MOVING ON: RE-ASSESSING THE ROLE OF STATE AID IN THE FORM OF RECAPITALISATIONS IN THE EU POST-BRRD CRISIS MANAGEMENT REGIME

Tytti-Maria Tanninen 501015
Kilpailuoikeus ja taloustiede
Turun yliopiston oikeustieteellinen tiedekunta
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Vuoden 2008 finanssikriisi johti laajamittaisiin valtioiden tukemiin pankkien pelastamistoimenpiteisiin. Vaikka nopeita tukitoimenpiteitä voitiin pitää tarpeellisina järjestelmäriskin hillitsemiseksi, tukitoimenpiteet nähtiin ongelmallisina niin kutsutun moraalikato-ongelman vuoksi. Moraalikato tarkoittaa tilannetta, jossa riskinottaja on suojattu riskin realisoitumiselta siten, että kannustimet varovaisuuteen heikentyvät. Pankkien pelastamisissa oli kyse tilanteesta, jossa valtiot osaksi kantoivat pankkien liiallisen riskinoton seuraukset. Rahoitusjärjestelmän kriittinen rooli yhteiskunnan toiminnan kannalta implisiittisesti suojaa järjestelmällisesti tärkeimpiä pankkeja kaatumiselta.

Moraalikato-ongelman rajoittamiseksi ryhdyttiin laajoihin lainsäädäntöuudistuksiin, yhtenä niistä elvytys- ja kriisinratkaisudirektiivin (2014/59/EU, ”BRRD”) säätäminen. Direktiivin tarkoitus on harmonisoida jäsenmaiden kriisinratkaisu- ja maksukyvyttömyysmenettelyitä koskevia sääntöjä muun muassa siten, että ennen kaikkea turvataan rahoitusvakaus. Direktiivissä säädetään myös periaatteesta, jonka mukaan pankin osakkeenomistajien ja vakuudettomien velkojien tulisi kattaa pankin tappiot kriisitilanteessa veronmaksajien sijaan. Pankkien pääomittaminen verovaroilla on kuitenkin yhä direktiivin puitteissa rajatusti mahdollista. Tutkielman tarkoituksena on selvittää niitä BRRD:n säännöksiä, joiden mukaan pankkien pääomapohjaa voidaan vahvistaa valtion varoin.

Pääomapohjan vahvistamista valtion varoin tutkitaan erityisesti kilpailuvaikutusten näkökulmasta. Apuna vaikutusarvioinnissa käytetään taloustieteellistä metodia. Keskeisimmät havainnot kilpailuvaikutusten osalta ovat, että valtiontuen aiheuttamat staattiset kilpailun vääristymisvaikutukset saattavat hyvinkin olla oikeutettavissa positiivisten ulkoisvaikutusten vuoksi, kun taas dynaamisten kilpailun vääristymisvaikutusten aiheuttamia ongelmia, kuten moraalikatoa, on vaikea ratkaista kilpailupolitiikan keinoin. Poikkeuksena ovat kuitenkin tukitoimenpiteet, jotka on toteutettu aitojen markkinahäiriöiden, kuten luottolaman, korjaamiseksi. Moraalikadon torjumiseksi on tällöinkin varmistettava, että tuettujen pankkien ongelmat johtuvat muusta kuin niiden sisäisistä ongelmista esimerkiksi riskienhallinnan saralla. Lopputulemana tutkielmassa on, että *ex ante* kriisinratkaisusääntelyn on oltava ensisijainen kriisinhallinnan keino. Valtiontukeen turvautuminen *ex post* olisi mahdollista ainoastaan tarkoin perustelluissa poikkeuksellisissa tilanteissa, joissa tukitoimenpide täyttää niin sanotun tasapainotestin vaatimukset.

Asiasanat: elvytys, kriisinratkaisu, valtiontuki, rakenneuudistustuki, pääomapohjan vahvistaminen, pääomavaje, rahoitusvakaus, moraalikato, sijoittajavastuu, tasapainotesti

UNIVERSITY OF TURKU
Faculty of Law

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The 2008 financial crisis led to wide-scale State supported bank rescues. Even if quick reactions were deemed necessary in order to contain systemic risk, these State measures were problematic due to moral hazard. Moral hazard refers to a situation where a risk-taker is protected from the consequences of the risk materialising in a manner which reduces incentives to take appropriate caution. When States took part in rescuing banks during the financial crisis, this meant States in part bore the consequences of banks' excessive risk-taking. The critical role which the financial system plays in the functioning of society implicitly protects systemically important banks from failing.

In order to reduce the moral hazard problem substantial legal reforms were initiated – including the enforcement of the Banking Recovery and Resolution Directive (2014/59/EU, "BRRD") in the EU. The objective of the directive is to harmonise Member States' resolution and insolvency proceedings regulation frameworks in a manner which safeguards financial stability. It is furthermore stipulated in the directive that the shareholders and unsecured creditors of a bank should be bailed-in prior to tapping into tax-payer money to cover the losses of a distressed institution in times of crisis. Bail-outs, meaning recapitalisation aid granted to banks from State budget funds, can however still be granted in a restricted manner. The extent to which and the channels by which tax-payer money can still be injected to recapitalise banks in the BRRD framework is examined in this research.

State-funded recapitalisations will particularly be assessed from the point of view of effects on competition. A refined economic approach is used as the basis of the effects-analysis. The key findings on competition effects are that static distortions of competition caused by State aid could well be justified on the basis of positive externalities whereas dynamic distortions of competition, such as moral hazard, are more difficult to solve via means of competition policy. Aid measures which are granted in order to correct genuine market failures, such as a credit crunch, constitute an exception. Even in these cases still, in order to limit moral hazard, it should be made sure that any aided bank's problems are the result of unforeseen exogenous shocks rather than the result of poor internal governance such as lacking risk management. The conclusion is that relying on *ex ante* crisis management prudential regulation should be the priority means of addressing financial crisis situations. Resorting to State aid *ex post* would only be possible in well-argumented truly exceptional circumstances in which a suggested aid measure clearly fulfills the conditions of the so-called balancing test.

Keywords: recovery, resolution, State aid, restructuring aid, recapitalisation, capital shortfall, financial stability, moral hazard, bail-in, balancing test

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ABBREVIATIONS

AQR asset quality review
BIS Bank for International Settlements
BRRD Banking Recovery and Resolution Directive
BU banking union
CA comprehensive assessment
CAR capital adequacy ratio; total capital ratio under Article 92(1) of the CRR
CL Crédit Lyonnais
CoCos contingent convertibles
CRD Capital Requirements Directive
CRR Capital Requirements Regulation
DG Directorate General
DFSA Danish Financial Supervisory Authority
e.g. for example
EBA European Banking Authority
EC European Commission
ECB European Central Bank
EEA European Economic Area
ELA emergency liquidity assistance
EMU Economic and Monetary Union
ESM European Stability Mechanism
ESRB European Systemic Risk Board
EStAL European State Aid Law Quarterly
EU European Union
FAQs frequently asked questions
FROB Spanish National Resolution Authority
FSB Financial Stability Board
GDP gross domestic product
GSIB global systemically important bank
i.e. in essence; as in
Ibid. ibidem; reference to the same source as the previous footnote
HFSF Hellenic Financial Stability Fund
HS Helsingin Sanomat
IMF International Monetary Fund
ING Internationale Nederlanden Groep
IRB internal ratings based approach
Kak. Kansantaloudellinen aikakauskirja
KBC Kredietbank ABB Insurance CERA Bank
LM Lakimies
LME liability management exercise
MoU memorandum of understanding
MPS Monte dei Paschi di Siena
MREL minimum requirement for own funds and eligible liabilities
NPL non-performing loan

Q&A questions and answers
R&R rescue and restructuring
RWA risk-weighted assets
SAAP State Aid Action Plan
SAM State aid modernisation
SG Société Générale
SME small and medium-sized enterprises
SREP supervisory review and evalution process
SRB Single Resolution Board
SRM Single Resolution Mechanism
SRMR Single Resolution Mechanism Regulation; REGULATION (EU) No 806/2014
SSM Single Supervisory Mechanism
TFEU Treaty on the Functioning of the European Union
TSCR total SREP capital requirements
UK United Kingdom

GRAPHS

1 INTRODUCTION

1.1 Background: the effects of the financial crisis in the EU

The financial crisis in short was a result of the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight.[1] Many of the risks materialised were known risk factors from past banking crises – the risks were only greatly underestimated[2] and not monitored to an extent necessary. The crisis unfolded and evolved at a rapid speed which led to competition policy concerns in crisis management to be left as "a distant bystander"[3]. In comparison to single jurisdictions, the EU additionally suffered from the lack of a harmonised set of rules[4], leading to fragmentation of the internal market and endangering financial stability. More particularly this meant that the smooth functioning of payment systems and access to finance were endangered. Moreover, in the EU, what was initially a liquidity crisis for many financial institutions, worsened into a sovereign debt crisis to some of the Member States. Trust in the financial system deteriorated[5] and the EU suffered from slow economic growth for several years.

Banks and other major financial institutions as undertakings are built on a unique type of business model based on an exceptional equity-to-debt ratio, which makes banks vulnerable to the loss of trust for example in the form of a *bank run*, meaning liquidity evaporating via large-scale deposit withdrawals by nervous customers. Banks' liquidity problems further developed into solvency problems also due to the so-called *"fire sales"* whereby losses and the shortage of liquid funding forced institutions to reduce their *leverage*[6] significantly over a short period of time. This amplified downward pressures on asset prices, causing further losses for institutions which in turn led to

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[1] The High-Level Group on Financial Supervision in the EU. Chaired by Jacques de Larosière. Report. 2008, page 14.
[2] *Den Haan* 2012.
[3] *Marsden – Kokkoris* 2012, pages 321 and 335: "state aid control did not really 'control' all that much – essentially the authorities approved what was necessary – though it contributed to an ordered release of aid with, what is to be hopes, were minimal competitive distortions".
[4] The High-Level Group on Financial Supervision in the EU. Chaired by Jacques de Larosière. Report. 2008, page 28.
[5] COM(2008) 706 final, pages 4-5: "European businesses and citizens need to be able to trust financial institutions as reliable partners for translating their deposits into the investment that is so central to the long-term health of the economy. Market surveillance and enforcement of contractual and commercial practices will play an important role in restoring consumer confidence in retail banking."
[6] Leverage means (large) exposure in relation to own funds.

further declines in their own funds.[7] In the words of *Quigley*: ”Apart from the fact that the largest banks are so much bigger than the largest non-bank businesses, no other sector has a comparable share of debt in their funding compared to equity, given that banks are largely financed through a limited amount of equity supplemented by funds provided by creditors. It follows that markets in which banks operate may be subject to systemic risk due to the massive negative externalities that a bank failure, or its anticipation, may generate on competitors and the economy at large”[8]. Assets in the form of equity tend to have better loss-absorbency capacity than liabilities.

In the EU, in particular government guarantees were initially granted as a form of State aid to banks in order to quickly restore trust in the financial system and so to avoid wide-scale bank runs. With these guarantees governments aimed to stop the outflow of funds from banks as these guarantees constituted a promise not to let these banks fail. In the period between 1 October 2008 and 1 October 2011, the Commission approved aid to the financial sector for an overall amount of € 4.5 trillion which counted as 36.7% of the EU GDP[9]. From statistical data provided by Eurostat, it can be seen fairly evidently that granting State guarantees was an emergency response to the initial crisis since there is a sharp peak visible in 2009 from which the amount of contingent liabilities has gone down steadily ever since[10]. Beginning from 2008 and by the end of 2015, the total amount of aid approved in the form of guarantees still climbed to € 3.3 trillion. Aid approved in the form of recapitalisations, meaning capital injections from Member States’ national budgets, had amounted to € 820.9 billion by the end of 2015[11].

Within the same time period of 2008-2015, the largest total amounts of capital injections were *approved* by Spain (€ 174.3 billion), Germany and the UK (both € 114.6 billion). In 2014 and 2015 more than half of new recapitalisations in the EU to financial institutions were approved by Greece; € 12.4 billion in 2014 and € 10.6 billion in 2015. In 2015, six Member States still approved new recapitalisation aid measures and from those three crossed the one billion mark; along with Greece there were Italy and

[7] The High-Level Group on Financial Supervision in the EU. Chaired by Jacques de Larosière. Report. 2008, page 13.
[8] *Quigley* 2015, page 132.
[9] http://ec.europa.eu/competition/recovery/financial_sector.html 2012. (Last accessed 12.2.2018.)
[10] EUROSTAT SUPPLEMENTARY TABLE FOR REPORTING GOVERNMENT INTERVENTIONS TO SUPPORT FINANCIAL INSTITUTIONS. Background note (October 2017), pages 11-12.
[11] EC: State Aid Scoreboard. http://ec.europa.eu/competition/state_aid/scoreboard/index_en.html#crisis . (Last accessed 14.1.2018.)

Portugal with recapitalisations worth of € 3.8 billion and € 2.6 billion approved.[12] In terms of recapitalisation aid actually *used* in the time period of 2008-2015, the biggest bill fell on the UK, with a total of € 100.1 billion used out of all approved recapitalisation aid measures. However, half of the bill already accumulated in 2008. Germany, Ireland and Spain all used over € 60 billion in capital injections to banks.[13]

Ultimately, moral hazard can easily arise in any case of aid being granted to a distressed undertaking which cannot compete by its own means and needs governmental support in order to be kept going-concern. Public financial support therefore serves as a sort of an insurance policy against failure[14]. What is particular with regard to financial institutions comparing to any other type of distressed undertakings, is that not in all cases and sectors is financial stability endangered in correlation with an undertaking's possible market exit. Banks and other financial institutions serve an important role in any economy as they contribute to the fundamental economic elements of a sufficient amount of credit available in the markets, security of deposits and smoothly functioning payment systems. A functioning financial market facilitates investments and therefore allows for the optimal allocation of resources increasing consumer welfare.[15] According to *Lyons – Zhu*, bank bailouts "convey a *positive externality* on rivals if exit would have caused or worsened a systemic crisis"[16].

What additionally sets banks apart from other undertakings as aid beneficiaries are the aid amounts required which are incomparable to any other sector. While the prior

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[12] Ibid. Overview tables: State aid approved. The table mistakenly reads 2008-2014 instead of 2008-2015. (Last accessed 14.1.2018.)

[13] Ibid. Overview tables: State aid used. The table mistakenly reads 2008-2014 instead of 2008-2015. (Last accessed 14.1.2018.)

[14] Moral hazard is traditionally a concept of insurance law. As the idea of insurance policies is to compensate for losses over the materialisation of a risk, entering into such a policy will also reduce incentives of taking caution in order to avoid the risk from materialising. Therefore, "the provision of insurance tends to increase the probability of a loss or the size of the loss because the insured person has less of an incentive to take precautions". The described risk here is a *detrimental* one but moral hazard can affect *beneficial risk* as well as "the provision of insurance tends to decrease the likelihood of a gain or the size of the gain because the insured person has less of an incentive to engage in effort to obtain the gain". See *Polinsky* 2011, pages 60-62. The problem of moral hazard can to some extent be solved by adjusting the insurance premia according to level of risk and likelihood of the risk materialising. "In other words, the moral hazard problem can be eliminated if the insurance premium depends on how much care is exercised by the insured person." In practice however, it is difficult and probably even impossible for the insurer to monitor the behaviour of the insured, whereby moral hazard cannot be feasibly eliminated completely. In the case of banking, the "insurance premium" for government rescue would be the appropriate and corresponding level of own contribution to the bearing of losses with regard to the size of the risk materialised and taken.

[15] *Finnish Competition and Consumer Authority* 2011, page 93.

[16] *Lyons – Zhu* 2013, page 45.

characteristic of contributing to financial stability may be considered to be in the common public interest and a positive effect, the latter characteristic of the sheer large amounts of aid required in order to save banks is considered a negative factor when assessing the level of moral hazard generated and competition distorted. Weighing the positive effects on stability against the negative effects of distortions of competition is not an easy task to complete.[17] Aid should not be deemed distortive based only on amount. *Haucap – Schwalbe* have noted that the "amount of aid is always to be assessed proportionally to the size [and structure] of the market. A small amount of aid in a small market can lead to significant distortions of competition, while large aid in a sufficiently large market has no noticeable effects on competition"[18].

As aid in the form of State guarantees to banks was visibly a panic response to the crisis, actual long-term solutions to restore trust in the financial system were also required. This meant substantial regulatory reforms in order to correct some of the profound incentive problems attached to banking. The crucial role which financial institutions play in the functioning of State economies justifies more extensive regulation in order to safeguard financial stability[19]. The *Liikanen Group*'s analysis revealed excessive risk-taking, such as trading highly-complex derivative financial instruments, and excessive reliance on short-term funding to have led to the financial crisis. Risk-taking was not matched with adequate long-term capital protection[20], such as equity instruments "stuck in the bank"[21]. Capital requirements for banks placed too much reliance on both the risk management capabilities of banks themselves and on the adequacy of external credit ratings[22]. Remuneration policies which induced high risk-taking and encouraged short-term profit to the detriment of long-term performance were deemed a great failure of corporate governance[23].

One of the reasons leading to the financial crisis was poor macro-prudential oversight. Naturally, financial institutions themselves also focused on controlling individual risks

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[17] *Finnish Competition and Consumer Authority* 2011, page 97.
[18] *Haucap – Schwalbe* 2011, page 24.
[19] *Finnish Competition and Consumer Authority* 2011, page 93.
[20] High-level Expert Group on reforming the structure of the EU banking sector. Chaired by Erkki Liikanen. FINAL REPORT. 2.10.2012.
[21] *Dewatripont* 2014, page 42: "Only if a sufficient buffer of bank funding is 'stuck in the bank' can one be confident that other, short-term, creditors will not run." "Stuck in the bank" means funding that cannot be withdrawn be depositors and creditors.
[22] The High-Level Group on Financial Supervision in the EU. Chaired by Jacques de Larosière. Report. 2008, pages 11-12.
[23] Ibid, pages 30-31.

rather than systemic risk. The objective of macro-prudential oversight is to limit the distress of the financial system as a whole. Macro-prudential analysis pays particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects.[24] While direct macro-prudential oversight is mainly the duty of banking supervisors, the notion of systemic risk has now been incorporated into financial institutions' capital adequacy planning. Additional capital requirements and pro-cyclical capital buffers are classes of capital designed in order to take into account the possible *negative externalities*[25] a failure of a financial institution may generate on its counterparties and the real economy.

