The Impact of the Financial Crisis On the Functioning of the Internal Market.
Bailing Out the Banks… Burning Down the House?

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Two questions constantly recur in discussions over State aid to the financial sector. **First question**: why is State aid given to bail out the banks and not other sectors? **Second question**: given the huge amounts of money involved, is this the end of the Lisbon era aiming to reduce State aid and to redirect "intelligent state aid" away from sectors to horizontal projects and how will this impact upon the Lisbon Process and the Internal Market project?

First Question: Why Give State Aid to Banks?

The first question is easier to answer. If I asked how many people in the room have a bank account there would most likely be a 100% response. Similarly many people in the room will have a mortgage and some will have personal and/or business loans. In many EU states banks also play a prominent role in providing loans (and advice) for social, regional and cohesion initiatives, alongside commercial activities. Although the EC Commission[1] and the Court[2] have not recognised banking as a service of general economic interest there has been a long-held view that *access* to financial services could, and should, be recognised as an SGEI. Thus while there may be public dismay at bailing out banks because of the mistakes made by the banks' own misjudgement one has to think of the consequences of *not* taking action: alongside losing major and small businesses, homes and life-time savings, pensions would be at risk and also, for many of us, life would not function without access to the ATM on a Saturday night.

Banking and financial services are regarded as a discrete sector for a number of other reasons. Vickers points out that banks rely more than any other sector upon promises and confidence. A crisis in the banking sector can lead to a systemic crisis of the global economy.[3] The banking sector is not only inter-connected, but also provides "the essential oil in the economic system,

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[1] EC Commission, *Report of the European Commission to the Council of Ministers: Services of General Economic Interest in the Banking Sector*, presented to the Ecofin Council on 23 November 1998.

[2] Case 172/80 *Züchner v Bayerische Vereinsbank* [1981] ECR I-2021.

[3] See Luc Laeven and Fabian Valencia, *Systemic Banking Crises: A New Data Base*, IMF Working Paper WP?08/224.

allowing other firms to absorb the bumps of fluctuating revenues and payments."[4]

Background: the EC Commission and European Courts' Perspective in Earlier Crises

State aid to the financial sector is not a new issue on the EC Commission's economic and political agenda. It has been around for many years, but not necessarily for the reasons just outlined in relation to the pivotal role banks play in the EU and the systemic repercussions the failure of a bank may have in the national and global economy. The concern of the EC Commission in the past has been focused more upon the role financial services play in the realisation of an Internal Market and the need to ensure transparency where State resources are involved in public and private financial institutions. Alongside the fundamental freedoms found in the EC Treaty (establishment, services and capital) the EU has created a wide-ranging set of secondary rules to open up financial markets to cross-border activities and competition. This relies upon the principle of mutual recognition and the use of self-regulation in the sector to reduce the barriers to cross-border penetration into new markets. The attempts at abolition of discriminatory practices led to the privatisation of many State-owned banks but not State *involvement* in financial activities, as public ownership was replaced by less than covert State intervention and support for newly-privatised activities. [5]

The Use of the Private Investor Principle, Article 87(3)(b) EC to Justify State Intervention

States use a variety of forms of intervention to support the banking sector, ranging from direct investment, capital injections, State guarantees, rescue and restructuring aid (for individual institutions as well as the whole sector) and special tax regimes. The Court took a robust view of such forms of intervention from a very early stage, determining that such intervention was not a part of monetary or fiscal public policy but a form of State aid which could distort competition.[6] However, the State aid rules allow some leeway in granting State aid to the financial sector without resort to special treatment. For example, the use of the private investor principle, [7] although, in practice,

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[4] Bruce Lyons, *Competition Policy, Bailouts and the Economic Crisis*" CCP Working Paper 09-4.

[5] See for example, *EC Commission, Seventh Survey on State Aid in the European Union in the Manufacturing and Certain Other Sectors*, COM (1999) 148 final.

[6] Cases 6 and 11/69 *Commission v France* [1969] ECR I-523. See also the approach to "State resources" in Case C-290/83 *Commission v France* [1985] ECR I-445.

[7] See for example, Case C-142/87 *Belgium v Commission* [1990] ECR I-959; Commission Decision 2000/600/EC of 10 November 1999 conditionally approving the aid granted by Italy to the public banks *Banco di Sicilia and Sicilcassa*, OJ 2000 L256/21. The principle was also used to question operating aid in the form of equity

this is a high threshold to meet. Article 87(3)(b) EC would allow for State aid to be declared compatible with the Common Market where there is a serious disturbance in the economy of a Member State. This provision has been used rarely. [8] The CFI has held that the provision should be used restrictively and should only be used to address a disturbance in the *entire* economy of a Member State. [9] The Commission has also applied the same test in Decisions concerning State aid and banking.[10]

No special Guidelines have been adopted for State aid to the financial sector and therefore the generic "R & R" Guidelines apply.[11] During the 1990s the Commission did not disapprove of rescue and restructuring aid given to banks and other credit institutions in difficulty: *Banesto* (1994), *Crédit Lyonnais* (1998) *Gan* (1998), *Banco de Sicilia and Banco di Napoli* (1999) *Bankgesellschaft Berlin AG* (1999). But in other cases has found State intervention to be incompatible with the State aid rules: *Société de Banque Occidentale Lyonnais, Crédit Foncier de France* (1999). [12]

State guarantees have created problems for the Commission generally and have played a prominent role in the banking sector. The most significant case was the complaint made by the European banking federation against the German scheme of guarantees for its public banks which led to the eventual restructuring of these banks. The Commission has taken an equally tough stance against guarantees used in Austria and in France,

Article 86(2) EC: SGEIs

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transfer in the *WestLB* investigation: Case C-209/00 *Commission v Germany* [2002] ECR I-11695; Joined Cases T-228/99 *Westlandesbank v Commission* and T-233/99 *Land Nordhein-Westfalen v Commission* [2003] ECR II-435.

