CPI Antitrust Chronicle
May 2014 (2)

EU State Aid and the Financial Sector—Is the Crisis Over Yet?

Andreas von Bonin
Freshfields Bruckhaus Deringer

EU State Aid and the Financial Sector—Is the Crisis Over Yet?

Andreas von Bonin[1]

I. INTRODUCTION

Since the start of the worldwide financial crisis in 2008, EU governments have used more than EUR 1.6 trillion to reduce the adverse effects of the shock on banks and financial institutions.[2] Between October 2008 and October 2013, the European Commission ("the Commission") took more than 400 decisions authorizing State aid measures for the financial sector. This included government guarantees as well as direct liquidity support in the forms of recapitalization and impaired-asset support.[3] In response to the immediate crisis, the Commission's efforts were set to reduce systemic risks and to increase the transparency of financial markets. EU State aid rules were used as an emergency tool to co-ordinate the responses of Member States and preserve a level playing field in the banking sector.

Following the collapse of Lehman Brothers in 2008, the Commission produced an emergency set of guidelines on measures to support banks during the crisis ("the Temporary Framework"). The Temporary Framework consisted of the following communications:

1. 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"),
2. Communication on the recapitalization of financial institutions in the current financial crisis ("the Recapitalisation Communication"),
3. Communication from the Commission on the treatment of impaired assets in the Community banking sector ("the Impaired Assets Communication"), and
4. Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ("the Restructuring Communication").

The measures contained in the Temporary Framework were based on Article 107(3)(b) Treaty on the Functioning of the European Union ("TFEU"), i.e. to "remedy a serious disturbance in the economy of a Member State," and set out the conditions under which State aid could be granted to financial institutions. The Temporary Framework was prolonged twice and is currently in force for an indefinite period.

---

[1] Partner in the Brussels office of Freshfields Bruckhaus Deringer LLP. The author wishes to thank Merit Olthoff, Associate, for the invaluable contribution to this article.

[2] *See* EUROPEAN COMMISSION, REPORT ON COMPETITION POLICY 2012, page 4.

[3] http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html.

Since the crisis, financial markets in many Member States have undergone deep restructuring and consolidation processes under the EU adjustments programs. Under these programs, certain "Programme countries" (Greece, Portugal, Cyprus, Spain, and Ireland) have received loans from other Eurozone countries via the European Financial Stability Facility ("EFSF"), the European Stability Mechanism ("ESM"), and the International Monetary Fund ("IMF"). As a result, private recapitalization of banks in these Programme countries is possible again for the first time in years. For example in Greece, systemic banks have raised a total of EUR 8.3 billion equity capital from the private sector in the latest share capital increases. In addition, the third out of five Member States under European adjustment programs to announce its exit from the program—Portugal—has announced its exit will occur by May 17, 2014. Ireland announced its exit in December 2013 and Spain in January 2014.

According to Commissioner Almunia, the European Union will be faced with a transition period over the next few years before a fully functioning EU Banking Union enters into force.[4] For this period, the Commission has adopted a new Banking Communication on the application of State aid rules to support measures in favor of banks in the context of the financial crisis ("the New Banking Communication"), which replaces the Banking Communication of 2008. The New Banking Communication aims at tackling the future challenges of the EU financial sector from a State aid perspective. This article summarizes the main features of the New Banking Communication and gives an overview of new regulatory challenges that lie ahead.

II. THE NEW BANKING COMMUNICATION

As part of the Commission's State Aid Modernisation programme ("SAM"), the Commission adopted the New Banking Communication in August 2013. According to Commissioner Almunia, the reform of the State aid rules under the SAM programme is the most comprehensive reform of competition policy undertaken during the term of the present Commission.[5] The New Banking Communication is aimed at remedying the shortcomings of the Temporary Framework. The Temporary Framework provided for emergency rescues, which were approved temporarily on the basis of their compliance with the framework. This approval was then followed by a final decision authorizing the State aid received on the basis of a full restructuring plan.

However, the previous rules often failed to adapt to the increasing divergence in economic recovery between Member States and burden-sharing requirements across the European Union. The Commission therefore revised the rules and adopted the New Banking Communication. The most important changes as compared to the previous regime are the improvement of the restructuring process and the strengthening of the burden-sharing requirements.

---

[4] Joaquín Almunia, *Banking crisis, financial stability and State aid: The experience so far*; remarks delivered at an event from Bruegel, *available at* http://www.bruegel.org/nc/blog/detail/article/1040-banking-crisis-financial-stability-and-state-aid-the-experience-so-far/.