1.2 Research questions and methodology

While the objective of protecting tax-payer money has been implemented throughout the new BRRD in for example requiring that no recourse to extraordinary public financial support should be assumed in either recovery or resolution planning[26], the new crisis management rules do still allow, subject to certain conditions, the granting of State aid in order to restructure financial institutions. The aim here is to establish to which extent recourse to public financial support as a means of funding for restructuring is still possible. The compatibility of State aid in the form of restructuring aid granted to distressed financial institutions is assessed on the basis of the so-called "Crisis Communications" issued by the Commission[27], whose legal basis is Article 107(3)(b)

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[24] Ibid, page 39.

[25] Externalities can be considered a market failure. A popular example is that of pollution. A business which causes pollution may not have the incentive to take this negative effect of pollution into account in its pricing. Decreasing pollution may increase production costs. However decreasing pollution is beneficial in the public interest for matters of health for example. By imposing for example taxation on business practices which cause pollution, the negative externality is forced to be paid for in production costs. This may incentivise engaging in production choices which cause less pollution. In the case of banking, systemic risk, meaning risks caused by an individual bank on third parties in the financial markets, can also be considered such an externality. As banks probably would mostly be concerned with individual risks rather than risks posed to third parties, enforcing prudential requirements will force each bank to take systemic risk into account in their capital planning and risk management, at least to some extent. Systemic risk is the "pollution" of banking.

[26] This principle is derived from the FSB Attributes of Effective Resolution Regimes for Financial Institutions. See *Financial Stability Board*: Key Attributes of Effective Resolution Regimes for Financial Institutions set by the Financial Stability Board. 15.10.2014, Preamble.

[27] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('2008 Banking Communication') (2008/C 270/02); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication') (C(2008) 8259 final); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication') (2009/C 72/01); 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 ('Restructuring Communication') (2009/C 195/04); Communication from the Commission on the application, from 1 January 2011, of State

TFEU. The most recent one of these communications, the "Banking Communication" was issued in 2013. Communications are not legislative instruments. Regardless of this, the 2013 Banking Communication set the tone for the upcoming legislative reforms, especially for the BRRD[28]. In the 2013 Banking communication, burden-sharing requirements reminiscent of the BRRD bail-in requirements were introduced. A bail-in requires that a bank's shareholders and uncovered creditors absorb losses prior to triggering a public bail-out. Legislative harmonisation was first of all important in order to prevent excessive fragmentation of the internal market, for national reforms setting different levels of burden-sharing requirements had already been implemented per individual Member States.[29] Secondly, any favourable stance towards bail-outs had to be removed in order to prevent the generation of moral hazard and regulatory arbitrage.

These reforms in crisis management setting "obstacles" for triggering bail-outs enforced by the BRRD, together with stricter minimum capital requirements set by the CRR[30] and the CRD IV[31], aim at building a financial sector where no banks would fail in a *disorderly* manner which would potentially *endanger financial stability* or *cause a serious disturbance in the economy of a Member State*. Safeguarding financial stability is the overarching objective of crisis management whereas tax-payer money should be protected respectively. In all circumstances, protecting tax-payer money and so not resorting to State aid is not however, possible. Accordingly, resorting to State aid on a higher level results in a situation where the primary means of crisis management, prudential internal market regulation, is not sufficient in order to tackle the effects of a financial crisis. The secondary means of competition policy is invoked instead or additionally.

aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2010 Prolongation Communication') (2010/C 329/07); Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2011 Prolongation Communication') (2011/C 356/02) and Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') (2013/C 216/01).

[28] 2013 Banking Communication, point 13; DIRECTIVE 2014/59/EU.

[29] 2013 Banking Communication, point 18. Some Member States had already enforced bail-in requirements while others preferred to stick to minimum requirements set by the EU, at that point more favourable towards bail-outs.

[30] REGULATION (EU) No 575/2013.

[31] DIRECTIVE 2013/36/EU.

In this research the roles of competition policy and of the Crisis Communications, which are still deemed to be temporary rules in nature by the Commission, in crisis management are examined. This is with regard to the objectives of the Commission's State aid modernisation plan (SAM)[32] and more specifically with regard to general principles concerning rescue and restructuring (R&R) aid. Particularly, it shall be investigated how successfully the objective of safeguarding financial stability fulfills the conditions for *a well-defined objective of common interest* which contributes to "less and better targeted aid" pursuant to the SAM plan.

Because the emphasis of crisis management is and should be on *ex ante* means of controlling financial stability – rather than on *ex post* means such as competition policy – some of the reforms in prudential regulation stipulated in order to build a resilient financial sector shall be discussed. These reforms include adequate stress testing and capital planning. Discussing these ex ante means is necessary in order to present the regulatory framework built in order to prevent economic shocks. The meaning of a detected *capital shortfall* shall be discussed.

While it could be alternatively be argued that certain State measures would not fall under the scope of Article 107(1) TFEU, the starting point of this research is rather that the criteria of Article 107(1) TFEU are fulfilled and aid compatibility with the internal market is assessed under Article 107(3) TFEU. No specific requirements concerning banking groups are paid regard to. Group-level requirements are therefore left out of the scope of this research[33]. No distinguishing is made between banks and non-bank financial institutions. The focus of this research shall be on recapitalisations as a form of State aid rather than for example on State guarantees or impaired asset relief measures. This is due to the adoption of the precautionary recapitalisation exemption in Article 32(4)(d)(iii) of the BRRD and also due to the direct effect recapitalisations have on State budgets, weakening sovereigns. Furthermore, the research is focused on institutions which will be kept going-concern, not liquidated. Finally, this research concentrates on the crisis management regime enacted in the BRRD even though further legislative harmonisation has been taken in the context of the Banking Union with the

[32] COM/2012/0209 final.
[33] The 2013 Banking Communication does not even make any distinction between banks and banking groups which means the competition rules regarding bank restructuring are the same even if additional requirements would be set in the BRRD.

enactment of the SSM[34] and SRM[35] regulations. This is due to the fact that BRRD is applicable in all Member States and that certain rules which are substantial for this research such as bail-in requirements are almost identical in both the BRRD and the SRMR. The highly complex institutional framework concerning banking supervision and restructuring most certainly raises interesting questions for example in terms of transparency. Due to some necessary limitation to the scope of this research, issues regarding specifically the interplay between institutions will be left out.[36]

The method used in this research is broadly legal-dogmatic. Legal dogmatism can be described as argumentative context analysis.[37] According to *Aarnio*, the tasks of legal dogmatic analysis are interpretation and systematisation[38]. The legal dogmatic truth according to *Aarnio* is relative; there can be several interpretations for one legal problem. The interpretation which is argumented best will be selected as the acceptable interpretation by the majority of a rationally-thinking auditorium. In order to convince the auditorium, any method is allowed as long as the interpretation has legal grounds and the hierarchy of sources of law is complied with.[39] The task of systematisation is to create any coherent and appropriate legal system from the legal order created by legislation. The objective is to *reconstruct* any relevant part of the legal order in order to reveal connections between norms. Here the legal system is systematised under "provisions granting access to State aid in the BRRD". Systematisation establishes the framework which controls the scope of acceptable interpretations[40].

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[34] COUNCIL REGULATION (EU) No 1024/2013.

[35] REGULATION (EU) No 806/2014.

[36] Banking supervisory tasks in the Banking Union have been divided between Member State level supervisory authorities and the SSM whereas in the non-Eurozone Member States there is no supranational supervisor such as the SSM (acting under the ECB). The supervision of banking groups could however be consolidated under supervisory colleges. A similar institutional structure has also been adopted for resolution authorities where for the Banking Union the SRB has been established to resolve financial institutions in accordance with the provisions of the SRMR. Member States outside of the Banking Union do not have a similar centralised resolution authority. Additionally, even in the context of the Banking Union, should the SRB not decide to trigger resolution in accordance with the SRMR, the distressed bank would have to be wound down by national resolution authorities according to Member State level national insolvency proceedings. While the Council and the European Parliament have the competence to enact laws in the EU, the newly founded EBA also has the authority to issue regulatory technical standards binding on the level of the whole Union. The EBA may also issue guidelines and recommendations which are not considered legally binding but should still be complied with. Meanwhile with regard to State aid policy, it is the Commission who holds exclusive competence.

[37] *Laakso* 2012, page 178.

[38] *Aarnio* 1978, pages 52-59.

[39] Ibid, pages 103 and 124.

[40] Ibid, pages 74-81 and 93. See also *Laakso* 2012, pages 385 and 449-452.

Legal dogmatism according to *Aarnio* is based on hermeneutics, meaning bound by language and the understanding of language. Where a clause is considered semantically weak, one must use other sources of law than merely statutes in order to deduct a conclusion and to provide for stronger argumentation.[41] Sources of law are divided into three categories based on the level to which each source binds; ought-sources, should-sources and may-sources. Ought-sources such as national and EU legislation *ought* to be followed. State aid decisions by the Commission fall into this category as decisions are secondary Union law[42]. For example national case law is a source of law which *should* be followed. The variety of different soft law instruments[43] in the context of EU law is extensive, subject to differing levels of binding effect, but I would still place soft law instruments, especially guidelines issued by EU institutions, in the category of should-sources. Should-sources should in principle be followed but this is not obligatory providing there are feasible and well-argumented grounds for deviation. May-sources instead only *can* be used in order to supplement argumentation derived from superior sources of law. A legal decision cannot be based solely on may-sources. May-sources include for example real-pragmatic arguments such as economic analysis. Real-pragmatic arguments and for example value-based considerations allow for a more dynamic approach to legal interpretation.[44]

The research at hand is tinged by two special considerations which affect the selection of appropriate methods of argumentation. First of all, the research is based on EU law. Secondly, and more specifically, the research is based on EU competition law. In both general EU law and competition law, the importance of objectives and principles is emphasized.[45] This is because primary EU law is open to interpretation semantic-wise. Understanding EU law requires in-depth knowledge on the level of legal culture.[46] While an interpretation could preferably be made based on linguistic arguments, the so-called systemic-contextual and teleological-axiological arguments have significant

[41] *Laakso* 2012, page 384.
[42] Technically decisions do however only bind the Member State(s) over which the decision is taken. Therefore there is uncertainty over to which level Member States which the specific decision does not concern are required to take these decisions into account. I would not treat these decisions as ought-sources at least in the case of Member States not technically bound by the decision.
[43] *Merikoski* 1997, page 37. It is stated from the binding effect of guidelines that where for example guidelines codify case law, it is not the guidelines which would have a binding effect but rather the case law only.
[44] *Laakso* 2012, pages 261-265 and 317-319. Including real-pragmatic and value-based considerations into the hierarchy of sources of law rejects a traditional strict view of legal dogmatism in favour of *pluralism* and *polycentrism*.
[45] *Laakso* 2012, page 386 and *Kuoppamäki* 2007, page 192.
[46] *Raitio* 2013, page 210.

influence compared to any singular civil law jurisdiction.[47] Both systemic and teleological arguments emphasise the objectives, targets or purpose of legislation rather than exact wording.[48]

In both systemic and teleological interpretation the norm in question is construed against the context of the whole relevant legislative field. Different interpretations are assessed based on how well each one manages to help achieve the objective of the legislative context. The interpretation which achieves the set objective in the most optimal manner shall be selected.[49] With regard to the BRRD, the objective of the legislation is to ensure financial institutions are not wound-down in a disorderly manner, meaning in a manner which would cause financial instability. As the BRRD is a directive aiming at minimum harmonisation, its implicit objective is also the promotion of the integration of the internal market. The very concept of a directive prioritises the achievement of certain results or objectives over the implementation of specific means in order to achieve these results. While the BRRD is a rather detailed piece of legislation imposing restrictions on means as well, the priority objective of ensuring financial stability can especially in the case of resorting to State aid serve as the main argument of justification. "Disorderly" failure would mean a manner which could cause contagion, negative feedback effects, negative spill-over effects or negative externalities on the rest of the financial system and real economy – basically the threat of financial stability being endangered. The objectives of EU competition law in general can roughly be divided into 1) the objective of competition and; 2) the objective of integration. Free competition should be ensured to the extent of being workable/effective. Integration means the promotion of the internal market objective.[50]

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[47] See for example *Raitio* 2013, pages 211-217. The categorization of arguments used is based on the work of the *Bielefeld Kreis*. A linguistic argument can be derived from an ordinary meaning or from a legal-technical meaning of a term. If a term has a specific legal-technical meaning, this meaning is prioritised. In case a term has several ordinary meanings, interpretation occurs on the basis of context . Systemic arguments are divided into arguments from contextual-harmonisation, precedent, analogy, logico-conceptualism, the general principles of law and history. With regard to the subject of the thesis, the most relevant ones of these systemic arguments are contextual-harmonisation and general principles of law. These mean that a clause should be interpreted in the context of the legislative instrument the clause is part of. General principles of law in the EU include for example the principles of proportionality and subsidiarity. These principles have been enacted in the EU treaties specifically but EU law also consists of principles established in case law. Whereas the strong reliance on principles and case law favour systemic and teleological argumentation in EU-law, relying on these types of arguments is also justified in order to correct any incoherence between translation versions of all official EU languages.

[48] *Raitio* 2013, pages 214-217. In the Union case law, even an interpretation which best achieves the objectives why the Union was first established, have in some cases surpassed exact wording of the law.

[49] *Kuoppamäki* 2007, page 192.

[50] *Kuoppamäki* 2007, pages 202-204.

Especially the teleological argument type allows for considerations of a broader societal view.[51] In the context of State aid, these societal views could mean objectives of common or public interest, which ensuring financial stability can be considered to be. Real-pragmatic arguments can be considered to contribute to teleological interpretation and argumentation since a teleological point of view aims at weighing the concrete effects of each option of interpretation against the achievement of objectives.[52] This is also the case with for example economic analysis which weighs negative and positive effects of interpretation options against each other on the basis of different welfare standards. The application of real-pragmatic arguments is beneficial especially on a case-by-case-basis and for *ad hoc* type of application. EU competition law is a field of law prone to ad hoc type of application, dependent on principles and rules established in case law[53]. In order to provide for as ample of an argumentation basis as possible, pursuant to *Aarnio*'s rational auditorium, economic analysis should be a welcome addition to State aid effects analysis[54].

While economic analysis has established its position in assessing effects of horizontal agreements and market dominance, its role in State aid assessment is less clear[55]. At first, compared to for example Article 101(3) TFEU, whereby a restrictive agreement may be deemed compatible with the internal market if consumers are allowed "a fair share of the resulting benefit", there is no such direct reference to consumer welfare in Article 107 TFEU concerning State aids. Secondly, this one-sided welfare approach emphasizing consumer welfare as a welfare standard would perhaps not even be so well-suited for State aid in order to measure the effects on welfare. Third, it can be questioned whether State aid can really be judged on purely efficiency-based grounds at all. The wording of Article 107(2)-(3) TFEU refers to mostly objectives of a social nature rather than economic efficiency.[56] Some scholars do not even consider State aid

[51] *Laakso* 2012, pages 355-356.
[52] *Laakso* 2012, page 323.
[53] *Kuoppamäki* 2007, page 192.
[54] *Aarnio* supports an "all things considered" type of approach with regard to arguments, as long as hierarchy is followed in selecting the sources of argumentation. See *Laakso* 2012, page 179.
[55] *De Cecco* 2013, page 36: "State aid remains a distant relative of antitrust law." While there are "areas in the definition of State aid in which economic notions are given crucial weight, the analysis of the impact of State aid on trade and competition remains largely confined to satisfying the Commission's duty to provide reasons for its decisions, and often relies on legal presumptions". "[E]conomics plays a purely instrumental role which consists in containing the anti-competitive impact resulting from the pursuit of non-competition policy objectives."
[56] Ibid, page 35: "Most Article 107(3) TFEU headings are of an economic nature, in that they can be ascribed to economic policy considerations, though – in contrast to competition policy – they are not based on economic efficiency or on consumer welfare. The link between the efficiency considerations in

policy as a field of competition policy but rather as one of trade or industrial policy.[57] However, the requirements of deeming an aid measure incompatible with the internal market according to Article 107(1) TFEU include that the aid “distorts or threatens to distort competition” and that the aid “affects trade between Member States”. These are inherently economic concepts which deserve a thorough economic assessment.[58]

A restrictive stance towards the generation of moral hazard and State intervention in markets are derived from the economic school of *ordoliberalism*. This school of thought originates in Germany and derives from the ideas of *Walter Eucken.*[59] Ordoliberalism emphasises the principle of economic liability. The objective is competition based on performance[60] by which the least efficient market players (or “performers”) should exit the market. Inefficient and therefore overtly costly business structures should be dismantled. The school rejects the idea of *ad hoc* interventions by a State acting in an active role in the markets as such interventions may not be politically neutral. The school however emphasises the State’s strong role in establishing strong constitution-like *per se* rules[61] on the basis of which markets would operate freely. While efficiency is emphasised, this should be achieved on the basis of a functional market mechanism

Article 101(3) TFEU and the immediate benefit to customers is a direct one, whereas the reasons that justify the authorisation of a State aid measure have only an indirect impact on consumer welfare.”

[57] See for example *Dewatripont* 2006, page 94. See also *Motta* 2004, page 30.

[58] *Coppi* 2011, pages 64-65.