[8] EC Commission Fifth Report on Competition Policy (1975) April 1976, para 133; Seventeenth Report on Competition Policy 1987, (1988) paras 186 and 187 with reference to Greece.

[9] Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663 para 167.

[10] Commission Decision case C 47/1996 *Credit Lyonnais*, OJ 198 L221/28, point 10.1; Commission Decision in case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L116/1, points 153 *et seq;* Commission Decision case C50/2006 BAWAG nyp, point 166. For more recent decisions in the current crisis see: Commission Decision of 5 December 2007 in case NN 70/2007 Northern Rock, ABI C 43 of 16 February 2008, 1; Commission Decision of 30 April 2008 in case NN 25/2008 Rescue Aid to WestLB, ABI C 189 of 26 July 2008; Commission Decision of 4 June 208 in Case C9/2008 Sachsen LB, nyp.

[11] The first set of Guidelines for Rescue and Restructuring firms in Difficulty were produced in 1994 and have been modified over time. The current rules are found in: *Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*, OJ 2004 C244/2.

[12] See: V Sansonetti and P Rossi-Maccanico, "State Aid in the Lending Sector" SSRN Paper October 2007. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962050

It is possible for a Member State (and individual banks) to obtain an "exemption" from the application of the free market and competition rules where a SGEI satisfies the criteria of Article 86(2) EC. More recently, the application of the *Altmark* criteria[13] and the Commission's Framework and Decision may also provide safe heavens in which State support for banks can be given, albeit in limited amounts. [14] In the Amsterdam Declaration, preceding the Commission's 1998 Communication on SGEIs and the banking sector, the Council acknowledged that the use of local authorities in Germany to finance regional projects satisfied the criteria of Article 86(2) EC. But in the French cases of *Crédit Mutuel* and *Crédit Agricole* the Commission found aid contrary to the State aid rules because in the former case special rights granted for the distribution of tax-free savings products and the financing of social housing altered the functioning of the market and were not necessary for the financing of social housing of providing access to banking services. In the latter scheme public notaries were given exclusive rights to hold deposits in authorised banks and credit institutions and the Commission found that this altered the competitive balance in the EU in a market which had been progressively liberalised and opened up to competition.

The New Approach: Co-ordinated State Aid and Co-ordinated Macro-Counter-Cyclical Plans

The current crisis in confidence in the banks can be traced back to the 2007 State interventions in Northern Rock (UK)[15] and IKB, SacchsenLB (Germany)[16] but it was not until September 2008[17] that the EU banking system was shaken by the threat of default by a number of leading financial institutions in the US, Germany, Ireland and the UK . The initial reactions were national responses, with Ireland taking the lead to guarantee, in full, all bank creditors. On 27 and 28 September 2008 the Belgian and Dutch Ministers of Finance met to avert

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13 Case C-126/01 [2003] ECR I-7747.

14 Community framework for State aid in the form of public service compensation, OJ 2005 C 297/4; Commission Decision of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest , OJ 2005 L 327/488.

15 Case NN70/2007 *Northern Rock*; Case C14/2008 *Restructuring aid to Northern Rock*.

16 C9/2008 (ex NN 8/2008).

17 Denmark communicated measures to rescue Roskilde Bank in July 2008 and the EC Commission approved the measures but the bank was liquidated under the November 2008 EC Commission Communication on State aid to overcome the financial crisis.

the collapse of the Fortis bank and agreed an initial cash injection, followed by the Dutch operations being nationalised. This was followed by a similar crisis meeting of the Belgian and French governments to discuss the response to the crisis in Fortis, Dexia and BNP. President Sarkozy then invited the Heads of Government of the Euro-group states, along with the President of the Central Bank, to discuss the financial sector crisis at a meeting in Paris on 11 and 12 October 2008. The British PM Brown had talks with President Sarkozy before the meeting.

As is well known, the British public had been shaken by the near collapse of Northern Rock, witnessing long queues of savers driven to withdraw, what were often life-time savings, from a High Street institution, but also the collapse of the Icelandic banks had shaken not only private investors but also many institutional investors such as charities[18] and local authorities. Full or partial nationalisation of banks and building societies, alongside mergers of competing banks[19] have subsequently challenged the competitive structure of the banking sector in the UK .[20]

The outcome of the Paris summit was again national responses where each Member State committed to providing guarantees to its own banking sector in the hope of stabilising confidence in the banks but also hoping to avert cross-border im-balances. The Irish government had initially been criticised for taking unilateral action which could have produced huge incentives for investment from the UK as savers switched their savings. [21]Lurking at the back of politicians' and economists' minds was also the risk of Europeans adopting the Japanese response to their lack of confidence in banks from their crisis in

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[18] The most publicised case being The Cats' Protection League having some £11.2 m invested in Iceland.

[19] LloydsTSB and HBOS.

