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Three years after the financial meltdown: Quo Vadis, state aid control?

Ulrich Soltész and Christian von Köckritz of Gleiss Lutz analyse the European Commission's state aid practice during the financial crisis



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THREE YEARS AFTER THE FINANCIAL MELTDOWN: QUO VADIS, STATE AID CONTROL?

Ulrich Soltész and **Christian von Köckritz** analyse the European Commission's state aid practice during the financial crisis, and take a look at the challenges lying ahead

The financial crisis – a challenge for the commission

The financial and economic crisis was – and continues to be – a true baptism of fire for DG Comp's state aid watchdogs. The crisis triggered an urgent and unprecedented need for state support to help the European financial sector survive. The figures are most impressive and speak for themselves. Between October 2008 and September 2010, the member states provided a total of 4.59 trillion euros in state aid to the financial sector. The lion's share (76 percent) of this support consisted of state guarantees. The remainder of the support went to recapitalisation measures, impaired-assets relief and other forms of aid for individual banks.¹

The conflict in which DG Comp found itself at the height of the financial crisis therefore was inevitable. On the one hand, the European Commission was subject to enormous political pressure by the member states to approve state aid quickly and flexibly. A delay or even a prohibition of member state's rescue efforts in favour of financial institutions due to state aid concerns would have been unacceptable. A failure of DG Comp to react flexibly

could easily have led to a joined effort of the member states to deprive EU state aid law of any role whatsoever in managing and overcoming the financial crisis. On the other hand, the need for effective state aid supervision was more urgent than ever during the crisis. Uncontrolled national rescue efforts would certainly have led to serious disruptions of the internal market. In light of the considerable differences among member states in terms of financial and economic strength, a "subsidy race" between the member states would have put the economically weaker countries with "empty pockets" at a serious disadvantage. As the member states failed to – or refused to – co-ordinate their support efforts, EU state aid law was the means to safeguard at least some degree of homogeneity and comparability of the national rescue efforts, and thus a "level playing field."

Between October 2008 and September 2010, the member states provided a total of 4.59 trillion euros in state aid to the financial sector

The rapid and effective response of the commission has certainly surprised the competition-law community. The commission acted a great deal more efficiently and innovatively than some of its critics had considered possible. It went to great lengths to reconcile the conflicting needs for effective state aid control, and for swift and flexible authorisation of aid measures.

The commission's response to the crisis in the banking sector: "Yes, but ... only on our terms"

The commission recognised the true dimensions of the crisis very quickly after the Lehman collapse and reacted to the new challenges with the application of Art. 107(3)(b) TFEU, first of all in the case of the *Guarantee scheme for banks in Denmark*.² This marked a fundamental reorientation, since in its many years of practice, the commission had consistently refused to apply this provision.³

In order to provide guidance on the commission's assessment of state aid measures under Art. 107 (3) (b) TFEU, the commission has adopted five Banking Communications concerning state support measures in favour of banks in times of crisis.⁴ The first three Communications set out the requirements for various aid measures (namely guarantees, recapitalisations and asset-relief measures) and thus function as a common set of "minimum standards" for the member states' aid programmes. These Communications also set out which banks have to undergo "in-depth restructuring" and submit a full restructuring plan.

The details on the necessary contents of such a restructuring plan and the criteria for the commission's assessment of such a plan are contained in the fourth Communication, the Restructuring Communication. In essence, this Communication is modelled on the well-established "Rescue and Restructuring Guidelines" for aid to firms in difficulty,⁵ which generally apply to individual restructuring cases under Art. 107 (3) (c) TFEU.

The Restructuring Communication takes account of the special circumstances of the systemic crisis in being a little more lenient and flexible than the Rescue and Restructuring Guidelines in some respect. Overall, however, the Communication continues the aim of the R&R Guidelines: it seeks to ensure that banks which face fundamental problems do not get away without first having to "bring their own house in order" and without "paying a price" for their past mistakes. The Restructuring Communication therefore provides that a final approval of restructuring aid measures is dependent on fulfilment of the following conditions:

- a) Ailing banks must present a detailed **restructuring plan** to the commission which demonstrates how they will become viable again and even withstand future economic shocks without state support.
- b) The aid recipient should make a substantial **own contribution** to the restructuring out of its own funds, but also through the sale of assets or outside financing

at market terms. Moreover, the commission also requires the shareholders and the holders of hybrid instruments of the bank to bear a substantial part of the restructuring costs. The commission therefore regularly insists on a general prohibition of paying dividends to shareholders or coupons on hybrid capital for the duration of the restructuring process ("**burden sharing**").