[59] According to *Brunnermeier – James – Landau*, no academic economist would “seriously” call themselves ordoliberal in the modern world. See *Brunnermeier – James – Landau* 2016, page, 63. Instead the ordoliberal role has rather been assumed by lawyers more than economists. The influence of the core ideas of Eucken is still very much alive in Germany today. For example in the legislative debate of the BRRD, MEP Gunnar Hökmark stated of the BRRD proposal that “[i]t establishes *the Berlin principle*, which means that banks’ shareholders and creditors will be the first to face the losses from a bank failure”. http://www.europarl.europa.eu/sides/getDoc.do?type=CRE&reference=20140415&secondRef=ITEM-006&language=EN&ring=A7-2013-0196 . 2014. (Last accessed 31.1.2018.) Only in 2008, the then Member of the ECB executive board, Jürgen Stark, in his speech specifically referred to Eucken’s work. See speech by *Stark* 2008.

[60] *Virtanen* Kak. 1/2015, pages 92 and 94. Ordoliberalism has strong similarities to the Harvard school of thought in economics. *Virtanen* notes however that the theory base of ordoliberalism is more wide-scale than that of Harvard school. However, the Structure-Conduct-Performance hypothesis derived from the Harvard school of thought is in correlation with ordoliberalism. See also *Kuoppamäki* LM 7–8/2008, page 1088.

[61] *Virtanen* Kak. 1/2015, page 92. This economic ”constitution” is called *Wirtschaftsverfassung.* According to *Miettinen*, ordoliberalism sees the role of economics as a normative one rather than as what may be traditionally considered economic. Economic policy should be constrained by and tied to legislation. See *Miettinen* Oikeus 2017 (46); 2, page 209. *Virtanen* states ordoliberals were even skeptical of economists’ ability to forecast future economic conditions. See *Virtanen* Kak. 1/2015, page 93. This is in keeping with the negative attitude towards ad hoc State actions, especially of the macroeconomic kind. See *Brunnermeier – James – Landau* 2016, page 63: “emphasizing microeconomic foundations rather than macroeconomic interventionism”.

operating on top of the ex ante per se rules rather than via means of ex post *ad hoc* efficiency-enhancing types of interventions.

A synthesis[62] of ordoliberal ideas and exceptional ad hoc or case-by-case based considerations is beneficial. This approach allows for taking the general ex ante view of not allowing State interventions. It would only be in exceptional circumstances that State aid could be granted. The justification of these exceptions would happen on the basis of what is regulated in law. However, in order to deem the most efficient interpretation of applicable law, economic analysis can and should be used to determine the most welfare-increasing outcome of State aid. While the BRRD does not set competition rules, one of the objectives of the BRRD is to prevent resorting to State aid policy as a means of crisis management. Therefore the BRRD sets an ex ante rules framework based on which the markets should operate in a manner which would allow failing, inefficient firms to exit the market without having the State intervene actively in the process. The link between crisis management and competition policy is evident. As State aid should not be assumed in recovery or resolution planning, but the granting of such aid is still possible under exceptional circumstances, the evaluation based on which such aid would be granted is inevitably case-by-case based.

Forming this synthesis may even be justified by ordoliberal principles themselves; ordoliberalism supports the idea whereby the market mechanism in a self-coordinating manner, not subject to regulation, might not produce consistently optimal results in terms of competition. Rules can be necessary for coordination in order to ensure optimal allocation of resources and to support incentives for businesses to develop more efficient processes.[63] Therefore ordoliberalism acknowledges that genuine market failures may arise and that market forces alone might not correct these market failures. Even if relying solely on per se ex ante rules would be ideal from an ordoliberal point of view to address market failures, these ex ante rules cannot possibly cover all circumstances, especially those of an unforeseen nature.[64] In order to address genuine market failures, an ex post type of ad hoc assessment should be justified. Furthermore,

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[62] *Kuoppamäki* for example supports the idea of an eclectic approach in economic analysis. He bases his determination on the fact that as economic analysis is only a supplementary tool for a lawyer in order to amplify argumentation, using an economic approach does not mean assuming strictly the ideas and toolkit of any singular school of thought. See *Kuoppamäki* LM 7–8/2008, page 1079.
[63] *Kuoppamäki* 2012, pages 35-36.
[64] *Virtanen* Kak. 2015, page 94.

ordoliberalism rejects excessively complex regulation as this might compromise the clarity of the core principles which should be followed in the markets.[65] While high-level regulation can be considered to flexibly apply to a variety of circumstances, such rules can inevitably also be semantically open to interpretation or allow workarounds.

Taking a strict stance towards the generation of moral hazard can help fulfill the objectives set in the State Aid Action Plan (SAAP)[66] and the SAM plan, which call for less and better targeted aid tackling genuine market failures. Examples of these include *externalities* and *asymmetric information*. Moral hazard again is the result of asymmetric information taken advantage of. In order for State aid to be a justified corrective measure for a market failure, the market failure must be truly genuine, meaning not including moral hazard. It should be proven that any risks on solvency threatening to materialise result from genuinely exogenous unforeseen shocks rather from endogenous errors in capital planning and risk monitoring. A strict ordoliberal viewpoint can help draw the line for what is morally "acceptable" rescue.

The core ideas of ordoliberalism adjusted into approving a limited economic effects based ad hoc analysis in order to cover those exceptional fringe cases to which ex ante regulation does provide an adequate solution[67] fit the objective of *workable* or *effective competition*[68] in EU competition law. Workable competition does not, most importantly, mean perfect competition but "*the degree of competition necessary to ensure the observance of the basic requirements and the attainment of the objectives of the treaty, in particular the creation of a single market achieving conditions similar to those of a domestic market"*[69]. The EU as a concept is built on common regulation to promote free

[65] *Brunnermeier – James – Landau* 2016, pages 61 and 66. See also *Stark* 2008, page 5 : "new regulation needs to be in the spirit of Eucken, i.e. setting general principles rather than drawing up long lists of individual measures, which are necessarily incomplete and invite renewed regulatory arbitrage".
[66] COM(2005) 107 final.
[67] See for example *Brunnermeier – James – Landau* 2016, page 207: "the economy is too complicated for a rigid, fully specified ex ante rule to be optimal. History does not repeat itself; it only rhymes, and for this reason some discretion will always be needed to manage a financial crisis." Furthermore "it is impossible to design rules for all possible contingencies, so in extreme tail events, a departure from the rules-based framework may be optimal".
[68] The term "effective competition" seems to be preferred at present. See for example COM(2017) 285 final.
[69] Case 26-76: Judgment of the Court of 25 October 1977. - Metro SB-Großmärkte GmbH & Co. KG v Commission of the European Communities. - Selective distribution systems, point 20. The concept of workable competition furthermore acknowledges that intensiveness of competition may vary: "*the nature and intensiveness of competition may vary to an extent dictated by the products or services in question and the economic structure of the relevant market sectors"*.

markets. In conjunction with ordoliberal ideas, competition policy should only intervene where a market failure is detected and should be corrected.

Concluding, the role of economic analysis in the context of the BRRD should be relevant only where the ex ante rules of crisis management do not suffice in order to prevent resorting to State aid. In these cases only it is relevant to analyse whether planned State aid is distortive in nature, meaning that its negative effects exceed its positive effects. The determination whereby the positive effects of aid would be determined to surpass its negative effects would lead to the conclusion whereby State aid is compatible with the internal market as the aid would not fulfill all the criteria of Article 107(1) TFEU. Should the negative effects of the aid measure however surpass its positive effects, an extensive economic analysis can help quantify the exact amount of distortive aid.

A correct estimation of the level of distortion of competition is important in order not to impose too strict ex post structural or behavioural measures on an aid beneficiary. Excessive restructuring can be considered more "punitive" [70] than necessary for the restoration of efficiency and thus long-term viability. The strict stance which ordoliberalism takes towards the principle of economic liability can be seen to have influenced in these ex post structural measures of an implicitly punitive nature. Imposing such structural measures on aid beneficiaries can be seen as the result of non-economic "fairness" considerations. In this research, an ordoliberal view is assumed in order to minimise the possibility of resorting to State aid as a means of crisis management. However, should the established ex ante framework of rules be complied with in a manner which would prove the need for State aid could not have been foreseen reasonably and so avoided, punitive measures over the aid beneficiary should not be taken just because the principle of economic liability is not entirely fulfilled when support is granted. Competition policy should protect competition, not competitors[71].

[70] *Lyons – Zhu* argue that the use of structural measures such as divestitures is "punitive" in the case where a financial institution has been saved for reasons of financial stability. See *Lyons – Zhu* 2013.
[71] *Motta 2004*, page 52.

2 GENERAL PRINCIPLES CONCERNING RESCUE AND RESTRUCTURING AID

2.1 Notion of State aid pursuant to Article 107(1) TFEU in the context of aid granted to financial institutions

A measure may be deemed incompatible with the internal market if the following four criteria are fulfilled cumulatively: 1) the measure is imputable to the state and the advantage is granted directly or indirectly from State resources[72]; 2) the advantage is any economic benefit which an undertaking could not have obtained under normal market conditions (in the absence of State intervention)[73]; 3) the advantage is granted in a selective manner to certain undertakings or categories of undertakings or to certain economic sectors[74]; and 4) *the advantage is liable to improve the competitive position of the aid recipient compared to other undertakings with which the aid recipient competes*[75] and that *the advantage is liable to affect trade between Member States*[76].

In-depth analysis of the criteria enacted in Article 107(1) TFEU here is not necessary, for in my opinion there is not much ambiguity in the applicability of criteria 1-3 to the financial sector[77]. The aid measures accepted thus far have clearly been derived from State resources and under the discretion of a Member State's officials. Moreover, it has been stated explicitly by the Commission that a transfer of State resources is also present where resources are at the joint disposal of several Member States who decide jointly on the use of those resources, which would apply to, for example, funding from the European Stability Mechanism (ESM)[78]. Furthermore, in point 47 of the BRRD it is

[72] 2016/C 262/01: Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, point 38.
[73] Ibid, point 66.
[74] Ibid, point 117.
[75] Ibid, point 187. Note that the notion provided in the Communication emphasises the effect of aid on competitors compared to the original wording of TFEU: "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."
[76] Ibid, point 190.
[77] A rare exception of a banking restructuring case in which the criteria of Article 107(1) TFEU were not fulfilled and so no State aid was deemed existing, is the Portuguese recapitalisation of the fully state-owned bank Caixa Geral de Depósitos in March 2017. EC – Fact Sheet. State aid: How the EU rules apply to banks with a capital shortfall – Factsheet. http://europa.eu/rapid/press-release_MEMO-17-1792_en.htm . 2017. (Last accessed 21.2.2018.)
[78] 2016/C 262/01, points 59-60. Resources coming from the Union (for example from structural funds), or from international financial institutions, such as the International Monetary Fund, are considered as State resources if national authorities have discretion as to the use of these resources (in particular the selection

stated that State aid may be involved, inter alia, where resolution funds or deposit guarantee funds intervene to assist in the resolution of failing institutions[79]. Assistance provided by central banks at their own initiative, and under specific further conditions, forms a derogation and not constituting State aid under the meaning of Article 107(1) TFEU[80].

The exact form of an economic advantage is irrelevant[81], as long as the economic situation of the aid beneficiary is improved as a result of State intervention. This means the economic position of the aid recipient does not improve on normal market conditions.[82] It could be argued that aid granted in times of financial turmoil is not granted under *normal market conditions*. However, "normal market conditions" refer to the market conditions prevailing at the time the aid is granted[83]. Hence even extraordinary crisis conditions may be considered "normal"; "normality" depends on context. Normal market conditions also present in practice a *counterfactual* comparative situation in which aid is not granted.

The private investor test commonly used to determine the existence and quantity of aid has remained applicable to bank restructuring aid, although in modified form. Governments have supported banks primarily for reasons of financial stability rather than for return of profit which would be acceptable to a private investor.[84] A private

of beneficiaries). By contrast, if such resources are awarded directly by the Union, with no discretion on the part of the national authorities, they do not constitute State resources.

[79] Furthermore according to recital (55) of the BRRD: "Save as expressly specified in this Directive, the resolution tools should be applied before any public sector injection of capital or equivalent extraordinary public financial support to an institution. This, however, should not impede the use of funds from the deposit guarantee schemes or resolution funds in order to absorb losses that would have otherwise been suffered by covered depositors or discretionarily excluded creditors. In that respect, the use of extraordinary public financial support, resolution funds or deposit guarantee schemes to assist in the resolution of failing institutions should comply with the relevant State aid provisions."

[80] This approach has been confirmed in recitals (32)-(33) of C(2007) 6127 final (Northern Rock).

[81] 2016/C 262/01, point 68. Not only the granting of positive economic advantages is relevant for the notion of State aid, but relief from economic burdens can also constitute an advantage.

[82] Ibid, point 67. To assess this, the financial situation of the undertaking following the measure should be compared with its financial situation if the measure had not been taken. See also for example C(2016) 6573 final (Attica Bank), recital (20) : "the Bank receives a State guarantee under conditions which would not be available to the Bank in the market, and so it receives an advantage".

[83] *Parikka – Siikavirta* 2010, page 30. See also *Quigley* 2015, page 13.

[84] Restructuring Communication, point 14. See also *Laprévote* 2012, pages 94-95. The objective of the private investor test is to assess whether a private investor would have made the same "investment" decision as a State "investing" in the form of granting aid. Based on publicly available information, a private investor would most likely not invest in a failing undertaking. Should it be assessed that a private investor would make the same investment as the State, the criteria of Article 107(1) TFEU would not be fulfilled and so the State measure would not constitute State aid. Example of this private investor application in C(2015) 8626 final (Piraeus Bank), recitals (78)-(86).

investor pursues individual benefits rather than chooses to support an objective of public interest. This finding to an extent denounces the economic analysis value of the test because a workable market price as a benchmark for quantification of aid is absent. This may result in the Commission's assessment of the aid amount being crude. The amount of aid identified by the Commission might not necessarily reflect the actual benefit for the beneficiary[85] or conversely the benefit may be deemed too large if the benefit is deemed correspondent to the exact aid amount. Weighing the positive and negative effects of the aid is therefore especially important when a private market benchmark for comparison is missing.[86] It shall be interesting to see whether banks' systemic risk potential can ever be lowered to a level where the public interest of preserving financial stability would no longer be of such concern that the private investor test could be applied to financial institutions similar to any other undertaking – meaning the only acceptable objective of investment would be to receive profit on investment.[87]

The criterion of selectivity may be deemed equally fulfilled in the context of aid granted to banks. The aid measures have exclusively been targeted towards individual institutions or towards national financial sectors in the case of aid schemes.[88] The criteria of distorting competition and affecting trade between Member States are arguably the most debatable ones in banking restructuring. While it may appear evident that any form of State aid as a fundamentally protectionist measure deteriorating the promotion of an internal market objective would generate negative effects, it is worth considering the following: if an aid measure is necessary in order to preserve financial stability on a national and ultimately on a Union level, can it truly distort competition

[85] *Bacon* 2013, page 407.
[86] *Haucap – Schwalbe* 2011, page 26: "Unlike favouring, the criterion of distortion of competition is usually not subject to a sophisticated economic analysis". With "favouring", *Haucap – Schwalbe* refer to the private investor test.
[87] In 98/490/EC (Crédit Lyonnais) it was also pointed out that simply the amount of funds required for recapitalising a bank is not comparable to any private investment: "the unprecedented total amount mobilized in this aid operation, which is the largest ever in the history of the Community concerning a single undertaking, indicates the State as the sole player which could have mobilized such amounts in view of its virtually unlimited ability to raise finance via tax or borrowing on the market. No private group in Europe or (probably) anywhere else in the world would have had sufficient financial capacity to mobilize such a huge amount of aid".
[88] Prior to the issuance of the Crisis Communications, State aid granted to financial institutions was categorised under sectoral aid. http://ec.europa.eu/competition/state_aid/studies_reports/conceptual_remarks.html#crisis . 2013. (Last accessed 12.2.2018.)

and negatively affect trade in the internal market?[89] A thorough assessment of the positive and negative effects of the aid should be carried out to determine the outcome.

When assessing the effect of an aid measure on competition the Commission may take into account the following indicators: *aid characteristics* (e.g. aid amount; duration and repetition of the aid; effect on the beneficiary's costs), *structure of affected markets* (e.g. market concentration, number and size of firms, barriers to entry and exit) and *industry/market characteristics* – e.g. markets with overcapacity, inefficiencies at the level of the beneficiary (productivity) and importance of innovation.[90] Aid granted to the financial sector, where there is considerable overcapacity in terms of physical branches as well as high entry barriers imposed by strict regulation, could in the light of this market structure assessment be deemed to cause great negative effects on competition.[91] From an ordoliberal viewpoint especially, structural inefficiencies such as overcapacity should be dismantled in order to achieve the most efficient and therefore competitive business structure. Due to strict regulation of financial institutions however, the market in which they operate is quite homogenous, therefore more prone to competition.[92] Competitiveness is still restricted due to regulation. Credit products offered by banks to for example SMEs most likely do not differ drastically from each other. Identifying the relevant product and geographical[93] markets similar to the assessments pursuant to Articles 101 and 102 TFEU could prove beneficial in order to assess the level of distortion in State aid cases as well. Customers in the SME sector have very different interests from those of risk investors.

[89] According to point 72 of the Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, the Commission is for example more likely to take a positive stance towards aid when the positive effects are spread across several Member States and when the aid results in positive spill-over-effects outside of the aid recipient's product market. This is evidently true when safeguarding financial stability on union level to secure funding to the real economy.

[90] Ibid, point 56. Furthermore, the aid, market and industry characteristics should not be seen as stand alone indicators, but should be considered together with other information about the aid measure concerned like the market failure addressed or the objectives of common interest pursued.

[91] See for example C(2015) 8930 final (National Bank of Greece), recital (98): "Since the Bank is active in other European banking markets and since financial institutions from other Member States operate in Greece, measure A is also likely to affect trade between Member States."

[92] While there are switching costs to switching a bank, no bank probably can impose significantly higher fees compared to its competitors without facing any loss of customers. Banks therefore have limited market power.