[20] OFT, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform* 24 October 2008. The OFT recommended that the Competition Commission should investigate the proposed merger of Lloyds and HBOS but this recommendation was overridden by a rare intervention by the Secretary of State (who was supported by the Bank of England, the Financial Services Agency and the Treasury). This was a political intervention which was contrary to the reform of the merger legislation in the Enterprise Act 2002 which had sought to de-politicise mergers allowing only for political intervention where national security interests were at stake. The Enterprise Act also allows for political intervention to maintain plurality in the media. Thus the UK government resorted to expedient tactics by creating a new public interest "to ensure the stability of the UK financial system " by an Order made by the Secretary of State under section 124(7) of the Enterprise Act 2002: SI 2008/No 2645 The Enterprise Act 2002 (Specification of Additional Section 58 Consideration Order 2008, available at:
http://www.opsi.gov.uk/si/si2008/uksi_20082645_en_1

[21] A trans-national problem which has re-emerged as UK banks are accused of offering preferential lending rates to first-time home-buyers in Ireland: "Rescued UK Banks Sell Cheap Home Loans to Irish", The Times, April 28, 2009, page 37.

the early 1990s by placing savings under the mattress, [22] rather than investing in financial institutions. The amounts of guarantees on offer were substantial : the UK, France and Germany promised 450 billion euros, 320 billion euros and 400 billion euros respectively . [23]

The Commission had attended the Paris meeting and subsequently issued a *Communication entitled From Financial Crisis to Recovery: a European Framework for Action*. [24] The purpose of this *Communication* was to underwrite the need for concerted Community reaction to the financial crisis, both in terms of Community responses to the immediate problems facing the banking sector as well as taking a new look at the regulation or, as some would argue, lack of regulation, in the financial sector. The EIB had already created a scheme of loans for SMEs involving some 30 billion euro, to be distributed through commercial banks. The Commission in its *Communication* also proposed that the EBRD should become involved and also noted that under the Cohesion Funds some 350 billion euro were available in the period up to 2010.

The *Communication* also proposed measures to tackle the problems resulted from the regulatory model for the financial sector by establishing the High Level Larosière Group.

The Conclusions of the Brussels European Council of 15/16 October 2008 had drafted a balance between recognising the exceptional circumstances of the crisis in the financial sector leading to systemic risks for the economies not only of the Member states but the EU as a whole. [25] However sharp divisions were clearly visible between the UK and the rest of the Euro-group with clear conflicts as to who was to blame for the banking crisis with the biggest rifts emerging between PM Brown and Chancellor Merkel. The UK crisis was blamed upon the looser regulation of the financial sector and the heavy reliance upon self-regulation (or light touch State regulation) of the sector which had given the UK a competitive advantage and allowed it to grow as one of the leading international financial sectors. In contrast continental European Central Banks were regarded as better disciplined and regulated more stringently. UK banks had taken greater risks and were levered, with more debt relative to liquid assets and fewer secured assets in the form of say,

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22 "Tansu yoking" - "cabinet/chest of drawers savings".

23 For a Useful summary of current and proposed global initiatives see:*A Reference Guide to the Financial Crisis Rescue Efforts, available at:* http://www.lexology.com/library/detail.aspx?g=bdcecaa8-e0f6-40b3-bce6-6db9df1a8bb5
My thanks to colleague Richard Perkoff at Littleton Chambers for this reference.

24 COM(2008)706 final.

25 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/103441.pdf

Government bonds. But perhaps the most sensitive criticism was directed at the pro-US bias of taking on risky loans with more loans outstanding in toxic debts as a result of being "in bed with the US" and not Europe. Initial responses were that even the European banks were exposed to risky assets and that eventually some Trojan horse debts would emerge (for example, risky loans to Russia and other Eastern European states).

The Commission has responded, so far, by offering a "resolution" to the financial crisis by three soft law measures:

- a Banking Communication adopted on 13 October 2008
- a Recapitalisation Communication of 5 December 2008
- an Impaired Assets Communication of 25 February 2009

The Banking Communication, 13 October 13 2008

The Commission and the Council used the legal base of Article 87(3)(b) EC to justify intervention where a Member State wanted to use State aid for the entire financial sector (or for large banks playing a significant role in the economy of a Member State) and situations where an intervention was needed to shore up smaller banks but the rigorous conditions for Article 87(3)(b) EC were not triggered. In the latter situation resort would normally be to Article 87(3)(c) EC. The EC Commission has made it clear that the banking sector was an unusual sector and that:

> "The use of Article 87(3)(b) of the EC Treaty cannot be envisaged as a matter of principle in crisis situations in other individual sectors in the absence of a comparable risk that they have an immediate impact on the economy of a Member State as a whole."[26]

Given the very sparse consideration given to this clause in the history of EU integration a crucial question emerges as to how a "serious disturbance in the economy of a Member State" is assessed, and in particular is this a political or economic assessment to be made?

In a *Communication* issued on 13 October 2008 entitled *Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis* (the Banking Communication)[27] the EC Commission announced a new fast track approval of aid under Article 87(3) (b) EC to remedy situations where there is a serious disturbance in the economy of a Member State and where there is the need to support State aid schemes as well as individual banks. It acknowledged that it was bound by the 2004 Guidelines on Rescue and Restructuring and in principle banks should not be treated any differently, thus rescue aid should normally be limited to a six month rescue period followed up by a restructuring plan. However because of the unusual effects on the economy

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26 *State Aid Scoreboard, Spring 2009 Update*, 10.

27 OJ 2008 C270/8.

the beneficiaries did not have to show they were in difficulty and structural measures were in principle allowed. Thus the response was an exception to the State aid rules, *not* a rule of reason. In the Spring 2009 Update State Aid Scoreboard the EC Commission emphasises the exceptional steps taken will not apply automatically to other areas of the economy of a Member State.

