* doctrine as a possible obstacle to the effectiveness of the SRM, a curtailment on the powers of European Union bodies to act outside their remit and co-opt the functions and roles of the delegating authority, in this case the Commission.[34] As the Single Resolution Board [hereinafter the Board] "is an EU agency" then its "discretionary decisions" will remain "limited.[35] Kern also goes onto note how the EU's own Council Legal Service proposed that some of the Board's powers be re-allocated to the Commission or otherwise subject to clearer parameters.[36] On the other hand, the current Regulation does set explicit limits on the role and powers of the Board as Member States retain discretion to determine whether or not to provide public support to a financial institution.[37] Yet conflicts of interest between the Board and Member States seems highly likely particular

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[33] C. V. Gortos, "The Single Resolution Mechanism and the Single Supervisory Mechanism" A comprehensive review of the second main pillar of the European Banking Union, Second Edition, European Centre of Economic and Financial Law, 2015, at p.115 available at http://www.ecefil.eu/UplFiles/monographs/Gortsos_SRMSRF.pdf [last accessed on 09/102/107].
[34] K. Alexander, "The European Banking Union: a legal and institutional analysis of the Single Supervisory Mechanism and the Single Resolution Authority", (2015) Vol.40(2) European Law Review pp.154-187 at p.180.
[35] *Ibid*.
[36] *Ibid*.
[37] *Ibid*.

in times of financial instability where a bail-out may appear more politically expedient than a bail-in.[38]

One solution to this possible conflict is to establish a new Pan-European Resolution and Recapitalisation fund. The centralised resolution component would be controlled and supervised by the European Banking Authority as in line with certain commentators' recent proposal and so the level of resolution funding would then be determined by a supranational body.[39] State funds would not be completely insulated under this proposal but would be limited to the recapitalisation strand of the central fund which would fall under the control of the EU Council and Commission, to circumvent any *Meroni* related discretion limitations. Thus State resources would only be utilised for the restructuring of long-term viable institutions, with the "rational State" criterion applying to the level of recapitalisation the institution in question may avail of. Under this proposal each participating Member State will have contributed to this new pan-EU recapitalisation fund based on the systemic threat posed by their domestic banking sector to the wider internal market. These contributions can then be drawn down in line with the proposed new State Aid Crisis Framework. Thus any central funds from the recapitalisation sub-fund would have to meet the proposed long-term viability State aid criteria and the related competition distortion safeguards.

A Member State will have discretion to avail of their recapitalisation funds for resolution purposes if this is required in exceptional circumstance but the limits such as the proposed restriction on "operational aid" as set out under Chapter 4 would then apply as would the proposed competition distortion safeguards. The current European Stability Mechanism [hereinafter ESM] currently fails to divorce the financial link between a sovereign and their domestic banking sector. The above proposal does not necessarily constitute a panacea for the bank-sovereign link but does at least represent a new form of crisis response whereby *ex ante* funds are already in place for either resolution or recapitalisation purposes. Further with a specific State Aid

[38] *Ibid*.
[39] See Chapter 8 at p.305.

Crisis Framework for the banking sector the level of aid support provided and how this aid is targeted should ensure that an Irish scenario does not arise in the future.

9.5.2. Existing Bank Recovery and Resolution Directive and the need for new Systemic Resolution Tools

The above proposals do not necessarily run counter to the objectives of the BRRD, if anything the proposed future Crisis Framework would complement the existing resolution tools under this Directive. However, as noted above these tools may only suffice in cases involving an isolated financial institution in times of overall market calm. In these circumstances applying resolution tools such as the bail-in tool or the bridge bank tool, may not trigger wider market instability. Thus, in this scenario policymakers will have the opportunity to determine the systemic importance if any of the institution in question, and then be able to decide whether long-term viability or resolution is the correct call to make.