[93] Credit options in peripheral markets are limited compared to larger cities.

In a stiff market, also subject to somewhat high switching costs[94], it is hard to consider any bank business model efficient from the point of view of competition policy. It may well be that the financial sector cannot even operate on a very dynamic basis; it might need to be static in order to remain stable. Market regulation is therefore the primary safeguard for financial stability; competition and State aid policy should be secondary.

The exit of a credit institution from the market might mean there is less credit available to finance the real economy, worst case scenario being a *credit crunch*[95]. More competition in terms of more producers on the market traditionally results in more benefits to consumers[96]. If, however, an undertaking's difficulties are the consequence of its inefficient cost structure, rescue and/or restructuring aid may allow the inefficient undertaking to remain in the market at the expense of more efficient competitors. In this case there may be little or no benefit to consumers for example in terms of increased output or lower prices, but rather only increased production costs being met by taxpayers.[97] Since the main objective of restructuring is facilitating the return to long-term viability, this will have to intrinsically mean the obligation of rebuilding the "failed" business model into a more efficient one whilst still ensuring a stable, viable structure. Viability and efficiency should go hand in hand. Maintaining unviable banks on the market would further impair the financial system[98] and subsequently create a medium to long-term risk to financial stability – even if short-term financial stability would be safeguarded. An increase in welfare in the short term should therefore not directly lead to the acceptance of an aid measure. Quantifying short-term effects is

[94] *Motta* 2004, page 79.
[95] This phenomenon, "credit crunch", can also spin the other way around. If there were to be a string of company failures and unemployment in the real economy, that would lead to defaults on loans. Such defaults would reduce banks' capacity to lend, exacerbate the credit crunch and in turn further damage the real economy. FAQs on the European Economic Recovery Plan. Is the financial market crisis over – is it only the real economy that matters now? http://europa.eu/rapid/press-release_MEMO-08-735_en.htm?locale=en . 2008. (Last accessed 12.2.2018.)
[96] *Ahlborn – Piccinin* EStAL 1/2010, page 53. However, if there is overcapacity in the market, competition is likely to be intense already and the aid will not have much effect on the total quantity produced for consumers (and thus will have only a small positive effect for consumers). This will cause all firms to produce at lower per-firm quantity and higher cost. Thus, the net effect of the aid on social welfare may be negative (in the absence of other strong policy considerations).
[97] 2014/C 249/01 (2014 R&R guidelines), point 6. See also *Ahlborn – Piccinin* EStAL 1/2010, page 54. More on wrong incentives in point 28 of the Restructuring Communication.
[98] 98/490/EC (Crédit Lyonnais): The possibility of credit institutions which are structurally non-viable being penalized and, where appropriate, expelled from the market by being put into liquidation, is a fundamental element in ensuring the confidence of economic operators. Maintaining credit institutions with insufficient profit margins in business artificially results in serious distortions of competition, a morally hazardous enterprise which ultimately may weaken the rest of the banking system. It also leads to major distortions in the allocation of funds and consequently to dysfunctioning in the economy as a whole.

easier than assessing long-term effects[99] which would be crucial especially in the case of restructuring.

This *static* productive inefficiency arising from allowing inefficient players to survive is a traditional distortion of competition considered in State aid analysis. The focus of this type of distortion is often tinged by non-economic fairness considerations, such as maintaining a level playing field. Maintaining a level playing field should mean equal chances of competing – on the basis of equal ex ante rules[100]. As State aid can be considered to favour the aid beneficiary in comparison to its competitors on the market, the requirement of maintaining a level playing field may in practice end up in considerations of protecting competitors rather than competition. Should the aid beneficiary be subject to structural measures, which are considered "fair" rather than justified on actual economic grounds, the position of non-aid receiving competitors which do not have to undergo restructuring might even be artificially strengthened[101]. A level playing field should ideally not be created via ex post structural and/or behavioural measures[102] but based on ex ante established rules.

Still, from a static short-term perspective distortions may be relatively modest compared to long-term *dynamic* effects. Recent economic theory focus has rather been on these dynamic distortions, i.e. potential negative effects of aid on incentives. These incentive-manipulating dynamic distortions are likely to be more serious, long-lasting and more

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[99] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, point 64.

[100] *Motta* 2004, page 26.

[101] *Ahlborn – Piccinin* EStAL 1/2010, page 55: There is a trade-off between competitive distortions that are *limited by remedies* (e.g. reducing moral hazard) and competitive distortions that are *caused by remedies* (e.g. the aid recipient's limited ability to compete). This is because the required remedies to limit competition distortions might go beyond those necessary to restore viability and are designed to inflict "pain" on aid recipients.

[102] Even in markets with overcapacity, and where probably a more efficient business model can be rebuilt by reducing costs created by overcapacity, it should be taken into account that where this capacity has been created by natural growth of market power on the basis of operating in compliance with level market rules with all players, excessive measures should not be taken to decrease this market power. Concluding, only if the agreed ex ante rules would favour certain undertakings, the level playing field could be restored by ex post means of intervention. After all, ex post corrective measures also tilt the playing field from ex ante agreed rules. It should be carefully considered when the level playing field is actually restored and when it is altered in a manner where the field is tilted into the wrong direction with regard to the aid recipient. In some of the banking State aid cases assessed by the Commission, a popular policy response to reduce overcapacity has for example been to close branches and subsidiaries outside of the aid recipient's domicile country which could in fact reduce competition in the territories where such shut-downs occur. Such measures are especially detrimental to EU-wide competition as the foreclosure of foreign rivalry supports protectionism.

difficult to solve than allocative and productive inefficiencies. Moral hazard is an example of a dynamic distortion.[103] The trouble is that it is potentially not only the aid recipient whose incentives are manipulated in the long-term – the aid beneficiary's competitors may also assume wrong incentives as they expect to be treated in a similar manner as their aided competitor. An "aid culture" can be created, whereby weak firms will be tempted to invest less wisely and try less hard to improve performance. Strong firms would also have lessened incentives to compete[104] as "too strong competition", meaning a large number of firms artificially maintained in the markets, would lessen the probability of being able to appropriate the results of investment made into building an efficient business structure. An artificially large number of firms on the market might be good for short-term static consumer welfare but will result in future costs due to dynamic inefficiency.[105]

Welfare is the standard concept by which an industry's performance is measured in economics. If an economic analysis of State aid were to be brought closer to the assessment of horizontal agreements and market dominance, a relevant welfare standard must be set along with the definition of the relevant product and geographical markets in order to properly assess competitive distortions.[106] Ordoliberalism emphasises consumer welfare over other welfare standards such as producer welfare[107]. Other welfare standards include: 1) the effect aid has on the beneficiary company and its respective competitors (effect-on-rival standard); and 2) total welfare, which is the sum of consumer and producer welfare.

According to the effect-on-rival standard, an aid measure is always anticompetitive if it changes the relative market position of companies. This standard does not correspond

[103] *Bacon* 2013, page 10-11. See also *Coppi* 2011, page 80.
[104] *Lyons – Zhu* 2013, pages 46-47. In the case of the banking sector, it cannot be argued there is monopoly power present. However, the result of having monopoly power is that incentives to compete and to innovate are reduced. This is due to the fact that a company holding monopoly power does not have to face the consequences of competition such as market exit. In case there is an implicit promise existing on the part of States to not allow banks fail, this also means creating the expectation of not having to face the consequences of competition. A realistic chance of having to face the consequences of a competitive loss is instrumental in order to promote dynamic efficiency.
[105] *Motta* 2004, page 57.
[106] *Haucap – Schwalbe* 2011, page 20.
[107] *Virtanen* Kak. 1/2015, page 94. See also *Kuoppamäki* LM 7–8/2008, page 1088. According to ordoliberal views, customers "vote" for the ranking order of products in the markets on a daily basis by deciding which products to buy. It should be taken into account however that the competition policy considered by ordoliberalism probably covers only "traditional" competition policy fields of horizontal agreements and abuse of market dominance. This means State aid policy is not applicable even.

well to the effects-based approach, because it does not consider the effect of aid on markets, the competition and consumers. The focus is quite strictly on fairness. If however the consumer welfare standard would be applied, only the effects on consumers would be assessed. Choosing this standard would end up again in a too narrow view of assessment. The long-term viability of the aid recipient and therefore the effect on producer welfare should be taken into account as well.[108] The perks of a total welfare standard are exactly that this standard allows for the evaluation of several welfare standards combined. Finally, a State aid-specific form of welfare loss to be taken into account is that of "shadow costs of taxation" meaning tax funds which are directed into State aid are tax funds deducted from other objectives of public funding. If the so-called "tax-payer welfare" standard is not taken into account, the effects of aid using the total welfare standard could be assessed too positive[109]. The shadow costs of taxation are especially worth considering with regard to ad hoc State interventions addressing sudden shocks in the market. Such State aid would not have been taken into account in State budgetary planning and will therefore result in unplanned government deficit.

A static component measures welfare at the present moment whereas a dynamic component assesses future welfare. A solely static view will favour more emphasis put on consumer welfare than on other welfare standards, especially producer welfare, because the static view assesses the allocation of resources. Welfare would be maximised when consumers only pay for the cost of production without the producer being able to reap any profit. However, such a situation would not incentivise the producer to develop its processes in the long run. Being able to gain profit and market power provide incentives to improve productive and dynamic efficiency.[110] As allowing gaining profits and market power incentivise dynamic efficiency, this should also result in the market exit of inefficient businesses. Therefore, even though the rescuing of failing undertakings as such may manipulate incentives to compete and create an aid culture; should these rescue measures still occur, overtly punitive structural measures should not be taken in order not to reduce incentives to innovate in the future. Since extensive regulation already restricts dynamic competition between financial institutions and leaves little room for example in terms of differentiated pricing of

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[108] *Haucap – Schwalbe* 2011, pages 20-22.
[109] Ibid, page 30.
[110] *Motta* 2004, pages 19-21, 64 and 69-70. Structural measures should only be adopted if all other measures have failed. Targeting firms because they are "too profitable" is wrong.

credit[111], this little room is essential in order to maintain any incentive of winning market power and so to innovate and optimise cost and business structure in the context of the applicable legal framework and requirements set.

While this chapter already more than scratched the surface on aid compatibility assessment under Article 107(3) TFEU, the objective was to present the problematics of weighing the positive and negative effects of aid already when assessing whether a measure is deemed State aid under Article 107(1) TFEU. While criteria 1-3 of the notion of State aid seem to be fulfilled quite evidently with regard to the bank R&R aid, it could theoretically be argued that the fourth criterion would not be fulfilled, subsequently meaning the examined measure would not be considered prohibited aid under Article 107(1) TFEU. However, as the wordings "the advantage is *liable* to improve the competitive position of the aid recipient compared to other undertakings" and "the advantage is *liable* to affect trade between Member States" would imply, in the context of Article 107(1) TFEU actual weighing of positive and negative effects does not matter to a similar extent as under Article 107(3) TFEU; instead it is only assessed whether the aid could in theory – more than in a merely *hypothetical* manner – cause competition to be distorted. According to the Commission Notice on the Notion of State aid: "For all practical purposes, *a distortion of competition within the meaning of Article 107(1) of the Treaty is generally found to exist when the State grants a financial advantage to an undertaking in a liberalised sector where there is, or could be, competition*."[112] The threshold of fulfilling the fourth criterion of Article 107(1) TFEU is therefore not high[113]. Thus, as State aid granted to banks seems to easily fulfill all the criteria of Article 107(1) TFEU, the aid measures should in principle be considered prohibited and aid compatibility with the internal market should subsequently be assessed under Article 107(3) TFEU instead.

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[111] *Wuolijoki* HS 31.1.2018. Complying with stricter legal requirements increases costs of banking which ends in problems of maintaining productive efficiency.

[112] 2016/C 262/01, point 187.

[113] Ibid, point 189: "Public support is liable to distort competition even if it does not help the recipient undertaking to expand and gain market share. It is enough that the aid allows it to maintain a stronger competitive position than it would have had if the aid had not been provided. In this context, for aid to be considered to distort competition, it is normally sufficient that the aid gives the beneficiary an advantage by relieving it of expenses it would otherwise have had to bear in the course of its day-to-day business operations. The definition of State aid does not require that the distortion of competition or effect on trade is significant or material. The fact that the amount of aid is low or the recipient undertaking is small will not in itself rule out a distortion of competition or the threat thereof, provided however that the likelihood of such a distortion is not merely hypothetical."

2.2 State aid modernisation (SAM)

The Commission's State aid modernisation (SAM) plan contributes to the Europe 2020 strategy[114]. The objectives of the plan are: (i) to foster sustainable, smart and inclusive growth in a competitive internal market; (ii) to focus Commission ex ante scrutiny on cases with the biggest impact on internal market whilst strengthening the Member States cooperation in State aid enforcement; and (iii) to streamline the rules and provide for faster decisions. The objectives are closely interlinked.[115]

Aid granted should be "good aid"; State aid control should facilitate the treatment of aid which is *well-designed, targeted at identified market failures*[116] *and objectives of common interest, and least distortive*[117]. According to the SAM plan, guidelines for R&R aid should *allow State aid to ailing companies only under strict conditions and only if the aid granted results in the companies' return to long-term viability*[118]. Member States should *aim to direct scarce public resources to common priorities and make for a better use of the tax-payers' money*[119]. R&R aid is undeniably among the most distortive types of State aid. Restructuring should usually be possible without State aid, through agreements with creditors or by means of insolvency or reorganisation proceedings. Undertakings should only be eligible for State aid when they have exhausted all other market options[120]..

2.3 Common interest, necessity, appropriateness, incentive effect, proportionality, recurrence, transparency and the balancing test

The Commission's 2005-2009 reform for State aid, the State Aid Action Plan (SAAP), was guided by the principle that State aid assessment should be based on a "balancing

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[114] COM(2010) 2020 final: COMMUNICATION FROM THE COMMISSION: EUROPE 2020: A strategy for smart, sustainable and inclusive growth.

[115] COM/2012/0209 final (SAM), points 8-9.

[116] *Ahlborn – Piccinin* EStAL 1/2010, page 52: "The objective of State aid control is to allow Member States to provide State aid to address genuine market failures while preventing the distortions of competition to which state intervention can give rise." *Bacon* has divided sources of failures into four categories: 1) externalities, 2) asymmetric or incomplete information, 3) coordination failures and 4) public goods. See *Bacon* 2013, page 8.

[117] COM/2012/0209 final, point 12.

[118] An interesting question would be how this statement fits the concept of liquidation aid.

[119] COM/2012/0209 final, points 13-14.

[120] *Petzold* EStAL 2/2014, page 290.

test"[121]. According to the test, first, the aid must contribute to a well-defined objective of common interest. The first step of the test therefore requires the definition of an objective of common interest which is to be attained. This can mean *efficiency* objectives, such as correcting market failures, or *equity* objectives, which are of a more social benefit nature. The second step of the balancing test assesses whether a planned aid measure is the most suitable instrument for attaining the defined objective of common interest. This consideration encompasses three issues: 1) whether the aid measure is the *appropriate* instrument to achieve the objective of common interest (instead of i.e. regulation); 2) whether the aid measure has an *incentive effect* to bring about a change in the aid beneficiary's behaviour[122]; and 3) whether the aid measure is *proportional*, meaning whether the change in behaviour could be achieved by lesser means than planned[123]. The name of the balancing test really refers to the third step; weighing the positive effects of the aid measure against its negative effects[124]. This third step is also the actual economic part of the balancing test. Should a suggested measure fail either step 1 or 2 of the balancing test, economic analysis of effects according to step 3 would not be necessary. However, an economic analysis of whether there exists for example a market failure to be addressed at all, is required[125].