The acceptance of State assistance to the banking sector within the EC Treaty rules and the Guidelines rests on satisfying 5 *cumulative* criteria.

The aid must be:

1. Objective and not discriminatory
2. Limited in time
3. Well-targeted
4. Proportionate
5. Designed to minimise negative spill-over effects

The last criterion is the most important in deciding if the response will jeopardise the long-term ambitions of EU integration. The EC Commission outlines what is required to minimise negative spill-over effects in that aid must contain appropriate mechanisms to minimise distortions and potential abuse by beneficiaries with a combination of behavioural constraints to avoid aggressive expansion and mechanisms (sanctions) to remove State guarantees if there is abuse. These criteria look to the time of the request for State aid but do not address the long-term effects of bailing out banks. It may not be possible, for example, to rule out collusion in applying for the state aid, the limited information available to competitors who may wish to challenge the assessment of the seriousness of the economic situation, the ineffectiveness of the aid, the creation of monopolies/duopolies as a result of the crisis. EU law may apply where cross-border mergers of banks takes place where there is a Community dimension, and a special set of rules and policy guidelines may be put in place by the EC Commission as the fall-out after the crisis clarifies the market position of banks. An issue which has emerged is does bailing-out the banks work? Certainly banks have been saved from collapse but the reluctance (or cautiousness) to lend to kick-start the EU economy has led the Commission and the Member States to consider other economic responses to create a financial stimulus to ease out the EU recession.

The Commission established a special web page to record action taken as a fast response to State intervention (within 24 hours instead of the usual 2 month period for consideration of a notified State aid), and newly created 20 "crash teams", with the Commission adopting a working slogan "Part of the Solution to the Financial Crisis, Not Part of the Problem". Since October 2008 the number of staff working on State aid for the financial sector has risen from 15 to 78.

The Recapitalisation Communication

The problem which emerged was that banks were faced with capital inadequacy and were unable to stimulate the economy with lending. To prevent further deleveraging banks needed a new form of State aid and

many Member States wanted to provide such buffers to slow down the down-turn in the economy. These schemes, which varied between the Member States, were discussed at the ECOFIN Council of 2 December 2008, revealing the need for EC Commission co-ordination and guidance, not only for the Member States, but also for potential beneficiaries. A further Communication was issued on 5 December 2008: *The Recapitalisation of Financial Institutions in the Current Financial Crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition.*[28] The *Communication* acknowledged that the *Banking Communication* recognised that recapitalisation was one possibility under the State aid rules more detailed guidance was necessary, given the different schemes adopted by the Member States.

The *Communication* rests upon two over-arching principles: **first**, remuneration must be as close to market prices as a way to limit competition distortions and **second,** such schemes must be temporary in character with incentives for State capital redemption favouring an early return to normal functioning of the market. Competition concerns are reflected in distinctions drawn between the treatment of fundamentally sound, well-performing banks and what are now known as "zombie banks", distressed, less well-performing banks. [29] In particular, the Communication places emphasis upon the need to safeguard against possible abuses of competition in recapitalisation schemes, noting that an irreversible trigger can lead to an expansion of beneficiary banks at the expenses of non-beneficiary banks in the same or other Member States. Thus the *Communication* stresses the need to keep capital injections to a minimum and the Commission recommends the use of claw back mechanisms or "better fortune" clauses. The Commission relies upon the ECB recommendations of 20 November 2008 which established a corridor for rates of return for beneficiary banks which are seen as fundamentally sound financial institutions, notwithstanding their current risk profile. The price for the capital injection should be based upon the type of capital chosen, an appropriate bench-mark risk-free interest rate and the individual risk profile of the bank. The Commission added to this guidance by including further conditions other than remuneration rates as conditions for access to State aid in the form of capital injections. These addressed incentives for State capital redemption: the pricing mechanism should carry a sufficient incentive to keep State involvement to a minimum, giving an example of an increase over time of the remuneration rate. A review of the performance of the banks should take place after six months, with the Member State reporting to the EC Commission.

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[28] C(2008)8259 final, Brussels, 5 December 2008.

[29] The use of this term is also seen in the wider context of the risks of giving State aid to no hope firms in other sectors: J. Pisani-Ferry and B von Poettessberghe, "Handle With Care! Post-Crisis Growth in the EU" Breugal Policy Brief Issue 2009/2 April 2009, available at:
www.bruegel.org/Public/fileDownload.php?target=/Files/media/PDF/Publications/Policy%20Briefs/pb-2009-02_160409.pdf

One of the first Credit Guarantee and Recapitalisation Schemes to be assessed was the scheme established in the UK on 13 October 2008 (modified on 23 December 2008) and extended until 13 October 2009. The UK scheme was recently investigated and approved by the EC Commission in April 2009. Under this scheme the eligible beneficiaries must be fundamentally sound banks (with liabilities above £500 million) and must agree to provide loans to firms and individuals in the real economy. However a capital injection into a bank which has already accessed the recapitalisation scheme will be subject to individual notification.[30]

The Treatment of Impaired Assets Communication

Despite State aid, the market value of portfolio investments continued to decrease and banks could not attract confidence from new investors. Several Member States began to complement existing State aid by announcing that they would remove impaired assets from the banks through guarantees, swaps and asset purchases of such risks. Again the Commission was concerned to give transparency to such schemes as well as monitor the schemes through co-ordination in a Communication.