[5] Joaquín Almunia, *Developments in EU Competition policy*, Speech, Athens 10 April 2014, *available at* http://europa.eu/rapid/press-release_SPEECH-14-312_en.htm.

A. Improved Restructuring Process

The New Banking Communication adopts a new approach for the overall restructuring process. Under the previous rules, banks were typically granted State aid prior to the approval of a restructuring plan by the Commission. Although this model proved to be efficient in ensuring a quick stabilization of financial markets and preventing contagion at the beginning of the crisis, it sometimes led to long delays in discussions on the restructuring of aid beneficiaries.

Moreover, once the rescue plan had been achieved, the rescued bank did not always have sufficient incentives to implement necessary restructuring measures aimed at limiting the use of public money. For these reasons, the New Banking Communication establishes the principle that recapitalization and impaired asset measures will be authorized only once a convincing restructuring plan has been approved by the Commission. By way of exception, however, the Commission will still be able to temporarily authorize structural aid before the full restructuring plan is approved.

The New Banking Communication encourages Member States to discuss restructuring plans with the Commission as soon as capital shortages have been identified. These pre-notification contacts are aimed at improving and accelerating the restructuring process. The basis of the pre-notification discussions will be a capital-raising plan established by the Member State and the bank.[6]

B. Stricter Burden Sharing Requirements

Another key aspect of the New Banking Communication concerns the burden-sharing requirements. In order to limit the amount of State aid to the minimum necessary and to reduce moral hazard, the aid beneficiary shall share the burden of its own restructuring to the maximum extent possible.

The new rules increase burden-sharing requirements by establishing that losses are first absorbed by equity, hybrid capital, and subordinated debt holders. Senior debt holders are not required to contribute to burden sharing. The new mechanism can broadly be described as a two-step procedure. At first, banks with a capital shortfall have to carry out all possible capital-raising measures by private means. These capital-raising measures can include rights issues and sales of capital-generating assets and portfolios, as well as voluntary conversions of subordinated debt instruments into equity.[7] In a second step, taken only if those capital raising measures were not sufficient, shareholders and subordinated creditors will be required to contribute to the burden-sharing exercise. Such contribution can, for example, include the conversion of debt into equity or a write down.[8] Similar bail-in rules have been introduced in the Banking Recovery and Resolution Directive ("the BRRD"), which will need to be transposed into national (regulatory) laws of the Member States by January 1, 2015.

[6] New Banking Communication, ¶32.
[7] *Id.* ¶35.
[8] *Id.* ¶.41.

Hence, the new regulatory obligations, as well as the State aid rules, aim at ensuring that the granting of State aid to a bank should be employed only as a last resort to ensure return to long-term viability of the beneficiary, based on a profound restructuring plan.

III. NEW CHALLENGES AHEAD

The EU institutions recently adopted in April 2014 three key texts to wrap up the legislative work regarding the EU Banking Union: (i) the Single Resolution Mechanism ("the SRM"), (ii) the BRRD, and (iii) the Deposit Guarantee Schemes Directive ("the DGS") under which EU Member States will be obliged to set up their own bank-financed schemes to reimburse guaranteed deposits of up to EUR 100,000 should a bank be unable to do so.

The EU Banking Union aims at completing an economic and monetary union allowing for a centralized application of EU-wide rules for banks in the Euro area, i.e. in the 18 Member States that have adopted the euro as their currency (non-Euro Member States also have the possibility to join if they so wish). The idea is that the European Central Bank ("the ECB") would do a better job than national supervisors of preventing financial problems so that EU governments would not need to resort to bank bailouts that destabilize the euro and require taxpayers' money.

For banks and financial institution, the EU Banking Union will bring about centralized systems for supervision as well as for resolution.

A. Centralized Supervision

As of November 2014, the ECB will be the supervisor of all (approximately 6,000) banks in the Euro area within the framework of the Single Supervisory Mechanism ("the SSM"). Using the SSM, the ECB will have the ultimate responsibility for specific supervisory tasks related to the financial stability of all Euro area banks.

In order to ensure that the ECB has a clear view of the situation of the banks it supervises, a comprehensive review of the banks' financial health is currently being carried out. The review aims to enhance the transparency of the balance sheets of significant banks and to rebuild investor confidence prior to the ECB taking over its supervisory tasks in November 2014. It is deemed to be an important step in preparing the SSM and, more generally, towards bringing about greater transparency of the banks' balance sheets and consistency of supervisory practices in the Euro area. In doing so, the review should trigger balance sheet repair where necessary.