Whereas efficiency refers to maximisation of welfare, equity refers to income distribution or how welfare is distributed[126]. As an ordoliberal view, which rejects State-

[121] *Ahlborn – Piccinin* EStAL 1/2010, page 52.
[122] This condition would not be fulfilled in cases where the aid is not necessary because the beneficiary would achieve the objective even in the absence of aid. See point 13 in the Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper.
[123] Ibid, point 13. The aid amount should not exceed the amount necessary to achieve the objective.
[124] *Bacon* 2013, pages 15 and 101. See also Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 9 and 12.
[125] COM(2005) 107 final (SAAP), points 22-23: "Making more use of a refined economic approach is a means to ensure a proper and more transparent evaluation of the distortions to competition and trade associated with state aid measures. This approach can also help investigate the reasons why the market by itself does not deliver the desired objectives of common interest and in consequence evaluate the benefits of state aid measures in reaching these objectives. One key element in that respect is the analysis of market failures , such as externalities, imperfect information or coordination problems, which may be reasons why the markets do not achieve desired objectives of common interest , in particular if they are of an economic nature. In those cases, identifying the market failure at stake will help evaluate better whether state aid could be justified and acceptable, would represent the most appropriate solution, and how it should be implemented to achieve the desired objective without distorting competition and trade to an extent contrary to the common interest."
[126] *Polinsky* describes efficiency as "the size of the pie" whereas equity deals with how the pie is sliced. See *Polinsky* 2011, page 7. Economists traditionally concentrate on how to maximise the size of the pie while others such as legislators take the decision on how to divide the pie. See also *Motta* 2004, page 18: "The welfare measure is a summarising measure of how efficient a given industry is as a whole and does not address the question of how equal or unequal income is distributed".

led political aims in economic coordination, has been assumed in this research, only efficiency objectives should be taken into consideration as acceptable objectives. This leads to the assumption by which if financial stability is endangered, this should constitute a genuine market failure in order for intervention by means of competition policy to be justified.[127] In the absence of evidence to the contrary, the Commission will consider that markets deliver an efficient allocation of resources in the economy. Member States should demonstrate markets fail to deliver an efficient outcome[128]. In economic terms and in accordance with the *Pareto optimum*, an efficient outcome corresponds to a situation where the allocation of resources is optimal to an extent where no one can be made better off without making someone else worse off.[129]

A dead-weight loss occurs where fewer commodities are produced while still sold for an increased price.[130] This results in a suboptimal allocation of resources. If this criterion is used to identify a market failure, then a credit crunch seems to create circumstances closest to a genuine market failure of financial stability being endangered. A credit crunch would refer to a situation where the financial markets are in a "frozen" state – there is a so-called *market freeze*. Lending does not occur to the same extent nor on the same conditions as in normally functioning markets. The real economy is not financed to an optimal extent whereby possibly profitable investments are not made due to financial institutions "hoarding" assets to secure liquidity and solvency. However, a credit crunch also affects interbank markets eventually drying up liquidity on the whole market. The root cause of a credit crunch is usually the deterioration of trust in markets by which the effects of asymmetric information are amplified. Where banks assess the riskiness of a customer to determine whether to grant credit or not, banks have to operate in circumstances of imperfect information over the customer's creditworthiness. If a customer would be creditworthy and credit is denied due to stricter risk policies in

[127] *Quigley* has defined correcting a market failure to mean "bringing a material improvement the market cannot deliver". See *Quigley* 2015, page 270.
[128] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, point 19.
[129] Ibid, footnote 16. A more lenient option for optimal efficiency would be that of the *Kaldor-Hicks* criterion. Using the criterion of a Kaldor–Hicks improvement, an outcome is deemed an improvement if those that are made better off could in principle compensate those that are made worse off, so that a Pareto improving outcome could be achieved.
[130] *Kuoppamäki* 2012, page 202.

order to avoid granting credit to those customers who would not be creditworthy[131], less credit is granted than optimal and beneficial investments are not made. There would be more demand over credit than there would be supply. Most likely in such a situation where trust has deteriorated and risk policies are stricter, credit would also be granted under more expensive terms than in normally functioning markets. Concluding, where a Member State would be able to prove the occurrence of such a suboptimal allocation of finance, a genuine market failure could be deemed to exist.[132]

The types of market failures which are relevant with regard to financial stability are asymmetric information, as demonstrated in the example above, and externalities[133]. In the example above, asymmetric information hurt the party who was denied credit even though they would have been creditworthy. However, moral hazard works the other way around. In such a case a customer who is not creditworthy but cannot be differentiated from a creditworthy customer takes advantage of the situation of imperfect information. The customer is granted credit but defaults due to not having to bear the consequence of an economic loss. This situation where moral hazard is materialised should not be treated as a genuine market failure. The prevention of moral hazard should occur on the basis of ex ante measures, not treated by ex post intervention.

Externalities are aspects of transactions which affect economic agents other than those who take the investment decision.[134] There are both positive and negative externalities. In for example the field of research and innovation, the market failure of positive externalities could mean that the market players would be unable to reap the full

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[131] *Coppi* 2011, page 71. Asymmetric or incomplete information entails for example a situation in which a bank will not finance a low-risk customer because there is no absolute certainty over the low-riskiness comparing to a pool of customers with rather similar risk profiles.

[132] As a credit crunch would require that access to finance has become increasingly difficult on a wide-scale basis, it could be argued that banks heighten their risk assessment requirements of customers in a "coordinated manner". The situation is reminiscent of *tacit collusion*. No individual bank probably holds a dominant market position in any geographical market but consumers and especially SMEs are to a large extent dependent on finance granted by exactly by banks and financial institutions. Strict harmonised regulation forces banks to act upon the same minimum requirements. Instead of market dominance of a single undertaking, the banking industry as a whole is in a sort of a position of collective dominance.

[133] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 20-21.

[134] *Coppi* 2011, page 70. Externalities result in market failures only if there are *incomplete markets* which means the inability to trade a good/service/interest to another. According to *Coppi*'s example of a polluter choosing a polluting strategy due to the missing market of pollution rights, I do not see how systemic risk could be a good that would be traded in any way. Therefore the markets of systemic risk could be considered incomplete even if this sounds quite absurd because the incompleteness cannot be fixed.

benefits of their actions[135]. Positive externalities in the context of the financial sector would however rather be considered as the positive effects of aid to be taken into account. It has for example been proven in research that State aid granted to a single financial institution can significantly improve the situation of a whole financial market; even if only one institution is granted aid, this decreases systemic risk and improves market liquidity and therefore helps restore trust.[136] Negative externalities in turn represent the risk of contagion as a perspective of systemic risk. The appropriate measure of addressing negative externalities is ex ante regulation in the form of capital buffers which "force" an institution to take systemic risk into consideration in its "production costs".[137]

The requirement of choosing the most appropriate measure to address the well-defined objective of common interest means that the set objective could not be attained in a better way by any other means than State aid. Attention should be paid to the correct analysis of the problem to be solved. For instance in the case of solvency problems, recapitalisations can be considered appropriate, whereas the same would not apply to mere liquidity troubles.[138] According to the 2014 R&R guidelines, the presence of an incentive effect requires it to be shown that "in the absence of the aid, the beneficiary would have been restructured, sold or wound up in a way that would not have achieved the objective of common interest"[139]. Aid is considered to have an incentive effect if it is *necessary* for the aid beneficiary in order to be able to attain the defined target policy objective. In order to demonstrate the necessity of State aid, Member States should submit a credible alternative scenario (a counterfactual) in which, due to the aid not being granted, the desired objective of common interest could not be attained.[140] On the

[135] COM(2005) 107 final (SAAP), point 23: State aid in the context of the Lisbon Strategy.
[136] *Finnish Competition and Consumer Authority* 2011, page 97.
[137] A bank which has systemic risk potential may not have the incentive to take this negative effect into account in its capital planning for this increases costs. However decreasing the likelihood of contagion is beneficial in the public interest in order to avoid financial instability. As banks probably would mostly be concerned with individual risks rather than risks posed to third parties, enforcing prudential requirements will force each bank to take systemic risk into account in their capital planning and risk management, at least to an extent legally required.
[138] *Quigley* 2015, pages 411 and 414.
[139] 2014/C 249/01 (2014 R&R guidelines), point 38. In the guidelines, incentive effect and the "need for State intervention" are differentiated requirements even though they are quite close to each other.
[140] *Quigley 2015*, page 410. The Commission may require Member States to provide for example risk assessments with regard to the risk of commercial failure of the aid beneficiary to demonstrate it would not undertake the targeted activity without aid. The Commission may also use available external information, e.g. industrial benchmarks for profitability or risk. See Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 35-36.

other hand, Member States should also be able to demonstrate aid is not used to subsidise costs a company would in any case incur[141].

The Commission in its State aid assessment practice does not have the obligation to establish a counterfactual.[142] *Harbo* has stated of the ECJ's application practice that the Court will usually hold that the determination whether a measure is necessary or not lies within the discretionary powers of the authority which issued the measure and so the Court will withhold from further investigation[143]. If a proper counterfactual is not established, it is more difficult to not only assess the effects of the aid but also to initially grant an aid amount that is limited to the minimum necessary. *Lyons – Zhu* state that there have been no cases where too little aid has been granted, meaning the viability of an efficient aid beneficiary would have been undermined due to an inadeaquate amount of aid. If the optimal amount of aid is granted, there would be no need to enforce compensatory structural and/or behavioural measures.[144] It should be noted that it should not be interpreted to mean that too little initial aid was granted if aid becomes recurrent. This is instead an issue of the aid beneficiary incorrectly addressing its viability problems.

The correct assessment of the extent of the market failure to be addressed is important in order to limit the amount of aid to minimum.[145] The analysis of the proportionality of aid requires an appreciation of the extent to which the suggested amount of aid exceeds what is necessary to create an incentive effect. The amount and intensity of the aid must be limited to the minimum necessary.[146] The principle of aid being limited to minimum requires the aid beneficiary to contribute to the costs of restructuring by own funds and by gathering capital from private markets. While "proportionality" is explicitly stated to only constitute the third component of step 2 of the balancing test, in fact all three components of step 2 together express the principle of proportionality which is a general

[141] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 32-33.
[142] *Lyons – Zhu* 2013, pages 44-45.
[143] *Harbo* 2015, page 34.
[144] *Lyons – Zhu* 2013.
[145] *Haucap – Schwalbe* 2011, page 20.
[146] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 39-40.

principle of EU law.[147] The application of the principle of proportionality in fact also encompasses step 3 of the balancing test as the principle of proportionality not only requires measures to be appropriate/suitable and necessary but also that the disadvantages caused by the measure must not be disproportionate to its advantages.[148]

The "one time, last time" principle adopted consistently in the Commission's R&R guidelines prohibits repeated granting of aid to the same aid beneficiary. Recurrent aid should lead to a conclusion of the aid beneficiary only being able to survive on the market artificially, solely on State support. In such cases either the beneficiary's problems are of recurring nature or it does not deal with its problems adequately once aid is granted.[149] For the Commission to deem recurring aid compatible with the internal market, extra justification is required. Legitimacy may usually be found in unforeseeable circumstances for which the aid beneficiary could not be held responsible.[150] In the Crisis Communications, this principle finds its expression in the requirement for banks to demonstrate that, following receipt of aid, the financial institution can return to long-term viability without continued State support.[151]

As a rather thorough basic analysis of the factors to be taken into account in weighing the positive and negative effects of aid was presented in the previous chapter already, it is unnecessary to re-address the matter here. However, as noted at the end of the previous chapter, the actual effects of the aid have much more emphasis with regard to assessment under Article 107(3) TFEU than Article 107(1) TFEU. If Stated first is deemed to be the most well-suited measure to address a market failure and consequently the positive effects of the aid would be deemed to outweigh its negative effects, aid could be deemed compatible with the internal market under Article 107(3) TFEU.

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[147] Case C-331/88 (Fedesa), point 13: "The Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued."

[148] *Harbo* 2015, pages 36-40. This is the *stricto sensu* (proportionality in the narrow sense) test.

[149] *Quigley* 2015, page 406.

[150] 2004/C 244/02 (2004 R&R guidelines), points 72-73.

[151] Already in the case of Crédit Lyonnais, the issue of recurrent aid was raised: "SG takes the view that the Commission must require the French authorities to consider alternative solutions such as controlled liquidation and selling in blocks. This would be especially justified in view of the recurrent nature of the aid." See point 5.1 in 98/490/EC (Crédit Lyonnais)..

Finally, the 2014 revised guidelines for R&R aid introduce transparency as one of the principles of application. The definition for transparency in the guidelines is: "Member States, the Commission, economic operators and the public must have easy access to all relevant acts and pertinent information about the aid awarded"[152]. The principle guarantees procedural transparency in State aid matters.

3 IDENTIFICATION OF A CAPITAL SHORTFALL AND THE ASSESSMENT OF THE POSSIBILITY OF A RETURN TO LONG-TERM VIABILITY

3.1 Definition and identification of a capital shortfall

According to the 2013 Banking Communication, a *capital shortfall* refers to a capital shortfall established in a capital exercise, stress-test, asset quality review or an equivalent exercise at Union, euro area or national level, where applicable confirmed by the competent supervisory authority.[153] A capital shortfall can be detected in an adverse scenario or also in a baseline scenario. Both scenarios are required to be included in any relevant capital exercise. The scenarios are future-based estimations on how well a tested bank's capital position endures under different levels of stress experienced. An asset quality review covers all asset classes, including non-performing loans, restructured loans and sovereign exposures[154], which of course are of great importance to a bank's viability. Due to the focus area of recapitalisations and therefore issues with capital position in this research – rather than impaired asset relief measures, which would be better suited to address asset quality issues – only stress tests as a tool of identifying capital shortfalls are examined.

It is the EBA's legal duty, in cooperation with the ESRB, to conduct the Union-wide stress tests. These stress tests are conducted every two years. More frequent stress testing is left at the hands of national supervisory authorities and credit institutions themselves. The duty to conduct Union-wide stress tests is enacted in the EBA regulation[155]. The EBA, again in consultation with the ESRB, also has the duty to

[152] 2014/C 249/01 (2014 R&R guidelines), point 38 and further defined in point 96.
[153] 2013 Banking Communication, point 28.
[154] *Merler – Wolff* 2014.
[155] See Articles 21(2)(b) and 32(2) of REGULATION (EU) No 1093/2010 (EBA regulation). In Article 21(2)(b), the term used to describe the level of obligation to conduct stress tests is "may" whereas in

develop criteria for the identification and measurement of systemic risk and an adequate stress-testing regime which includes an evaluation of the potential for systemic risk posed by financial institutions to increase in situations of stress[156].

The duty to conduct Union-wide stress tests and the institutional duties to monitor capital adequacy and to have in place adequate risk management policies are derived from hard law. Capital and risk management policy requirements for credit institutions have been regulated in the CRD IV and the CRR. However, *the duty to* actually *address a capital shortfall* detected in a relevant stress exercise is not derived from hard law. The law therefore requires capital to be monitored but not to act upon a potential capital shortage as long as the requirements for authorisation remain fulfilled. As noted in the beginning of this chapter, a capital shortfall is an estimation based on hypothetical events of the future. Therefore "a capital shortfall" would not in a stress test context likely refer to a situation where the minimum legal capital requirements would not be fulfilled at the present moment. "A capital shortfall" in the context of the BRRD is only mentioned in Article 32(4) of the BRRD: "Support measures under point (d)(iii) of the first subparagraph shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, EBA or national authorities, where applicable, confirmed by the competent authority." No mention of the term is made in either the CRD or the CRR.

The 2018 EU-wide stress test methodological note provides that "[n]o hurdle rates or capital thresholds are defined for the purpose of the exercise. However, competent authorities will apply stress test results as an input to the SREP in line with the EBA Guidelines on common procedures and methodologies for the SREP"[157]. The 2016 EU-wide stress test did not contain a pass/fail threshold either[158]. The results of the EU-wide stress test are therefore meant to serve as a basis of assessment for national supervisors in the SREP process. Over the course of the SREP, based on soft law guidelines issued

Article 32(2), the term used is "shall". The obligation level presented by the term "shall" was chosen here and so it is the EBA's duty rather than only "right" to conduct Union-wide stress tests.

[156] Article 23(1) of the EBA regulation.

[157] *EBA* 2017: 2018 EU-WIDE STRESS TEST – METHODOLOGICAL NOTE, point 24.

[158] EBA – Press room: EBA clarifies use of 2016 EU-wide stress test results in the SREP process. https://www.eba.europa.eu/-/eba-clarifies-use-of-2016-eu-wide-stress-test-results-in-the-srep-process . 2016. (Last accessed 2.2.2018).

for the process by the EBA, national supervisors may apply the "capital guidance" tool by which national supervisors may request institutions to raise their capital over regulatory minimum requirements and to increase additional buffers in order to improve resilience in potential stress scenarios. Capital guidance does not constitute any form of binding capital requirements.[159]

The 2014 guidelines for the SREP process hold that "[c]ompetent authorities should assess the adequacy of the institution's own funds, and the impact of economic stress thereon, as a key determinant of the institution's viability. These assessments should also consider the risks posed by excessive leverage"[160]. Furthermore, "[i]f, according to the outcomes of the stress tests and taking into account the current macro-economic environment, *there is an imminent risk* that the institution will not be able to meet its TSCR[161] competent authorities *should consider* determining additional own funds requirements"[162]. Since the obligation to address potential capital shortfalls detected in stress tests is based on soft law instruments which additionally leave room for national discretion, it is safe to say that there is no clear legal obligation to address a potential capital shortfall as long as present minimum capital requirements continue to be fulfilled in a manner which does not justify the withdrawal of authorisation. Finally, it has been stated by *Michael Barnier*, on behalf of the Commission, that "[s]trengthening the capital base is only one of many supervisory measures that the supervisor may require or recommend a bank to take to remedy a potential capital shortfall"[163]. Other actions than a capital raise could therefore be considered in order to address a capital shortfall.

The 2013 Banking Communication requires Member States to provide a detailed methodology and input data used to determine the capital shortfall, validated by the competent supervisory authority.[164] The EBA and the BIS also instruct banks to

[159] Ibid.
[160] EBA/GL/2014/13, point 321.
[161] According to point 347 of the 2014 SREP guidelines, competent authorities should determine the TSCR, meaning the total SREP capital requirements, as the sum of: a) the own funds requirement pursuant to Article 92 of the CRR; and b) the sum of the additional own funds requirements and any additional own funds determined to be necessary to cover material inter-risk concentrations. Ibid, point 347.
[162] Ibid, point 367.
[163] 2014/C 312/01: E-001770/14 by *Werthmann* to the Commission. Subject: Negative consequences of stress tests.
[164] 2013 Banking Communication, point 33.

document their stress testing programmes as part of risk strategies. Consistent methodology and benchmarks across Member States should be pursued.

3.2 Stress testing and forward-looking scenario analysis

Stress tests build on and complement asset quality reviews by providing a forward-looking view of banks' shock-absorption capacity under stress.[165] Since an identified capital shortfall means basically a potential *solvency* problem of the future, our focus should be on *solvency stress tests* rather than any other type of stress test, such as a liquidity stress test. According to EBA, a "solvency stress test" means "*the assessment of the impact of certain developments, including macro- or micro-economic scenarios on the overall capital position of an institution, including on its minimum or additional own funds requirements, by means of projecting the institution's capital resources and requirements, highlighting the institution's vulnerabilities and assessing its capacity to absorb losses and the impact on its solvency position".*[166]

The EBA and the ESRB are responsible in the EU for harmonising the methodology used in stress tests across Member States[167] by issuing guidelines. While guidelines are not legally binding, in accordance with Article 16(3) of the EBA regulation, competent authorities and financial institutions *shall make every effort to comply* with the guidelines. Institutions are required to report of compliance with issued guidelines in order to not be registered as non-compliant. In addition to the EU-wide stress tests conducted by the EBA in cooperation with the ESRB, national supervisory authorities are legally bound by Article 100 of the CRD to carry out stress testing *as appropriate but at least annually* on institutions they supervise. The closest and most frequent monitoring of capital adequacy should take place internally by financial institutions themselves.