The *Communication* rests upon general principles which should be applied to the Member States' schemes. There must be:

- full transparency and disclosure of impairments, which has to be done prior to government intervention;
- coordinated approach to the identification of assets eligible for asset relief measures through development of eligible categories of assets ("baskets");
- coordinated approach to valuation of assets ex-ante, based on common principles such as valuation based on real economic value (rather than market value), certified by independent experts and validated by banking supervisory authorities;
- parallel viability review of the bank's activities and balance sheet with a view to assessing its present and prospective capital adequacy and viability;
- validation by the Commission of the valuation of the assets, in the framework of the State aid procedures on the basis of uniform assessment criteria;
- adequate burden-sharing of the costs related to impaired asset between the shareholders, the creditors and the State;
- adequate remuneration for the State, at least equivalent to the remuneration of State capital;
- coverage of the losses incurred from the valuation of the assets at real-economic-value by the bank benefiting from the scheme;
- aligning incentives for banks to participate in asset relief with public policy objectives, through an enrolment window limited to six months during which the banks would be able to come forward with impaired assets;

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30 N193/2009.

- management of assets subject to relief so as to avoid conflicts of interests;
- appropriate restructuring including measures to remedy competition distortion, following a case by case assessment and taking into account the total aid received through recapitalisation, guarantees or asset relief, with a view to the long-term viability and normal functioning of the European banking industry

Again Commission approval for the schemes is only for six months and is conditional on the commitment to present details of the valuation of the impaired assets, as well as the viability assessment and a restructuring plan for each beneficiary within three months of the beneficiary being included in the scheme. Each case will depend upon its own facts but appropriate restructuring may include measures to remedy competition distortions with the aim of ensuring that the bank can return to long-term viability and perform normal lending functions without State aid.

The Larosière Report 2009

The second collective EU response to the crisis was to revisit the causes of the financial crisis and the belief in self-regulation of the banking sector by establishing a working group (the Larosière Group) composed of Leszek Balcerowisz, Otmar Issing, Rainer Masera, Callum McCarthy, Lars Nyberg, Jose Perez Fernandez and Onno Ruding, under the Chair of Jacques de Larosière. The group reported quickly, presenting to the Commission on 25 February 2009[31] with the European Council in March 2009 endorsing the recommendations as a basis for further EU action.[32]

Stimulation of the "real" EU Economy

The Heads of State and Government invited the EC Commission to present further proposals for co-ordinated EU action to the December 2008 Council Meeting. On 24 November 2008 the Commission published a second response, a *Communication on a European Recovery Plan*.[33] In this exercise sharper divisions between the UK and the rest of the EU, especially Germany became even more obvious. The Commission moved from focusing upon rescue and restructuring to a plan to stimulate the economy and

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31 *The High Level Group on Banking Supervision in the EU Chaired by Jacques Larosière, Report, 25 February 2009, Brussels.* Available at:

http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf

32 Presidency Conclusions of the Brussels European Council 19/20 March 2009, Point 5.

Details of the Report (which is not discussed here) can be found at: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

33 COM (2008)800 final.

competitiveness of the EU. Germany and the UK were once again at loggerheads, but what is significant is the *pace* of the EU to respond to a crisis. A "Roadmap" was agreed and the Council on 2 December 2008 agreed a position on four draft Directives on solvency of insurance companies, banks' capital requirements, the functioning of UCITS. But equally significant is the role undertaken by the Commission on the co-ordination of the macro-economic management of the EU economy.

The European Council meeting of 11 and 12 December 2008 endorsed the Member State and Commission responses to the crisis but also turned attention to the international or global issues the financial crisis had revealed, asking for further work to be undertaken for the Spring 2009 Council meeting. There are two pillars to this recovery plan. The first pillar is a major injection of purchasing power into the economy, the second pillar stresses the need for direct short-term action towards reinforcing the EU's competitiveness. Again sharp divisions between the UK and Germany were visible but agreement was reached on a European Economic Recovery Plan.

At this meeting the Council also agreed to continue with the work of reforming the financial sector, looking at credit rating agencies, financial supervision and accounting standards.

The Commission published a second macro-economy Communication on a European Recovery Plan on 26 November 2008.[34] This broadened the EU response to the crisis by proposes a counter-cyclical macro-economic plan for the EU economy.

Thus, the European Council meeting of 11 and 12 December 2008 focused attention away from the purely internal dimension of the financial crisis to the role the EU was to play in reviving the down-turn in the global economy while ensuring its competiveness in the global trading system.

Second Question: The Fallout

The operation of the Internal Market relies heavily on trust. The free movement of goods, services, establishment and capital needs a competitive economy to function. The reliance upon such competitiveness is seen most clearly in the Court's rulings in *Laval* and *Viking*.[35] The financial crisis has tested this mutual trust and while the Commission has been very quick to respond to the special problems posed by a crisis in the financial sector using soft law *Communications*, it has shown an equally rigorous approach to keep the Lisbon agenda focused by refusing to apply the automatic relaxation of rules to other sectors. It is only now, after the first six months of "R & R" aid, can we begin to assess if the EC Commission is committed to a rigorous application of State aid policy in its follow-up reviews. First impressions suggest that the lack of personnel and the ongoing crisis have not allowed the EC Commission to

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34 COM(2008)800 final.