The review is comprised of two main pillars: (i) a backward-looking Asset Quality Review ("the AQR") covering 128 banks, to be carried out by the ECB; and (ii) a forward-looking stress test to be conducted in close cooperation with the European Banking Authority ("the EBA"). The latter will assess the resilience of financial institutions to adverse market developments, as well as contribute to the overall assessment of systemic risk in the EU financial system.[9]

The AQR is a preliminary examination to ensure that the ECB understands what is on banks' books in the first place. Together with the stress test, the AQR forms part of the strong efforts by EU governments to create a EU Banking Union. The methodologies applied for both

---

[9] http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing.

the AQR as well as the stress test have been developed in cooperation between the ECB, the EBA, and the Commission. The EBA expects to publish the final results of the stress test in October 2014. The AQR will be completed in August this year.

This comprehensive assessment will conclude with an aggregate disclosure of the outcomes, at both country and bank levels, together with any recommendations for supervisory measures. The comprehensive outcome will be published prior to the ECB assuming its supervisory role in November 2014.

It remains to be seen what will eventually be disclosed by the review and whether further capital requirements and other hidden problems will, in fact, be revealed. Notably, the ECB stated that the risk-weighted assets subject to review amount to approx. EUR 3.72 trillion.[10] Estimates for non-performing loans in Europe range between EUR 1 trillion and EUR 1.5 trillion.[11] All State aid required as a result of the AQR will need to be treated under the New Banking Communication, including the application of the bail-in rules.

B. Centralized Resolution

In addition to the SSM, the EU institutions have also provided for a centralized mechanism to be applied for resolutions of bank difficulties. The recently adopted Single Resolution Mechanism ("SRM") will allow for resolutions of these difficulties to be managed more effectively through a Single Resolution Board ("SRB") and a Single Resolution Fund ("SRF"). The SRB assesses, in cooperation with national resolution authorities, the resolvability of Member States' banks participating in the Banking Union and draws up their resolution plans. Banks need to make *ex ante* contributions to the SRF so that within eight years (at the latest) contributions amount to 1 percent of the protected deposits of all banks within the Banking Union (approx. EUR 55 billion).

The SRM is one of the pillars of the EU Banking Union complementing the SSM and ensures that, if a bank subject to the SSM faces serious difficulties, its resolution can be managed efficiently with minimal costs to taxpayers and the real economy. This mechanism will allow for troubled banks from sovereign nations to receive bailout funds from centralized sources in order to reduce the impact at the national level. With the SRM, EU financial market regulation takes over from DG Competition, which has played the role of the European banking resolution authority during the crisis: In the context of State aid proceedings, more than 20 banks have been resolved or sent into run-off mode over the last years.

In the future, under the SRM, the ECB, the Commission, and the SRB will assess a bank's health and decide what action to take to resolve the problem. This could involve insolvency, or using money from the SRF to support the bank. A takeover of the bank's control and managing its resolution is only seen as a last resort. How well this works in practice will be determined by how well the European and national supervisors and resolution authorities across the European Union work together.

---

[10] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140311.en.html.

[11] http://www.ey.com/Publication/vwLUAssets/Flocking_to_Europe/$FILE/Flocking_to_Europe.pdf, page 11.

The SRM will apply from January 1, 2015, together with the BRRD, which will constitute its rulebook. Before the SRM and the BRRD enter into force, any bank crises will continue to be managed on the basis of national regimes. However, these regimes are set to converge increasingly towards agreed principles of resolution, namely the allocation of bank losses to shareholders and creditors instead of taxpayers.

IV. CONCLUSION

As discussed above, the first signs of recovery from the financial crisis can be seen in some parts of the European Union. The Commission's New Banking Communication can therefore be understood as a more permanent post-crisis regime, which takes account of the lessons learned from the application of the Temporary Framework in response to the worldwide financial crisis. The new rules establishing a centralized supervision and resolution of troubled banks in the Euro area also reflect the teachings from more than six years of State aid enforcement in the financial industry.

State aid rules are fully embedded in the EU Banking Union. And before these rules enter into force, the financial sector will need to cope with the results from the AQR later this year. For the foreseeable future, the role of State aid control will remain very important as an instrument to protect financial stability in the internal market. In that sense, the crisis is not over, yet.