As stress tests are conducted on both national and supra-national level and also on both institutional and supervisory level, common methodology is truly of central importance to produce results institutions and authorities in different countries can rely on and compare. The BIS has even acknowledged communication over stress testing practices

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[165] *Merler – Wolff* 2014.
[166] EBA/CP/2017/17, point 9.(1).
[167] EBA regulation, Article 32(2).

between jurisdictions as one of the main stress testing principles.[168] The EBA is currently conducting a consultation round over new stress testing guidelines. The methodology of the said draft guidelines is used here.

The EBA draft guidelines for stress testing are comprehensive covering specific stress tests and risk types. As the detection of a capital shortfall is based on future estimations and future-looking scenarios, focus here is on the part of the draft guidelines considering scenario analysis rather than other types of analyses. Future estimations are important also for the assessment of an institution's ability to return to long-term viability. The EBA provides that a scenario analysis means *the assessment of the resilience of an institution or of a portfolio to a given scenario which comprises a set of risk factors*.[169] Institutions should ensure that scenario designs are forward-looking and take into account systematic and institution-specific changes in the present and foreseeable future.[170] The BIS has stated that the "impact of a scenario reflects *estimated changes to a bank's revenue, loss, balance sheet, exposure measures and risk-weighted assets*"[171].

Institutions should ensure that stress testing is based on severe but plausible scenarios[172] and that the degrees of severity should reflect the purpose of the stress test. Institutions should ensure that various degrees of severity are considered. Institutions should equally ensure that severity is set taking into account the specific vulnerabilities of the institution (e.g. exposed to international markets). Institutions should develop own scenarios and not depend exclusively on scenarios from the supervisors.[173] Stress test scenarios should be internally coherent[174].

[168] *BIS* 2017, page 14. In 2015, *Enria* noted that there were 80 options and national discretions left to Member States or competent authorities in the CRD IV package and 155 if case-by-case discretion were taken into account. The impact in some areas is significant according to *Enria*. He also noted that both the EBA and the ECB had observed the options and national discretions hampered the comparability of the outcomes of supervisory assessments. See *Enria* 2015, page 4.
[169] EBA/CP/2017/17, point 9.(9). More comprehensive requirements in points 72-78.
[170] Ibid, point 73.
[171] *BIS* 2014, pages 5-6.
[172] If an institution is permitted to use the IRB approach, Article 177 of the CRR provides guidance for credit risk stress tests: "Stress testing shall involve identifying possible events or future changes in economic conditions that could have unfavourable effects on an institution's credit exposures and assessment of the institution's ability to withstand such changes. An institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test shall be one chosen by the institution, subject to supervisory review. The test to be employed shall be meaningful and consider the effects of severe, but plausible, recession scenarios."
[173] EBA/CP/2017/17, points 79-81.
[174] Ibid, point 75(d).

Stress tests should be undertaken with appropriate frequency. This frequency should be determined having regard to the scope and type of the stress test, the size and complexity of institutions (*proportionality principle*), portfolio characteristics as well as changes in the macroeconomic environment or the institutions business activities. Generally stress tests should be undertaken according to a well-defined schedule.[175]

Stress tests should not be a separate process from capital planning. Both the EBA and the BIS have recognised that stress tests and scenario analyses should already be integral elements of a sound capital planning process, for these techniques are used to obtain a forward-looking view on the sufficiency of a bank's capital base.[176] Hence, whilst there is no binding regulation on acting upon the identification of "capital shortfalls" specifically, action should indirectly be required due to the legally binding requirements of having in place sound capital planning processes and strategies.[177] Institutions are also legally bound to report on the state of their minimum regulatory capital semi-annually.[178]

A clear benefit in conducting effective and frequent internal stress testing comes in the covert nature of these tests. The results will only be available to the institution itself, whereas the results of supervisory review and ultimately especially the results of an EU-wide stress test are at least to some extent made public. Financial institutions are vulnerable to any sudden loss of trust and subsequent bank runs. It is not completely unforeseeable that trust may deteriorate detrimentally due to "failing"[179] a public stress test. Establishing consistent stress testing practices will also be beneficial in the case of having to draw up a restructuring plan in which it is required to prove the institution is able to tolerate stressful market events in baseline and adverse scenarios and to return to long-term viability.[180]

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[175] Ibid, point 32. See also *BIS* 2017, page 8

[176] *BIS* 2014, page 5. See also EBA/CP/2017/17, point 29.

[177] Article 73 of the CRD IV. A sound *capital policy* details the range of strategies management is able to employ to address anticipated and unexpected capital shortfalls. See *BIS* 2014, pages 3-4. A capital policy is a written document agreed by the senior management of a bank. It specifies the principles that management will follow in making decisions about how to deploy a bank's capital.

[178] Articles 99-101of the CRR.

[179] Technically there is no pass/fail benchmarking in EU-wide stress testing.

[180] The *BIS* encourages banks to take a forward-looking view on *capital planning*, which would include a clear indication to decision-makers as to what capital actions they might feasibly consider taking should the bank experience distress. See *BIS* 2014, page 2.

3.3 Objectives of recapitalisation

Recapitalisations are designed to fill capital shortfalls suffered by banks in order to satisfy regulatory requirements and to create a buffer against future losses.[181] Recapitalisations of banks can serve a number of objectives. Recapitalisations contribute to the restoration of financial stability and help restore the confidence needed for recovery of inter-bank lending.[182] Recapitalisations can secure adequate lending to the real economy. In the case of a credit crunch, even sound banks can prefer to restrict lending in order to avoid risk and maintain higher capital ratios. As part of restructuring, recapitalisation could and should support efforts to prepare the return of a bank to long-term viability.[183] State funded recapitalisations could also be a response to the problems of financial institutions facing solvency problems as a result of their particular business model or investment strategy, but this is not durable with regard to moral hazard.

The Commission considers recapitalisations and asset relief measures to be 'structural' measures in nature, because they are designed to address deficiencies in the recipient's balance sheet (e.g. insufficient capital), whereas funding guarantees and liquidity measures are considered to be non-structural measures, as they are only designed to improve the recipient's access to funding on a temporary basis.[184] The conditions for the compatibility of recapitalisations made from public resources are set out in the Recapitalisation Communication, as supplemented by the First Prolongation Communication, the Second Prolongation Communication and amended by the 2013 Banking Communication.

[181] *Bacon* 2013, pages 412-413. See also Recapitalisation Communication, points 4-6: "additional capital provides a cushion in recessionary times to absorb losses and limits the risk of banks becoming insolvent".
[182] Recapitalisation Communication, points 4-6: "fundamentally sound banks may require capital injections to respond to a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk and the increased cost of funding".
[183] Recapitalisation Communication, points 4-6. See also *Quigley* 2015, pages 476-477.
[184] *Bacon* 2013, page 409. The Commission tends to impose more onerous conditions on banks that receive structural aid than on those that only receive non-structural aid.

3.4 Article 107(3)(b) TFEU

3.4.1 Article 107(3)(b): serious disturbance and the financial crisis

In the early stages of the financial crisis and prior to the issuance of the Crisis Communications, the 2004 guidelines for R&R aid[185] whose legal basis was Article 107(3)(c) TFEU, were applied to bank bail-outs. The Crisis Communications broadly follow the general principles developed under the R&R Guidelines.[186] However, the legal basis is different; Article 107(3)(b) TFEU allows for more extensive measures to be taken than Article 107(3)(c) TFEU.[187] In accordance with Article 107(3)(c) TFEU, aid may be considered to be compatible with the internal market if it is to "facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest". Pursuant to Article 107(3)(b) TFEU, aid may be considered to be compatible with the internal market if it is to "promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State".

Prior to 2008, the Commission had taken a narrow view on the applicability of Article 107(3)(b) TFEU, accepting it only under exceptional circumstances. Application was for example rejected in the State aid decision concerning French bank Crédit Lyonnais[188] – despite the largest amount of aid ever granted in the European Community at the time – in 1998, and in the aid decision concerning UK bank Northern Rock[189] still in 2007. Application was rejected due to the determination that economic difficulties of a single institution could not constitute a disturbance on the level of a whole Member State[190]. Having an effect merely on the economy of a larger region or

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[185] 2004/C 244/02 (2004 R&R guidelines).

[186] 2013 Banking Communication, point 15: "even during the crisis the general principles of State aid control remain applicable".

[187] *Ahlborn – Piccinin* EStAL 1/2010, page 47. It must be noted that especially following the issuance of the 2013 Banking Communication, the "Commission has increasingly tightened State aid control in the banking sector through the application of the principles of restructuring aid. These principles have been developed in the context of industries that often feature structural overcapacity and firms suffering from idiosyncratic difficulties".

[188] 98/490/EC.

[189] C(2007) 6127 final (Northern Rock), recital (38).

[190] 98/490/EC (Crédit Lyonnais): "Nor is it aid designed to remedy serious economic disruption, since its purpose is to resolve the problems of a single recipient, CL, as opposed to the acute problems facing all operators in the industry. As a result, the aid cannot be considered as in the common European interest either."

area of a Member State was also deemed not to justify the application of Article 107(3)(b) TFEU.

Since the 2004 R&R guidelines were drafted with focus on the difficulties of individual firms rather than on the challenges of a whole sector[191], the guidelines and their legal basis of Article 107(3)(c) were in the end deemed inadequate to address the financial crisis.[192] Credit institutions exhibit a high degree of interconnectedness and so the disorderly failure of even one credit institution can have a strong negative effect on the financial system as a whole. The distress of a single complex institution may lead to systemic stress in the financial sector, which in turn can also have a strong negative impact on any economy as a whole.[193] The legal basis of Article 107(3)(b) permits Member States to take necessary action to adopt appropriate measures to safeguard the stability of the financial system.[194] The initial debate over the applicability of Article 107(3)(b) should be borne in mind for future application as well; the key finding is indeed that it should be demonstrated that the disturbance occurs on the level of the *whole* Member State.

The aid objective "to remedy a serious disturbance in the economy of a Member State" could be broken down to several criteria requiring further definition:

1) the existence of a disturbance in the economy of a member state;
2) the serious nature of that disturbance;
3) the capability of the disturbance to affect the whole of the economy of the member state concerned; and
4) the necessity of the aid measure and its proportionality to remedy the disturbance, in the general interest, as well as the absence of less-distortive measures to attain an equivalent result.[195]

The "existence" of a disturbance should find its correspondent in having to demonstrate the occurrence of a genuine market failure which the market mechanism is incapable of correcting in a self-coordinated manner. As noted over the debate on the application of

[191] *Bacon* 2013, page 400.
[192] *Ahlborn – Piccinin* EStAL 1/2010, page 47: The banking industry during the current financial crisis differs in fundamental ways from the earlier restructuring aid cases, in particular the under supply of lending due to a general lack of confidence and the systemic causes of the recipient banks' difficulties. As a result, several of the assumptions underlying the restructuring aid principles do not hold and the restructuring aid principles lead to a fundamentally different outcome than under an effects-based analysis. By applying the restructuring aid principles in a fundamentally different context, the Commission risks pursuing a policy which not only fails to achieve any benefits but which is highly likely to make a bad situation worse, harming consumers, the banking industry and the economy at large.
[193] 2013 Banking Communication, point 25.
[194] *De Kok* EStAL 2/2015, page 227.
[195] *Micossi – Bruzzone – Cassella* 2016.

Articles 107(3)(c) and (b), it should furthermore be demonstrated that the disturbance is capable of affecting the economy of a whole Member State. Logically thinking, this should set a minimum requirement for how "serious" the disturbance detected ought to be at least. The fourth criterion again is the expression of the balancing test and the general principle of proportionality in EU law.

Especially "the serious nature of the disturbance" has hardly been evaluated. This criterion sets a clear qualitative additional requirement over the defined objective of public interest for the correction of which a State aid measure is suggested. Not only should there be a market failure existent, the market failure should be considered to be of a "serious nature" as well. Unfortunately instead of a more thorough analysis, the Commission has chosen in its practice to take a general stand that *the global financial crisis can create a serious disturbance in the economy of a Member State and that measures supporting banks are apt to remedy that disturbance*[196]. According to the Commission, the very adoption and continued application of the 2013 Banking Communication confirms the existence of a serious disturbance to remain true. In the Commission's State aid decisional practice argumentation one will have to settle for a description of the aid recipient's past economic difficulties[197] with no explicit connection made to seriousness. The case practice shaping the definition of a serious disturbance has almost exclusively developed around the context of the financial crisis. How beneficial or relevant will this case practice be in any future context?

[196] C(2015) 8626 final (Piraeus Bank), recital (106). Moreover, in recital (107): "The Commission's various approvals of the measures undertaken by the Greek authorities to combat the financial crisis confirm the presence of a serious disturbance in the Greek economy. Moreover, the need for a third sizeable macroeconomic adjustment programme for Greece confirms further continued existence of the serious disturbance in the Greek economy." The Commission is basing its judgment of the presence of a serious disturbance on the fact that aid was already granted previously. The same rationale is also used in recital (115) of C(2015) 8930 final (National Bank of Greece).

[197] Example of this in recitals (27) and (26) of C(2016) 6573 final (Attica Bank): "The Commission has acknowledged that the global financial crisis can create a serious disturbance in the economy of a Member State and that measures supporting banks are apt to remedy that disturbance. -- The Commission still considers that the conditions for State aid to be approved pursuant to Article 107(3)(b) TFEU are present. The Commission confirmed that view by adopting the 2013 Banking Communication. -- The Commission remarks that the Bank's liquidity position was initially deteriorated by the application of a bank holiday on 28 June 2015 and the subsequent maintenance of capital controls since banks reopened on 20 July 2015. The Commission observes that the deposit outflows encountered by the Bank since mid-September 2016 have significantly weakened its liquidity position. The Bank's dependence on ELA increased significantly and led to a subsequent reduction of the unencumbered collateral for ELA funding. The measure is, therefore, necessary for strengthening the liquidity position of the Bank. Hence, the Commission finds that the measure aims at ensuring financial stability and, thus, remedying a serious disturbance in the Greek economy."

The extremely case-by-case-based approach makes it difficult or even impossible to derive any practical guidelines or general principles in order to assess whether the supposedly continued existence of a serious disturbance is justified against current economic conditions. Such lack of guidelines and principles also constitute for little help in case of having to analyse whether any future market failure could be considered a serious disturbance in the economy of a Member State. Prior to 2008, Article 107(3)(b) TFEU had hardly been invoked, yet now even smaller banks which are not defined as systemically important institutions by relevant supervisory authorities have fallen under the scope of the application of the Article.[198] Is this necessary room left for flexible interpretation which happens to come at the price of legal certainty?[199] It should be noted here that the Commission's State aid decisions are not considered case law or precedents; they are instruments of secondary law imposing obligations solely onto the Member State which the decision concerns. Maybe it would rather be in the power of the ECJ to further define the meaning Article 107(3)(b) TFEU. Regardless of this still, as the Commission exercises exclusive competence in State aid matters, the body could at least on the level of soft law instruments, such as communications[200], provide examples of recommended patterns of application over any of the clauses enacted in Article 107(3) TFEU in order to increase legal certainty and transparency of State aid compatibility.

The focus of the Commission's compatibility assessment with Article 107(3)(b) has been rather on determining whether the aid recipient can return to long-term viability than on the economic conditions and effects of justifying the existence of a serious disturbance in the economy of a Member State. While this individual viability assessment is essential in R&R aid cases, it has caused State aid decision practice to be very much focused on the individual economic situation of the aid recipient, rather than

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[198] C(2017) 4990 final (Vestjysk Bank), recital (13): "Vestjysk Bank is classified as a non-systemically important financial institution by the Danish Financial Supervisory Authority ("DFSA") and is currently the 15th largest bank in Denmark, with a market share of less than 0.3%." It is also recognised in Article 2(1)(30) of the BRRD that "All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree." The same statement has been made in recital 15 of the EBA Regulation.

[199] *Olivares-Caminal – Russo* 2017, page 11: "Overall, the absence of a legal definition of serious disturbance leaves regulators and supervisors with a fair degree of flexibility in determining the need, or lack thereof, to provide extraordinary public financial support on the basis of their own assessment." "[T]he flexibility granted allows for a case-by-case assessment. Whereas this is in principle a positive outcome, which contributes to the limitation of moral hazard, it comes at the expense of legal certainty."

[200] On the use of soft law instruments in coordinating EU competition law, see for example *Berrod* 2015, page 286. Soft law can more effectively than soft law reflect changes in competition policy and is better suited in order to describe models of interpretation. Soft law equally allows codifying the Commission's decisional practice.

on further assessing the economic conditions of the surrounding economy as a whole and whether the difficulties the aid beneficiary bank is experiencing have the capability of affecting the surrounding economy in a negative manner. The viability assessment is in turn essential in order not to grant aid to institutions which will fail.

With regard to assessing the potential of a bank of negatively affecting economic conditions in its primary geographical areas of operation, for example in decision SA.47677 (2017/N) the Commission described the market share which MPS holds in its domicile country Italy and the geographical markets where the bank operates as follows; the bank mainly operates in Italy where the bank is the fourth largest one with a market share of approximately [5-10%] in branches and customer loans. The bank holds a market share of around [0-5%] of direct funding such as deposits and debt securities. With regard to "product markets" the bank is mainly active in the retail and SME segments.[201] This information is as far as an assessment of market influence goes in the decision. In comparison, extensive analysis is conducted over measures required in order to restore long-term viability and compensate for distortions of competition. The Commission still states in the decision that: "Given the size and market share of the Bank and the fact that the general market and economic climate towards banks has still not fully normalized, the Commission considers it appropriate, as confirmed by the 2013 Banking Communication, to examine the two measures under Article 107(3)(b) TFEU"[202].