35 Case C-438/05 [2007] ECR I-10779.

conduct the reviews in an intensive manner. The question emerges as to whether the alternative forms of enforcement of the State aid rules, especially through non-State, third party challenges to Commission Decisions and Member State interpretation of the soft law guidance offer a fall-back to counter any longer-term anticompetitive damages which has emerged from the crisis-management adopted by the EC Commission.

The EC Commission argues that the modernisation of the State aid regime as a result of the State Aid Action Plan programme allowed for a pragmatic approach to be taken to a crisis in one particular sector. Clearly of benefit is the new GBER which allows for greater responsiveness and some flexibility in key areas of the "real economy". [36] The EC Commission has yet to define its future policy on the proportionality of State aid, especially aid given to individual firms, which does not fall within the GBER. The EC Commission also introduced a *Handbook on Community State Aid for SMEs*[37] amended on 25 February 2009. As well as explaining the possibilities for State aid to SMEs the handbook is designed to pull together the information on the Temporary Framework for access to finance in the crisis. A question remains, could the Commission have done more? For example could the rules on *de minimis* aid, employment and training and aid to SMEs be relaxed on a temporary basis to complement economic stimulation of a national and the EU economy-downturn? A reluctance to do this may be an underlying concern of a lack of resources to monitor the use of opportunism by Member States who have the money to offer to State aid not only to bail out firms in crisis but also to offer incentives for inward investment. Thus the longer term anti-competitive effects of a relaxation of rules and arguably orders for recovery of illegal State aid in the future could create as much harm as crisis responses to failing firms.[38]

The second question posed at the start of this paper was has the acceptance of State aid to banks ended the Lisbon Agenda for reducing State aid and better targeting of such aid? Certainly other sectors, notably the car industry have shown few inhibitions in asking for State aid. This has led to join requests in some cases (for example, what might be seen as collusion by Renault and Peugeot-Citroen) with the Competition Commissioner taking a firm stance on the need for such aid to fall within existing State aid rules[39] or formal

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36 Commission Regulation 800/2008, OJ 2008 L214/3.

37 http://ec.europa.eu/competition/state_aid/studies_reports/sme_handbook.pdf

38 See also the recent concern of giving subsidies to "zombie" firms: J. Pisani-Ferry and B von Poettessberghe, "Handle With Care! Post-Crisis Growth in the EU" Breugal Policy Brief Issue 2009/2 April 2009, available at: www.bruegel.org/Public/fileDownload.php?target=/Files/media/PDF/Publications/Policy%20Briefs/pb-2009-02_160409.pdf

39 A number of ways in which the existing State aid rules can be used is attached to this paper.

acceptance by the Commission.[40] Linked to State aid policies have been rumours of protectionism (for example, only giving aid to parent companies located within the Member State or conditions of aid such as "Buy French" components for goods receiving a subsidy) but as of yet no cases have been officially been reported, although there is some anecdotal evidence of retrenchment to parent member State locations.[41] Does this mean a retrenchment away from competition to national industrial policies? There are strong arguments that the Internal Market and a competition policy thrive when European economies are buoyant and that a rigorous enforcement of the rules needs to be adapted, even on a temporary basis, when such conditions for mutual trust do not exist.

The crisis has exposed the weaknesses of using the mutual recognition principle and minimum harmonisation as a corner-stone of integration and freeing up trade. The use of EU resources, or ideas of solidarity between Member States to shore up one Member State facing difficulties has been discussed in Germany. It has been fortunate that the Member States using the most money to bail out the banks have been the richer Member States of the Union. The spectre of "what might have been" of re-locations of financial services and large manufacturing operations to Member States with less regulation and lower labour and capital investment costs but no means (or no political desire to) to bail-out firms and banks in difficulties now haunts the premises of the integration project.

The Member States have taken on and committed themselves to huge debts which strain their commitments under the broad guidelines of economic policy under Article 99 EC[42] and Article 104 EC[43] which set out the excessive deficit procedure and the Stability Pact. The European Council has called upon the Member States to return as soon as possible to their medium term budgetary targets point 13 but the question lurks as to whether, and how for how long, will Member States be allowed to stray from the 3% budget deficit rule and the Council fail to act?[44]

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40 EC Commission, *State Aid: Commissioner Kroes Meets French Industry Minister Luc Chattel on Car Support Measures*, Memo 09/50, 04/02/2009 http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/50&type=HTML&aged=0&language=EN&guiLanguage=en

41 For eg: on the Unite union's website there is a quotation from President Sarkozy of France; "We want a French industry, we want a French automobile industry, we want to keep production capacity on French territory." Available at: http://www.unitetheunion.com/resources/political_and_policy_departmen/unite_in_europe/eu_news/car_industry_commission_exami.aspx

42 This applies to all Member States, not only to the euro-zone Member States .

43 This also applies to all of the Member States but the sanctions contained in Article 104(9) EC and Article 104(11) EC do not apply to the non-euro-zone States.

44 Case C-27/04 *Commission v Council* [2004] ECR I-6649.

Glossary

Burning Down the House - readers of a certain age may need to resort to YOUTUBE to understand the title, taken from the lyrics of David Byrne, "Burning Down the House" first recorded by: Talking Heads on Speaking In Tongues – 1983, but currently playing live to packed and animated audiences of 50-somethings around the UK

ANNEX 2

Public support measures for the automotive industry/sector

On 26 November 2008, the Commission adopted the European **Economic Recovery Plan** which encompasses measures aimed at boosting demand, saving jobs and restoring confidence in the short-term while focusing on the 'smart investment' which will make the European economy competitive in the long–term. This plan has led to the adoption of the **Temporary Framework for State Aid**[45] which aims at reducing the negative impact of the crises in the real economy by providing Member States with additional possibilities to grant State aid and which is also applicable to companies in the car sector. This Framework is complemented by the **Communications on State aid measures to support the banking sector**[46] in the context of the global financial crisis adopted earlier by the Commission through which the Member States can support financial institutions specialized in car finance.