- c) Banks must adopt additional **compensatory measures** to make up for distortions of competition arising from the aid. In practice, this means that the bank must make a "sacrifice" that should ideally benefit its non-subsidised competitors. As a rule, compensatory measures consist of structural measures (sale of business areas, subsidiaries, customer portfolios, closure or sale of branches), as well as of certain behavioural restrictions (advertising prohibitions, prohibition to undercut competitors equals "non-price-leadership-commitment," restrictions on expansion and prohibition of acquiring competitors equals "acquisition ban"). However, the commission has in some cases also accepted certain "market opening measures" of the member state concerned as compensation for distortions.⁶ The extent of these compensatory measures is not based on a mathematical formula, but takes into consideration the market position and risk profile of the recipient bank, the level of remuneration for the aid measures, the amount of the own contribution, and the total amount of all state aid.

The commission was subject to enormous political pressure by the member states to approve state aid quickly and flexibly

A procedural evolution – preliminary authorisations and "commitment decisions"

The Banking Communications and their application in practice have led to a new way state aid cases are being handled, which is neither foreseen in the Treaty nor in the Procedural Regulation.

The existing legal provisions establish a system of full ex ante control of aid, combined with a strict prohibition to implement an aid measure without prior approval by the commission (Art. 108 (3) 3 TFEU). Such an ex ante control system obviously reaches its limits in situations such as the financial crisis, where the need for an implementation of state aid measures can be a matter of days or even hours. The commission therefore invented a new system of "preliminary authorisation decisions" for complex aid measures. In urgent cases, the commission adopts a preliminary decision to authorise the aid, while at the same time initiating a formal investigation into an aid measure because of doubts as to its compatibility with the internal market. The decision thus allows for the quick implementation of the aid measure, but it also gives the commission sufficient time to assess all elements of the aid in detail in the course of a formal

investigation. Of course, the opening of a formal investigation also entails the risk that the commission can ultimately adopt a negative decision and order recovery of the aid.⁷ To avoid a negative decision, beneficiaries will therefore often have no choice but to “appease” the commission by offering additional “compensatory measures” such as divestments.

This new system has changed the commission’s state aid control policy in the financial sector. While the commission had previously limited itself in most cases to the control of the state aid measures itself (i.e. to the approval or prohibition of aid), today it is increasingly involved in actively reshaping the financial sector by determining the necessary restructuring and compensatory measures banks have to adopt. Once the aid has been temporarily authorised, the state aid recipient essentially only faces the alternative of either accepting the commission’s “wishlist” as to the necessary restructuring measures, or of risking a negative decision that would result in an obligation to repay the state aid. The latter is, of course, not a realistic option in most cases.

The courts’ case law appears to back the commission’s approach by granting it a great deal of leeway to impose conditions.⁸ Nevertheless, it is remarkable that the commission’s decisions do not meet stronger resistance from the member states or from the banks concerned. It appears that, to date, only one bank, one member state and one shareholder of a bank have chosen to lodge an appeal against conditional approval decisions.⁹ This gives the impression that the commission has used its enormous power responsibly and managed to come to mutually acceptable solutions, in most cases already decided. On the other hand, it may well be that the most controversial cases are still pending before the commission,¹⁰ or that the deadline for appeals has not expired yet in many cases.

The challenges ahead: the implementation of the banks’ commitment packages

The implementation of the behavioural and structural commitments imposed by the commission has just started. It can be expected that it will keep the commission busy for the next few years. The management of these “commitment packages” is an ambitious work programme for the commission, and will lead to additional challenges for the commission’s state aid watchdogs.

As the commission insisted on substantial divestitures in most cases, a considerable portion of the European banking landscape will be up for sale in the near future. This wave of sales can, for its part, lead to further market disruptions and distortions. In addition, the sovereign debt crises in some EU

member states did certainly not contribute to an improvement in market conditions. Some banks therefore already had to ask the commission to extend the deadlines for their divestments, and it is likely that similar requests will follow in many other cases. In all these cases, the commission will have to decide whether and when the time is right for the implementation of the commitments. However, there is no guidance on the criteria the commission uses when assessing such requests, and its decisions are sometimes difficult to understand for the parties concerned. For example, the commission has adopted a “*sui generis*-decision” in the WestLB case, to extend a deadline for the sale of a subsidiary for a mere six weeks. Not surprisingly, two shareholders of WestLB have asked the General Court to overturn this decision, on the grounds that this period is “much too short”.¹¹

The crisis underscores the need for effective state aid control, and the extent of the commission’s power under state aid rules

The continuing crisis in the eurozone and the continuing uncertainty as to the future of many European banks (which still have to await the commission’s final “verdict” on their restructuring plans) suggest that market conditions in the European financial sector will not dramatically improve in the near future. It is therefore very likely that many banks will not be able to implement all the

commitments imposed by the commission. The commission thus will find itself in another dilemma. On the one hand, it has to take account of the unexpected delay of recovery of the EU financial sector and flexibly adjust the commitment packages to reflect the market environment. But on the other hand, it cannot “soften” the commitment packages too much as this would undermine its own credibility, and as the courts’ case-law does not allow the commission to simply modify the conditions at will. At least where “material conditions” are affected, the commission cannot grant a derogation without a formal investigation.¹² Whether the commission will again find the right balance between flexibility and strict enforcement in such cases will therefore prove to be the acid test for the commission’s state aid policy in the next years.