One can argue that the connection between the economic difficulties of MPS and the economy of Italy ("Member State") is left rather ambiguous. The market shares do not imply great significance for the bank. Possibly a more thorough analysis of the bank's significance exactly for the retail and SME sectors should have been conducted in order to establish whether the banks' problems were capable of adding up to a credit crunch and so to a genuine market failure affecting customers and counterparties. MPS's market share could possibly be larger if the relevant geographical markets here were restricted in scope. However, if rather an area or a region would be used as the basis of assessment of market influence, this could go against the requirement of the disturbance occurring on the level of a whole Member State. Regardless of these market share considerations, it seems that what truly should be established here in order to prove the

[201] C(2017) 4690 final (MPS) recitals (8)-(9).
[202] C(2017) 4690 final (MPS), recital (88).

bank's influence in Italy would be to evaluate the bank's interconnectedness and systemic risk potential.

The lacking assessment of economic conditions on a Member State level may be due to the segregation of duties between EU and national authorities. The Commission is not a supervisory authority nor is it the responsible EU body for macro-economic assessments. Macro-prudential supervision and identification of systemic risk factors on Member State level have been left largely at the hands of the Member States while the ESRB focuses on EU-wide systemic risk factors.[203] The Commission has in its State aid decisions relied on different national and supra-national level stress tests on a varying basis.[204] The Commission could also conduct its own stress test[205], which is maybe a too rarely used option – possibly in order to avoid duplicate work; an aid decision is often needed urgently in economic distress. Concluding, with the level of power that national supervisors continue to hold in assessing systemic risk and therefore national level serious disturbances, it is extremely important that stress testing across the Union is uniform and provides mutually comparable results; based on both consistent terminology and consistent benchmarks. However, stress tests conducted by the Commission separately would better ensure its exclusive competence in State aid matters and consistency of its decisional practice.

As long as the failure of an institution has enough systemic risk potential[206] in order to disrupt the financial system in a manner of potentially having "*serious negative consequences* for the internal market and the real economy"[207], the application of a serious disturbance probably cannot be ruled out. When the financial system is already in a weak shape, the effect of a crisis is also likely to be bigger than if the financial

[203] CRR, recital (16). See also High-level Expert Group on reforming the structure of the EU banking sector. Chaired by Erkki Liikanen. FINAL REPORT. 2.10.2012. Executive summary.
[204] *Laprévote* EStAL 1/2012, pages 97-99. In some cases (Lloyd's, RBS), the Commission entirely deferred to the national regulator's stress tests, which it considered reliable and sufficiently prudent. In other cases (ING, Dexia), the Commission only partly deferred to the national regulator's assessment (and applied its own stress tests in addition), or verified that the stress test was satisfactory (Bank of Ireland, Ethias). Finally, in other decisions, the Commission did not in its decision refer to stress tests conducted by national regulators (Caja Castilla Mancha, KBC).
[205] *Bacon* 2013, page 422.
[206] ECFIN/CEFCPE(2008)REP/53106 REV REV, page 34: "Public intervention, in particular when public money is at risk, should only occur when there is a clear systemic risk, i.e. when there is a serious disturbance of the financial system that, as a result, may have a major impact on the real economy."
[207] EBA regulation, recital (15).

system is robust.[208] The system must be built stronger and substantial reforms have been made to achieve this. The real question is whether this alone will be enough or if additionally the size of financial institutions should be subject to legal limitations as a precaution (ex ante). Currently structural measures, such as divestitures and balance-sheet reductions, are only imposed in an ex post manner, once an institution has already fallen into a state of deep crisis of which it cannot get out unassisted. System-wide reforms aim at building a stronger system as a whole but should ex ante structural restrictions be imposed on individual banks with the greatest systemic risk potential as well? System-wide reforms alone might prove inadequate where individually systemically risky banks remain at play. Restructuring currently is only required where a bank must undergo restructuring as a result of the imposition of crisis management measures. Is such a threat of ex post restructuring enough in order to limit the growth of systemic risk potential or should actual ex ante size limitations be imposed instead?

While the *present* state of the financial system and the real economy are relevant factors to be taken into account in systemic risk analysis, the pressure of present circumstances should not start the discussion on how to resolve a crisis before assessing the potential *future* impact of the crisis. From an ordoliberal point of view, such a future-looking view is preferred over ad hoc interventions. Such a view is equally important in order to assess the correct impact of the crisis and therefore to address the crisis in a proportionate manner. In 2008, a vast majority of the financial supervisory authorities, central banks and finance ministries in the EU signed a Memorandum of Understanding on cooperation on cross-border financial stability[209], consisting in part of guidelines for assessing systemic risk factors. The MoU is not legally binding on the parties.[210] However, some of the ideas presented in the MoU are highly beneficial for establishing a connection between systemic risk and the definition of a serious disturbance. Pursuant to the MoU, the characteristics of a crisis that should be assessed are: (i) the size and nature (idiosyncratic or general) of the shock, (ii) the expected pace (fast-moving or slow-moving) of the crisis, the (iii) affected financial systems; and (iv) the impact on

[208] ECFIN/CEFCPE(2008)REP/53106 REV REV, page 34. *Merler* suggests that while crisis management reforms are still combatting the too-big-to-fail-problem, crisis management is implicitly prone towards a "too-many-to-fail-problem", which means that "when the number of bank failures is large, the regulator finds it ex post optimal to bail out some or all failed banks, whereas when the number of bank failures is small, failed banks can be acquired by the surviving banks". See *Merler* 2017.
[209] ECFIN/CEFCPE(2008)REP/53106 REV REV.
[210] Ibid, point 10.1.

real economy. The MoU supports the usage of scenarios of different levels of severity and plausibility in determining a high-level systemic impact score[211].

According to the MoU, the financial system is composed of financial institutions, financial markets and financial infrastructure. In the case of a rapidly unfolding crisis, the focus of the assessment may need to be on the most critical parts of the financial system. The assessment of a financial system's components should therefore reflect 1) *the critical nature of the components' affected parts*[212] and 2) *the components' extent of disturbance* which may in the case of financial institutions be indicated for example by shortage in liquidity, loss of capital, fall in future profits and depositor confidence. The extent of disturbance will be influenced by the presence and effectiveness of risk mitigating factors, such as capital buffers, deposit guarantees and regulation. For the real economy, relevant factors are the reduction in the financial wealth of non-financial economic agents and their restricted access to financial services.[213]

In the context of the Crisis Communications, the definition of a "serious disturbance" is likely attached to that of "financial stability is endangered". Pursuant to the definition in the 2013 Banking Communication, financial stability implies *the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy*[214].

3.4.2 Restoring long-term viability in restructuring cases

The long-term objective of restructuring is returning to viability. Restructuring usually requires a withdrawal from activities that would remain structurally loss-making in the

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[211] The levels of plausibility are: "Best outcome", "likely outcome" and "worst outcome". The high-level scores for impact are: "No impact", "limited impact", "serious impact" and "severe impact". Ibid, pages 32-36.

[212] Ibid. "Two main criteria are relevant for a part's critical nature: (i) its role in performing the key financial functions (executing payments, matching savings to investments, managing financial risks) and (ii) its main users. Three additional criteria can be used to further differentiate the affected parts in terms if criticality: (i) the part's activity level ("size"), (ii) the availability of alternatives ("substitutability") within a reasonable time/at a reasonable cost and (iii) its linkages with other parts."

[213] Ibid.

[214] 2013 Banking Communication, point 7.

medium-term.[215] Long-term viability is achieved when a bank is able to cover all its costs, and to provide an appropriate return on equity, taking into account its risk profile.[216] Banks must have the ability to generate a sustainable income and preserve a satisfactory level of capital.[217] A restructured bank must be able to compete on its own merits on the market[218], free from aid. As an example of the interpretation of long-term viability by the Commission, in SA.43365 (2015/N), the Commission assessed the restructuring plan to show the Bank is *able to withstand a reasonable amount of stress* as, in the adverse scenario, the Bank *remains profitable and well-capitalised at the end of the restructuring period.*[219] Long-term viability will have to mean market trust is restored[220] and so the bank would have the ability to be financed at market conditions.[221] Long-term viability should also mean the bank is able to redeem the received State aid over time or is able to provide remuneration over the aid according to normal market conditions.[222] Restoring long-term viability should partly occur on the basis of structural measures which are necessary in order to cut the aid beneficiary's costs to an extent which allows for more efficiency but does not hamper the stability of

[215] *Bacon* 2013, page 420. However, according to point 14 of the Second Prolongation Communication: "The Commission will undertake a proportionate assessment of the long term viability of banks, taking full account of elements indicating that banks can be viable in the long term without the need for significant restructuring, in particular where the capital shortage is essentially linked to a confidence crisis on sovereign debt".

[216] For example in C(2015) 8626 final (Piraeus Bank), recital (121): "The base case scenario shows that at the end of the restructuring period set down in the 2015 restructuring plan *the Bank will be able to realise a return which allows it to cover all its costs and provide an appropriate return on equity* taking into account its risk profile. At the same time, the Bank's *capital position is projected to remain at a satisfactory level*." Recital (122): "The 2015 restructuring plan shows that the Bank is able to withstand a reasonable amount of stress as, in the adverse scenario, the Bank remains profitable and well-capitalised at the end of the restructuring period."

[217] C(2015) 8930 final (National Bank of Greece), recital (130).

[218] In 98/490/EC (Crédit Lyonnais), the bank's viability status and prospects were compared to similar banks: "CL's performance should be set against that of the institutions which are most directly comparable to it. In view of the variety of CL's functions, such comparisons are complex and require a substantial number of institutions and markets to be assessed using multiple criteria concerning the size, structure, organization, profitability, distribution and presence on the domestic and international market, etc."

[219] C(2015) 8930 final (National Bank of Greece), recital (131).

[220] EC – Press release. State aid: Commission approves amended restructuring plans for Alpha Bank and Eurobank: "Alpha Bank and Eurobank have succeeded in fully covering their capital needs with capital from private investors (existing creditors, through voluntary exchange of their bonds for new shares, and new investors), without having to resort to capital injections by the State. The private capital raising was helped by the HFSF's backstop, i.e. its commitment to cover any capital needs not found from private investors or from existing bond holders. *It is a clear sign of market confidence in the restoration of the long-term viability* of these two banks." http://europa.eu/rapid/press-release_IP-15-6184_en.htm . 2015. (Last accessed 21.2.2018.)

[221] *Adamczyk – Windisch* 2015, page 5. However, according to the Commission's decisional practice, it is not required that all funding comes from the private sector. It appears to suffice to raise some of the necessary capital privately.

[222] *Bacon* 2013, page 420. See also Restructuring Communication, points 12 and 14.

the business. Therefore, measures which aim at restoring long-term viability should be based on efficiency considerations.

The Commission's usual position is that the restructuring period should be as short as possible as required to restore viability. Generally, the restructuring period under the Crisis Communications should not last more than five years.[223] The Commission requests forecasts of viability against base case and 'stress' scenarios of future market developments included in a restructuring plan.[224] In principle, all foreseeable effects should be taken into account, although the further away in time the effects are, the greater the uncertainty. It might be useful to differentiate between short-term and long-term effects.[225] In a period of market uncertainty, forecasting is very difficult.[226] Given the large potential costs associated with a systemic financial crisis, particular attention should be paid to as far as the worst case scenario of wide-scale contagion.[227] This is to ensure a bank's capital position could endure such conditions. However, over-prudent capital buffers as a precaution for worst-case scenarios can impede a bank's profitability by increasing its costs structure and therefore hampering viability. This is not optimal either and only emphasises how difficult adequate and appropriate scenario analysis is. The assessment of banks' long-term viability for the purpose of State aid control may overlap with stress testing, which is only a good thing. It is important for consistency between supervisory review, application of prudential regulation and competition policy.[228]

[223] *Bacon* 2013, page 420. See also Restructuring Communication, point 15.
[224] Restructuring Communication, point 13. Stress testing should consider a range of scenarios (including a protracted global recession) as well as a combination of stress events; any assumptions should be compared with appropriate sector-wide benchmarks suitably adapted to reflect new elements arising from the financial crisis. For example in recitals 71-75 of C(2007) 6127 final (Northern Rock) the following alternative scenarios are listed: an "upside" scenario, a "downside – execution challenges" and a "downside – recession case". See also *Bacon* 2013, page 422.
[225] ECFIN/CEFCPE(2008)REP/53106 REV REV, page 34.
[226] Even adverse scenarios are not always worst case scenarios as is revealed by the Piraeus Bank State aid decision C(2015) 8626 final, recital 9: "The deterioration in the political and economic environment from December 2014 and the introduction of capital controls were not envisaged in any of the adverse macroeconomic scenarios used in the national 2014 AQR and stress test, the 2014 CA, and in the 2014 Restructuring Decision." For example in the May 2009 West LB decision, where the Commission found the restructuring plan "demonstrate(d) the capacity of West LB to restore its long-term capacity", it was informed only four months later that the initial forecasts were obsolete and additional aid was required.
[227] ECFIN/CEFCPE(2008)REP/53106 REV REV, page 34.
[228] Restructuring Communication, point 13: "The [restructuring] plan should include measures to address possible requirements emerging from stress testing."

3.4.3 Restructuring plans as the basis of aid compatibility assessment

The Commission's assessment of bank restructuring plans is built on three pillars:

i. Restore long-term viability without further need for State support in the future, by restoring sustainable profitability and reducing risk; if this proves not possible, consider an orderly winding-down;
ii. Minimise the use of taxpayers' money, through appropriate burden-sharing measures, including contributions by the bank, shareholders and junior creditors;
iii. Limit distortions of competition through proportionate remedies. Giving State aid to a particular bank can distort competition, as it gives the bank an advantage over its competitors.[229] These remedies include adequate remuneration for the aid, structural measures, meaning reductions of business activities, and interim behavioural measures.

As the term "remedy" in pillar iii. would imply, measures which are aimed at limiting distortions of competition mean compensatory measures. These measures, unlike structural measures which are necessary in order to restore long-term viability, are not based on efficiency considerations. Measures limiting distortions of competition de facto limit the aid recipient's capability to compete as compensation for receiving an advantage which its competitors did not receive[230], meaning State aid. Compensatory measures may overlap with structural measures which are necessary to restore long-term viability but go beyond, therefore imposing additional structural measures on the aid beneficiary. Imposing such additional measures does not have grounds in efficiency but rather in fairness. Behavioural measures alike are based on fairness considerations, as these literally restrict the behaviour of the aid beneficiary by for example imposing advertisement bans.[231]

The focus of this research is rather on ex ante measures of *preventing* distortions of competition, whereas remedies represent ex post means of *limiting* distortions of

[229] *Adamczyk – Windisch* 2015, page 2.
[230] For example in recital (84) of decision C(2017) 4690 final (MPS), the Commission explicitly made reference to the aid beneficiary's competitors: "Measure 2 provides the Bank with an advantage that other economic actors competing with the Bank do not have. Thanks to the measure, it is easier for the Bank to maintain or grow RWA and to preserve market share. As a result, the Bank could keep business that would otherwise have been available for other economic actors, which have to compete on their merits and cannot rely on recapitalisation aid. Therefore, Measure 2 distorts competition." From an economic standing-point, emphasis should have been in assessing whether the aid indeed allowed for an inefficient undertaking to survive in the market. After the restructuring period, the undertaking should be built on a more efficient business model. However, restructuring takes a long time, many years. There are really no absolute guarantees of the restructuring being successful as forecasting of economic conditions of both the beneficiary bank and the surrounding economy is difficult. In the light of these considerations which depend on uncertain events of rather distant future, imposing compensatory measures provides for a more "short-sighted" and more certain solution.
[231] Aid beneficiaries could increase their market share at the expense of their competitors, even if they are more efficient. Structural and especially behavioural measures can be seen as limiting such effects.

competition. Only circumstances in which no aid is granted, by means of preventive ex ante legislation, moral hazard will be eliminated[232]. Imposing remedies does little to achieve this objective, therefore not helping to reduce dynamic distortions. With regard to static efficiency, benefits achieved by imposing compensatory measures are questionable as it may be argued that State aid granted to a systemically important bank produces positive externalities; State aid granted to a single institution may reduce the likelihood of contagion and improve market liquidity by restoring trust significantly. In the presence of these positive externalities benefitting competitors, from a static perspective, it is difficult to argue that any distortion of competition occurs, justifying compensatory measures. *Lyons – Zhu* ask: “If the aid was already benefitting rivals, why should they need compensation?”[233] A compensatory measure which does have economic grounds is that the aid beneficiary has to pay adequate remuneration for the aid granted, similar to any loan agreement. An appropriate remuneration plan can even be profitable if proper interest is paid, in the end adding up to consumer welfare with regard to an increase in national budget funds. Profitable remuneration would also bring the State aid measure closer to an “investment”, possibly leading to a more workable use of the private investor test in banking restructuring.

In order to assess the possibility of returning to long-term viability, a restructuring plan will need to include a thorough diagnosis of the troubled bank’s problems. The plan should identify the causes of the bank’s difficulties and the bank’s own weaknesses and outline how the proposed restructuring measures address the bank’s underlying problems. To achieve this, it is recommended in the Restructuring Communication that banks stress test their business based on common parameters which build to the extent possible on methodologies agreed at Community level.[234]

In order for aid to be compatible with the internal market, it must also comply with the general principles for compatibility under Article 107(3) TFEU, viewed in the light of the general objectives of the Treaty such as the principle of proportionality. Therefore, according to the Commission's decisional practice any aid measure which is approved on the basis of a restructuring plan should comply with the conditions of

[232] *Heimler – Jenny* 2012, page 360.
[233] *Lyons – Zhu* 2013, page 45.
[234] Restructuring Communication, points 7 and 10.

appropriateness, necessity and proportionality[235] while targeted at safeguarding the common interest of financial stability. The principle of proportionality is not only relevant in limiting the amount of aid granted but with regard to the imposition of compensatory measures – this general principle should ideally be applied to the Commission as well when it exercises its powers. More restructuring than what is appropriate, necessary and proportional in order to safeguard financial stability should not be required. State aid policy is however, in the area of the Commission's exclusive competence whereby the explicit application of the principle of proportionality to the exercise of the Commission's powers is hampered.[236]

4 BAIL-IN, BURDEN-SHARING AND THE CURRENT EU LEGAL FRAMEWORK FOR BANKING RESTRUCTURING AND CRISIS MANAGEMENT

4.1 Bail-out vs. bail-in: pros and cons

A bail-out means the provision of public support, as in from national budget funds or tax-payer money, in order to prevent a financial institution from failing, whereas a bail-in requires bank losses to be absorbed by the "owners" and "investors" of the failing institution instead. This means the shareholders and unsecured creditors. According to the ordoliberal principle of economic liability, those who have taken the risk should bear the risk. Bearing this risk to the extent morally acceptable was not possible in the financial crisis due to for example missing and/or insufficient regulation and due to the acute nature and unforeseeable size of systemic risk and threat of contagion. The subsequent crisis management reforms have now attempted to solve this moral dilemma while still aiming to safeguard financial stability as well. However, in case these objectives of protecting both tax-payers and financial stability may not be attained simultaneously, financial stability as the overarching objective will prevail.