1. Public support to the car industry which does not entail State Aid

:
There are many ways in which Member States can support the car industry which, in principle, do not raise competition policy concerns:

First, there are measures aiming to encourage demand for certain products. They consist generally of a financial support granted to consumers for scrapping their old cars and buying more environmentally friendly cars. If such supports are granted without discrimination with regard to the origin of the product, they do not constitute State aid.

Second, there are the general policy measures which, if open to all companies on their territories, do not constitute State aid. For instance, Member States can alleviate financing problems of the companies in the short and medium term, by general tax measures or by extending payment deadlines for social security and similar charges. If such measures are applicable to all undertakings, in all sectors, in principle, they do not constitute State aid.

[45] Official Journal C 16, 22.01.2009, page 1
[46] Official Journal C 270, 25.10.2008, page 8 and Official Journal C 10, 15.1.2009, page 2

Third, under the **De minimis Regulation** Member States are free to grant aid of up to EUR 200, 000 per company over any period of three fiscal years (or State guarantee amounting to EUR 1.5 million) and this aid is not deemed to amount to State aid[47].

Fourth, under the **Reference Rates Communication** and **Communication on Guarantees**[48] Member States may grant loans or guarantees to the car industry which will not constitute State aid provided they are given on market conditions.

Finally, Member States can apply for co-financing of active social protection measures from the **European Adjustment Globalisation Fund** in order to support the workers made redundant as a result of major structural changes in the world trade.[49]

2. State Aid that can be granted to the car industry without prior authorization

Member States can support the car industry though measures with constitute State aid but which can be granted without prior notification through measures provided for in the **General Block Exemption Regulation** of 2008[50].

This Regulation can be used to support the car sector, including car producers and their suppliers and distributors, by numerous types of aid: favouring research, development and innovation, regional development, training of employees, aid to SMEs, risk capital, environmental protection, aid measures promoting entrepreneurship, newly created companies in assisted regions and female entrepreneurship. These categories of aid can be granted without prior notification and the subsequent Commission's authorization. The Member States only have to inform the Commission afterwards, using a simple information sheet, that such aid was granted. If a Member State wishes to grant State aid measures not included in the GBER, it might still do so subject to notification to the Commission. The Commission will examine such notifications on the basis of the existing legal rules (see section 3).

3. Support authorised under other State Aid legislation

In order to enhance the long-term competitiveness of the car industry, Member States can grant car sector various forms of State aid. This aid has to be notified to the Commission for its approval. In particular, the car industry can benefit from the following categories of State aid:

Environmental aid

The **Guidelines on State aid for environmental protection of 2008**[51] enable the Member States to grant, among others, the following types of aid to the car sector:

- Aid to companies which improve the environmental performance in their production process

[47] Official Journal L 379 of 28.12.2006, page 5
[48] Official Journal C 14, 19.1.2008, p.6 and Official Journal C 155 of 20.06.2008, page 10,
[49] Official Journal L 406, 20.12.2008, page 1
[50] Official Journal L 214, 9.8.2008, page 3
[51] Official Journal C 82 of 01.04.2008, page 1

- Aid for environmental studies
- Aid for the acquisition of new green transport vehicle under certain conditions
- Aid for energy saving
- Aid for sustainable biofuels (which indirectly benefits car manufacturers developing motors using biofuels)

Aid for Research & Development & Innovation (R&D&I)

The **Framework for State aid for Research and Development and Innovation**[52] enables the Member States to grant to the car sector:

- Aid for research and development projects for cars, including for the development of green technology
- Aid for the loan of highly qualified personnel (can be used to improve the automotive value chain)
- Aid for technical feasibility studies
- Aid for process and organisational innovation in services
- Aid for innovation clusters which can help car manufacturers to invest in open research and testing Infrastructures

Regional aid

Allowed by the **Guidelines for national regional aid 2007-2013**[53], national regional investment aid promotes the economic, social and territorial cohesion of the EU by addressing the handicaps of the disadvantaged regions through supporting investments and job creation linked to such investments. In disadvantaged regions, Member States can grant car sector investment aid for setting up a new establishment, extending an existing establishment, diversifying the establishment's output into new products or introducing fundamental change in the overall production process.

Aid in the form of risk capital

The risk capital constitutes an important instrument for the financing of SMEs, though closing an equity gap on the market. In the car sector, the **Guidelines on state aid to promote risk capital investments in SMEs**[54] enable the Member States to grant high-growth-prospect companies aid in the following forms:

- Aid to risk capital investors or venture capital funds for their risk capital investments
- Fiscal incentives to investment funds and/or their managers or investors
- Constitution of investment funds ("venture capital funds")

Rescue and restructuring aid

For companies in difficulties, a forward-looking instrument aiming to their restructuration is an appropriate response; this is the aim of the **Guidelines on state aid for Rescuing and Restructuring firms in difficulty of 2004**[55]. A company in difficulty can receive state aid in order to restructure its operations if it can prove that such aid will help it to be viable in the long-term. If any urgent assistance is necessary, Member State can, before preparing a comprehensive restructuring plan, grant to a car sector company either a loan or a state guarantee on commercial loan for duration of six months. By granting such aid, Member States gain time which allows

[52] Official Journal C 323 of 30.12.2006, page 1
[53] Official Journal C 54 of 04.03.2006, page 13
[54] Official Journal C 194, 18.08.2006, page 2
[55] Official Journal C 244 of 01.10.2004, page 2

the company to prepare a restructuring plan or, if the difficulties were overcame, to repay the aid or stop using the state guarantee.