Besides the problems surrounding the implementation of certain divestiture commitments, the strict behavioural restrictions contained in the commission’s decisions lead to additional difficulties. For example, the commission usually insists on a “(non-)price leadership commitment”¹³ and a prohibition on the purchase of competitors (*acquisition ban*).¹⁴ While the objective of such restrictions is clear – they are intended to prevent the banks from embarking on an aggressive expansion course financed by state aid at their competitors’ expense – the compliance with such commitments in practice is not an easy task. As non-compliance entails enormous and immediate risks for the bank concerned, the only possibility in cases of doubt is to ask the commission for guidance. It is

then for the commission to decide on what the bank is allowed to do and how the bank should behave. This new role of the commission is certainly far from the role the Treaties intended to confer to it under EU state aid rules.

After the crisis – where will the journey end?

The crisis has underscored yet again the need for effective state aid control, but also the tremendous extent of the commission's power under the EU state aid rules. State aid law was certainly an effective instrument to ensure a level playing-field at the peak of the crisis, and it has proved itself an efficient instrument to compel banks to engage in substantial restructuring (which was probably necessary in most cases). The commission therefore has every right to be proud of the way it reacted to the unprecedented events unfolding in autumn 2008. If the

commission also succeeds in managing the implementation of the commitments imposed in its decisions, and if most of these decisions remain unchallenged, DG Comp's state aid watchdogs will also rightfully consider themselves as having been a helpful "part of the solution" to the crisis. This will certainly further boost the (already strong) self-confidence of the commission's state aid enforcers, and could ultimately tempt them to use state aid control in order to act as a "super-regulator" even after the crisis. It is to be hoped that the commission does not yield to this temptation. ■

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Footnotes

1 Commission press release of 1.12.2010, IP/10/1635.

2 Case NN 51/2008 – Guarantee scheme for banks in Denmark.

3 See ECJ, joined cases T-132/96 and T-143/96, ECR 1999, II-3663, paragraph 167 – Freistaat Sachsen a.o. / Commission.

4 Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, [2008] OJ C270/8 (the "First Banking Communication"); Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, [2009] OJ C10/2 (the "Recapitalisation Communication"); Communication from the Commission on the treatment of impaired assets in the Community banking sector, [2009] OJ C72/1 (the "Impaired Asset Communication"); Commission Communication – 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 (the "Restructuring Communication"); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis, [2010] OJ C329/7.

5 Community Guidelines on State aid for Rescuing and Restructuring Firms in Difficulty, [2004] OJ C244/2 (the "R&R Guidelines").

6 See, e. g., Case N 546/2009 – Restructuring of Bank of Ireland, para. 241 et seq.; see also para. 45 Restructuring Communication.

7 In the WestLB case, Commissioner Almunia took the most unusual step to publicly and explicitly threaten with recovery at an early stage of the formal investigation (see SPEECH/10/622 of 05 November 2010, and related MLex coverage of the same day.

8 See, in particular, ECJ, Case T-301/01, ECR 2008, II-1753, paragraph 407 – Alitalia II (for restructuring cases under Art. 107 (3) (c) TFEU).

9 GC, Case T-33/10, [2010] OJ C 80/40 – ING v Commission; GC, Case T-29/10, [2010] OJ C 80/38 – Netherlands v Commission (also concerning the ING-decision); GC, Case T-457/09, [2010] OJ C 11/35 – Westfälisch-Lippischer Sparkassen- und Giroverband v Commission (action of a shareholder of WestLB against the WestLB restructuring decision).

10 See the list of pending cases in the Commission's MEMO/11/68 – State aid: Overview of national measures adopted as a response to the financial/economic crisis of 3 February 2011.

11 GC, Case T-22/11 – Westfälisch-Lippischer Sparkassen- und Giroverband v Commission; GC, Case T-27/11 – Rheinischer Sparkassen- und Giroverband / Commission; see MLex report "German savings banks challenge EC timetable for WestLB's sale of WestImmo" of 24 January 2011. Upon request by Westfälisch-Lippischer Sparkassen- und Giroverband in its earlier challenge of the Commission's restructuring decision (case T-457/09), the President of the General Court in the meantime granted interim relief and temporarily suspended the deadline for the relevant subsidiary (see MLex-coverage of 1 February 2011, "EU court gives WestLB more time to keep property arm alive").

12 ECJ, Case T-140/95, ECR 1998, II-3327, paragraphs 85 ff. – Ryanair; ECJ, Case T-68/03, ECR 2007, II-2911, paragraph 92 – Olympic Airways.

13 i.e. a prohibition from offering more favourable terms for certain products than the aid recipient's competitors on certain markets (cf. Case N 244/2009, paragraph 111 – Commerzbank; Case NN42/2008, NN46/2008, NN53/A/2008 paragraph 94 – Fortis).

14 Paragraph 40 of the Restructuring Communication; see for example Case N 244/2009, paragraphs 69 ff. – Commerzbank.