In contrast, if a bank poses a systemic threat then clearly specific systemic resolution tools should then be invoked that are primarily designed to ensure that wider financial sector stability is maintained. These systemic tools should be designed to ensure that critical banking facilities are maintained during any resolution process and where required a deposit protection tool could also be implemented to ensure that depositors are not bail-in where this may trigger further banking instability. These tools in turn could then be either financed via the proposed centralised pan-EU bank fund from private bank contributions or the public side of this fund. Although Member States' funds would ideally be used to simply recapitalise a financial institution, if required these funds could be utilised to support any costs associated with implementing any of the proposed systemic resolution tools. The State aid aspect of these tools would then be determined on the basis of the new guidelines for systemically important but non-long-term viable financial institutions as proposed in Chapter 4.

Recent developments in the Italian banking sector highlight the limits of the current BRRD process. For instance, in order to facilitate the restructuring of

Monte de Paschi di Siena the Italian State has recently injected State resources into this bank on the basis of the precautionary recapitalisation principle.[40] In effect this principle allows for a circumvention of the bail-in and resolution architecture so that a financial institution in vulnerable financial position can remain in situ. On closer examination this recapitalisation option has similar features to the pre-crisis framework response adopted by Member States such as Ireland. Instead of depositors and bondholders being bailed-in in line with the BRRD rules, this precautionary exception allows for Member States to avail of a bail-out rather than a bail-in option.

Conclusion

The aim of this Chapter was to set out the proposals developed in the preceding four Chapters. Each of these proposals are tailored to reflect the challenges facing both Member States and the Commission via its Directorate General for Competition arm. Instead of applying the 2008 Crisis Framework in a future crisis scenario, these new rules should not only resolve the failings of State aid enforcement during the last crisis but also provide a new benchmark for how State aid should apply to the European banking sector in general. A new State Aid Crisis Framework that specifically addresses the question of systemic importance from a State aid perspective, seeks to prevent the complete fusion between sovereign and bank debt due to a bank guarantee scheme, ensures that State aid resources are properly targeted in respect of both long-term viable banks and asset relief schemes, should prove a crucial resource for policymakers. The above proposals in effect seek to build on the existing State aid architecture and then develop a reinforced set of guidelines that are applicable in a future crisis scenario. These guidelines should also provide further scholarly debate about the exact parameters of how the "serious disturbance" exemption in Article 107(3)(b)TFEU should apply more generally in a non-banking context. Thus these proposals not only

[40] Commission Statement: Statement on agreement in principle between Commission Vestager and Italian authorities on Monte dei Paschi Siena, Brussels 1st June 2017, available at http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm [last accessed on 07/11/2018].

constitute a body of work on specific strands of European State aid law but to the wider State aid and indeed competition domains.

Conclusions

The 2008 financial crisis exposed how ill equipped both individual Member States and the European Commission were to respond to financial instability. The lack of supranational bodies in the bank supervision and resolution field, meant that disparate responses were taken by different Member States. Some of these failings have been addressed with the introduction of the Bank Recovery and Resolution Directive and the Single Resolution Mechanism.[1] Nonetheless, the fact remains that the State aid rules applied during the last financial crisis were not adequate in resolving the complex problem of the inter-linkage of sovereign and bank debt where individual Member States were responsible for the funding of bank bailouts. The exact parameters of Article 107(3)(b)TFEU were not clear prior to the financial crisis and so the three key criteria of "appropriateness", "necessity" and "proportionately" were applied in a broad manner. Determining what aid intervention meets these three criteria in times of systemic crises remains a difficult task for both EU Member States and the European Commission. Yet learning from these difficulties ensures that a new State Aid Crisis Framework can be formulated and applied in a future crisis scenario.

By developing a new set of criteria for each individual strand of the overarching crisis responses from bank guarantees to asset relief schemes, this Thesis has thus sought to provide policymakers in Europe with a new crisis-specific framework. Questions of systemic importance, long-term viability and breaking the sovereign-bank link where possible are all addressed in a critically manner. Instead of Member States and the European Commission falling into the same trap as in 2008, this new Crisis Framework should ensure that the use of public funds to support an ailing banking system will be "appropriate", limited to the "minimum necessary" and that "proportionate" competition safeguards are applied.

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