4. State Aid authorized under the Temporary rules: Temporary Framework and Communications to support the banking sector

4.1. The Temporary Framework

. On 17 December 2008, the Commission adopted a **Temporary framework for State aid measures to facilitate access to finance in the current financial and economic crisis**.[56] This Framework provides Member States with possibilities in the State aid area (in addition to "traditional" instruments mentioned in sections 2 and 3) to tackle the effects of the credit squeeze in the real economy. These temporary measures are based on the Article 87(3)(b) of the EC Treaty which allows the Commission to declare as compatible with the common market aid "to remedy a serious disturbance in the economy of a Member State".

The measures apply to all companies, including companies in difficulties which were not in difficulty on 1 July 2008 but only entered into difficulty thereafter due to the global financial and economic crises. For car manufacturers which were already in difficulty before this date or for those whose difficulties are mainly due to structural problems rather than the crisis, the Guidelines on state aid for Rescuing and Restructuring firms in difficulty of 2004 (see section 3) are the appropriate instrument to ensure long-term viability. Member States have to notify the schemes containing these measures, and once the scheme is approved, they can grant individual aid immediately without further notification.

The aim of the Temporary Framework is to facilitate the access to credit. It can therefore be beneficial for the car manufactures as well as car parts suppliers. Likewise, it encourages the car sector companies to invest into a sustainable future, including development of green products.

The following measures under the Temporary Framework can be applied until 31 December 2010:

"Small amounts" of aid

- Aid up to EUR 500,000 per company for the next two years, to relieve them from current difficulties

This aid can be only granted under aid schemes. If a car sector company has already received de minimis aid prior to the entry into force of the Temporary Framework or will so during the validity of the Temporary Framework, the sum of the aid received under the Temporary Framework and de minimis aid received under the De Minimis Regulation must not exceed EUR 500,000 between 1 January 2008 and 31 December 2010.

State guarantees

[56] Official Journal C 16, 22.01.2009, page 1

- State guarantees for loans in the form of a reduction of the premium to be paid

The Commission will (i) authorise a two years reduction of up to 15% of the annual premium to be paid for new guarantees for large car sector companies and up to 25% for SMEs operating in the car sector and (ii) will allow these companies to apply a premium fixed in the communication for other eight years. The maximum loan amount must not exceed the total annual wage bill of the beneficiary. The state guarantee may not exceed 90% of the loan but may cover both investment and working capital loans.

Subsidised loans

- State Aid in the form of subsidised interest rates applicable to all types of loans

In order to help bridging the current difficulties of car companies to access financing, the Commission accepts that a reduced interest rate is applied for interest payments until the end of 2012 for public or private loans. The reduced interest rate will be calculated on the basis of the central bank overnight rate[57], instead of one-year inter-bank offered rate (which is the reference under the Commission Communication on the method for setting the reference and discount rate of 2008[58]).

Subsidised loans for green products

- State aid in the form of subsidized loans for the production of green products

This measure is, in particular, applicable to the car sector. In order to encourage the production of green products, the Temporary Framework allows the Member States to grant subsidised loans for products involving the early adaptation to or going beyond future Community product standards which have been adopted but did not yet enter into force.

Large undertakings and SMEs can benefit from an extra rebate of 25% and 50% respectively from the subsidised interest rate described in the previous subsection. The subsidised interest rate for green products is applicable during a period of maximum 2 years following the granting of loan.

Improving access of the risk capital for SMEs

Under the Temporary Framework a Member State can grant increase of the tranche of finance from EUR 1.5 million per SME to EUR 2.5 million per SME. At the same time, the level of private participation is lowered from 50% to 30% (equally in and outside assisted areas).

Simplification of the requirements of the short–term export credit

The Commission accepts that certain non-marketable risks are taken on the account of public insurers if a Member State can demonstrate that such a cover in not available on the market. The Temporary Framework introduced a procedural simplification of the Members State burden of proof.

4.2. The Communications to support the banking sector

The **Communication on measures taken in relation to financial institutions in the context of the current global financial crisis**[59] and the **Communication on**

[57] This rate must be at least equal to the central bank overnight rate plus a premium equal to the difference between the average one year interbank rate and the average of the central bank overnight rate over the period 1 January 2007 to 30 June 2008, plus the credit risk premium corresponding to the risk profile of the recipient.

[58] OJ C 14, 19.1.2008, page 6.

[59] Official Journal C 270, 25.10.2008, page 8

recapitalisation of financial institutions in the current financial crisis[60] permit Member States to devise support schemes for financial institutions, such as guarantees or recapitalisation schemes. These schemes are approved by the Commission if they are well-targeted, proportionate to the objective of stabilising financial markets and contain certain safeguards against unnecessary negative effects on competition.

The Commission has already approved several schemes notified by Member States. Institutions specialized in car finance are among those eligible for aid under the Communications and the schemes approved by the Commission. Car manufacturers usually have such a branch and according to the information available, financial branches of car makers have indeed already benefitted from these rules.

[60] Official Journal C 10, 15.1.2009, page 2