[235] See for example C(2016) 6573 final (Attica Bank), recitals (31)-(32).
[236] The regulation of State aid policy is a unique aspect of the EU in comparison to any other jurisdiction or economic area. This is due to the conflict between the promotion of the internal market objective of the EU and the fundamentally protectionist nature of State aid measures. This conflict of State aid with the principle which is probably the most fundamental objective of the EU should be borne in mind also when assessing grounds of justification of compensatory measures.

The Liikanen High-Level Expert Group strongly supported the use of bail-in tools, as according to the Group, they improve the loss-absorbency ability of a bank. Furthermore, the Group held that bail-in is crucial to ensure investor involvement in covering the costs of recapitalisation. The imposition of a bail-in reduces the implicit subsidy in debt financing, which improves the incentives of shareholders and creditors to monitor the bank.[237] Normally, shareholders could have every incentive to encourage bank management to build leverage to maximise return on equity.[238] However, the enactment of the bail-in tool must constitute a credible "threat" in order to achieve these aforementioned objectives. For example *Bernard – Capponi – Stiglitz* claim that credible bail-in strategies only exist under optimally low conditions of negative externalities and contagion. When the perceived impact of a prospective failure of an institution is evidently great, "threatening" with denying bail-out does not work because all market players will know that in case they withhold from a private solution, the government will have no choice but to intervene.[239] If the "threat" of triggering a bail-in therefore is not credible, bank management and shareholders will continues to have every incentive to take disproportionate risks to reap profits.

It must be borne in mind that the bail-in tool will not in fact shift the penalty for failure to a failing institution as an entity. The penalty will in the end always be absorbed by individuals. These individuals facing the penalty should ideally be the ones responsible for the failure.[240] Unfortunately this is not always the case. For example in the case of a purely domestic bank, shifting from bail-out to bail-in will indeed transfer the burden of loss away from tax-payers but instead to other domestic players still; the average savers and pensioners as the "owners" of the bank. Such regular customers lack the expertise of a corporate investor and might in the case of a bail-in feel "tricked" into buying bail-inable debt.[241] In the case of MPS, retail junior bondholders were victims of actual mis-selling.[242] In the end however, what separates these misinformed average customers and average taxpayers from each other is that taxpayers do not make an investment choice of any kind in the scenario and so should not have to assume any risk. Risks that

[237] High-level Expert Group on reforming the structure of the EU banking sector. Chaired by Erkki Liikanen. FINAL REPORT. 2.10.2012. Executive summary.
[238] *Avgouleas – Goodhart* 2016, page 57.
[239] *Bernard – Capponi – Stiglitz* 2017.
[240] *Avgouleas – Goodhart* 2016, page 57.
[241] Ibid, page 69.
[242] EC – Press release. State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena. http://europa.eu/rapid/press-release_IP-17-1905_en.htm . 2017. (Last accessed 13.2.2018).

average depositors would have to bear are also greatly diminished by deposit guarantee schemes. *Brunnermeier – James – Landau* have moreover suggested solving the issue of mis-selling by means of consumer protection[243] rather than circumventing bail-in.

Triggering bail-in could potentially have a destabilising effect on other financial institutions and the financial stability as a whole.[244] A bail-in might reinforce pro-cyclicality. The bank undergoing the process can become weaker as a result and weakness will make raising funding on the market more expensive to the bank and so possibly further deteriorate its economic position and reduce chances of restoring the viability of the bank. Bail-outs too have a tendency of reinforcing the toxic link, the so-called "doom-loop", between weak banks and weak sovereigns. This is because direct recapitalisations from State budget funds increase budget deficit.[245] The pro-cyclical doom-loop may be demonstrated as follows:

Graph 1. Demonstration of the doom-loop[246].

[243] *Brunnermeier – James – Landau* 2016, page 202.
[244] Opinion of the EBA of 3 March 2011 on the Commission's Services consultation 'Technical Details of a Possible EU Framework for Bank Recovery and Resolution', page 11.
[245] *Avgouleas – Goodhart* 2016, pages 72-73. See also *Hinarejos* 2015, page 24. The *transmission of sovereign risks onto banks*, according to *Galliani – Zedda*, happens mainly through four channels: 1) a fall in the value of the government bonds held by banks, decreasing the value of banks' sovereign bond portfolios; 2) an increase in banks' funding costs as a deterioration of a home sovereign's creditworthiness reduces the value of the collateral that banks can use for wholesale funding and to obtain liquidity from the central bank; 3) erosion of the potential for public support as the financial backstop of the sovereign is weakened as rising funding costs for banks increase the magnitude and likelihood of public interventions; and 4) sovereign downgrades generally cause lower ratings for domestic banks, increasing their wholesale funding costs. See *Galliani – Zedda* 2015, pages 601-602.
[246] EC – Fact Sheet. Updated version of first memo published on 15/04/2014 - Banking Union: restoring financial stability in the Eurozone. http://europa.eu/rapid/press-release_MEMO-15-6164_en.htm?locale=en . 2015. (Last accessed 21.2.2018).

To meet the objective of reducing moral hazard in bank restructuring, the bail-in tool is superior to a bail-out, for a bail-in requires risks to be borne by those individuals who have taken the risk. The imposition of bail-in is an ex ante means of legislation to not grant State aid to a failing institution. Moral hazard can only be eliminated where no State aid is granted. Ordoliberal influence is very much visible in the enactment of the bail-in provisions in the BRRD, as the school of thought takes a highly negative stance towards the generation of moral hazard. In opinions which are more favourable towards bail-outs it has been argued that bail-in now is merely “in fashion” rather than truly an optimal means of addressing financial crisis situations.

A bail-in might leave a bank weaker than a bail-out, compromising both the bank’s viability and subsequently financial stability. Since the main objective of restructuring is to restore long-term viability, triggering a bail-in should not threaten the viability of the institution under restructuring. Therefore, if it is determined that an institution will be kept going-concern, the long-term viability of the institution should be ensured when imposing structural measures. Then again, it must be borne in mind that extensive structural measures imposed via means of State aid policy are capable of compromising the viability of the aid beneficiary as well. What sets the imposition of the structural measures enacted in the BRRD apart from those imposed by State aid policy, is that in accordance with the BRRD, restructuring occurs on the basis of an ex ante regulatory framework which imposes equal per se rules on each market player; the BRRD creates the basis of a level playing field ex ante, where State aid policy would restore the level playing field ex post via ad hoc measures.

As it has previously been argued, the ex post restoration of a level playing field can overtly be based on non-economic fairness considerations which can lead to the imposition of structural measures beyond those necessary in order to restore the long-term viability of the aid beneficiary. As the rules enacted in the BRRD are equal for all, the level playing field is already in place and does not need to be restored whereby no need for compensatory measures exists in restructuring. Structural measures imposed by the BRRD are therefore more purely necessary solely in order to restore long-term viability than structural measures in State aid policy. Concluding, where the imposition of a bail-in pursuant to the BRRD can leave a bank weak, so can the imposition of compensatory measures via State aid policy as well. At least the rules provided in the

BRRD are the same for all, therefore having more grounds for justification than ad hoc compensatory measures. Equal ex ante rules are free from punitive elements. A bail-out should however be the preferred option where regulatory ex ante compliance (bail-in) would weaken a bank's position of viability in a manner which would also threaten financial stability.

The benefits of a bail-out include speed; the need to address a shock can even occur overnight and the quick provision of a public bail-out may help to reduce the effects.[247] The exhaustion of private capital raising measures is a time-consuming process compared to the direct provision of public support. How tax-payers could also in the end profit from the provision of public support is through "tough repayment" conditions on the aid arrangement. However, this is only true where sufficiently tough conditions are indeed put in place and where the aided institution truly is viable enough to eventually repay.[248] Additionally, appropriate remuneration plans could also be agreed where State aid is granted only to cover any residual capital shortfalls after the imposition of bail-in and the exhaustion of private capital raising measures. As added consumer welfare can only be guaranteed where a correct estimation of the aid beneficiary's long-term viability is made and the beneficiary "pays back" so to speak, this "investment" of tax-payer money is a gamble; should the aid beneficiary turn out unviable, the money will be lost, generating moral hazard. The imposition of a regulatory bail-in will remove the gamble either completely or partly depending on whether public funds are required to cover residual capital shortfalls.

In times of crisis, even solvent institutions may face liquidity problems. Liquidity issues which do not result from operating an unsustainable business model – for example over-reliance on short-term funding – should not evolve into solvency problems. Solvent, viable institutions built on sustainable business models must be prevented from going insolvent because of market failures. The appropriate means of addressing such short-term liquidity problems may however be State guarantees rather than bail-outs which are recapitalisation measures. Recapitalisation measures are more appropriate to address

[247] However, especially since several reforms have now been made in order to detect systemic risks in advance and to have adequate capital buffers in place in order to address any sudden shocks, having in place such monitoring and capital planning processes should reduce the possibility of a completely unforeseen external shock having a wide-scale negative effect.

[248] Unviable institutions will likely not repay nor do they have the capacity to bear "tough" repayment conditions. See *Dewatripont* 2014, pages 37–43.

solvency issues. Direct access to State aid may be more justified for liquidity reasons rather than solvency reasons, as in the case of securing liquidity in the markets quick actions can provide for quick positive results. Solvency issues on the other hand take a longer time to solve and positive results are less certain – why not then impose a bail-in instead of approving a bail-out?

4.2 The 2013 Banking Communication burden-sharing requirements vs the BRRD bail-in requirements

4.2.1 Own contribution, the concept of burden-sharing and the 2013 Banking Communication

As one of the key principles of a free market economy is that owners and creditors should bear the losses of a failed venture, if it then would turn out not to be possible to bear the losses, it is justifiable to at least bear part of them – to contribute. Therefore, in order to limit aid to the minimum necessary, an appropriate own contribution to restructuring costs provided by the aid beneficiary is required. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources.[249] If this principle is complied with, a bail-out does not come completely free of bail-in either.

On top of this well-established principle of own contribution in R&R aid the concept of "burden-sharing" was developed in the Crisis Communications. According to the 2013 Banking Communication, State support should only be granted on terms which represent an adequate burden-sharing by those who have invested in the bank.[250] This concept involves two elements in particular: first, a contribution by shareholders and hybrid capital holders and secondly, ensuring the aid is adequately remunerated by the beneficiary.[251] The requirements for burden-sharing were gradually made stricter as new Crisis Communications were issued. Communications are however not legally binding, only providing guidelines for which kinds of measures are likely considered to be compatible with the internal market. Deviations from the patterns recommended in

[249] Restructuring Communication, point 22.
[250] 2013 Banking Communication, points 15 and 40.
[251] *Pesaresi – Mamdani* EStAL 4/2012, page 768.

communications can be considered compatible with primary law.[252] Therefore the adoption of the BRRD set first legally binding rules of burden-sharing in banking restructuring. Furthermore, the BRRD has set minimum requirements for burden-sharing based on fixed numerical benchmarks whereas the 2013 Banking Communication only requires for “adequate” burden-sharing. Finally, whereas the 2013 Banking Communication only requires the bail-in of subordinated debt holders, the BRRD requires even the bail-in of senior debt holders.

The 2013 Banking Communication requires the exhaustion of bank internal and private capital raising measures to the extent possible without endangering viability before conversion or write-down of debt becomes *mandatory* to cover losses. It must be noted that *voluntary* conversion of subordinated debt into equity is actually one of the private capital raising measures suggested in the 2013 Banking Communication. If all of the identified capital shortfall cannot be covered with private capital raising measures, it is stated in point 41 of the 2013 Banking Communication that “[a]dequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders.” After shareholders and subordinated debt holders have been bailed in, no contribution from senior debt holders is required.

The 2013 Banking Communication envisages two scenarios for burden-sharing to cover an identified capital shortfall in points 43 and 44 of the 2013 Banking Communication: a) the capital ratio of the bank with an identified capital shortfall remains above the EU regulatory minimum; or, b) the bank no longer even meets minimum regulatory capital requirements. In the first scenario, the Commission entails that the bank should normally be able to restore its capital position *on its own* – seemingly including shareholders – and through the exhaustion of private capital raising measures.[253] However, if there are no other possibilities (including any other supervisory action such as early intervention measures or other remedial actions), then subordinated debt must be converted into equity before State aid is granted. The write down of debt is not yet

[252] C-526/14 (Kotnik), points 37-41.
[253] Capital raising measures listed in point 35 of the 2013 Banking Communication: (a) rights issues; (b) voluntary conversion of subordinated debt instruments into equity on the basis of a risk-related incentive; (c) liability management exercises which should in principle be 100 % capital generating if the capital shortfall cannot be overcome in full and therefore State aid is required; (d) capital-generating sales of assets and portfolios; (e) securitisation of portfolios in order to generate capital from non-core activities; (f) earnings retention; (g) other measures reducing capital needs.

contemplated in this first scenario[254], only conversion into equity. In the second scenario on the other hand, subordinated debt must be converted or written down before State aid is granted. The Commission requires in this scenario that State aid must not be granted before equity, hybrid capital and subordinated debt have fully contributed to offset any losses.[255] The definition of "fully contributed" here is not tied to any ratio or quantitatively measurable minimum requirement.

4.2.2 Article 59(3) of the BRRD: write down or conversion power of relevant capital instruments

The power to write down or convert relevant capital instruments may be exercised either: (a) independently of resolution action; or (b) in combination with a resolution action, where the conditions for resolution are met.[256] Member States shall require that resolution authorities exercise the write down or conversion power without delay in relation to *relevant capital instruments,* meaning Additional Tier 1 instruments and Tier 2 instruments[257], when one or more of the following circumstances apply:

(i) where the determination has been made that *conditions for resolution specified in Articles 32 and 33 of the BRRD have been met*, before any resolution action is taken;
(ii) the appropriate authority determines that *unless that power is exercised* in relation to the relevant capital instruments, *the institution or the entity will no longer be viable*[258];
(iii) *extraordinary public financial support is required* by the institution or the entity except in any of the circumstances set out in point (d)(iii) of Article 32(4) of the BRRD.[259]

According to an unofficial statement from the Commission DG of Financial Stability, Financial Services and Capital Markets Union there is no automatic trigger for exercising write down or conversion powers. Exercising of the powers is to be determined by the designated authority.[260] Leaving room for discretion in whether to

[254] *Micossi* 2014.
[255] 2013 Banking Communication, points 43-44.
[256] Article 59(1) of the BRRD.
[257] Article 2(1)(74) of the BRRD.
[258] This means two conditions are met: 1) the institution or the entity is failing or likely to fail; and 2) having regard to timing and other relevant circumstances, there is no reasonable prospect that any action, including alternative private sector measures or supervisory action (including early intervention measures), other than the write down or conversion of capital instruments, independently or in combination with a resolution action, would prevent the failure of the institution or the entity within a reasonable timeframe. See Article 59(4) of the BRRD.
[259] Article 59(3) of the BRRD, sub-paragraphs a, b and e. In sub-paragraphs c and d there are circumstances applicable to subsidiaries and parent undertakings – so to banking groups – enacted. The measures of exercising the write down and conversion power have been defined in sub-paragraphs e-i of Article 63(1) of the BRRD.
[260] *EBA*: Single Rulebook Q&A: Question ID 2016_2955.

exercise these powers in my opinion goes against the wording of "Member States 'shall' require that resolution authorities exercise". The wording would have to be interpreted to mean at least that there should not be room for more than very narrow exceptions from the requirement of write down or conversion when relevant circumstances apply.

The Basel III requirements amount to "more and better capital". *Dewatripont* holds that the requirement of "better" capital means focusing on equity as the "key source of acceptable capital", since "other sources accepted in Basel I or II, like convertible instruments or junior debt, proved less 'risk-absorbing' in the crisis"[261]. As equity has proved as the instrument with the best risk-absorbing capability, it is appropriate to require that the write or conversion powers with regard to relevant *capital* instruments pursuant to Article 59 of the BRRD should be exercised prior to the write down or conversion of *liabilities*, stipulated in Article 44 of the BRRD.

The write down or conversion power is exercised in accordance with the priority of claims under normal insolvency proceedings, meaning first on shareholders and then creditors in order of seniority. According to point 41 of the 2013 Banking Communication, contributions in order to reduce a capital shortfall can take the form of either a conversion into CET1 or a write down of the principal of the instruments, whereas according to Article 60(1) of the BRRD, contributions should result in the following:

(a) CET1 items are reduced first in proportion to the losses and to the extent of their capacity and the resolution authority takes one or both of the actions specified in Article 47(1) in respect of holders of CET1 instruments;
(b) the principal amount of Additional Tier 1 instruments is written down or converted into CET1 instruments or both, to the extent required to achieve the resolution objectives set out in Article 31 or to the extent of the capacity of the relevant capital instruments, whichever is lower;
(c) the principal amount of Tier 2 instruments is written down or converted into CET1 instruments or both, to the extent required to achieve the resolution objectives set out in Article 31 or to the extent of the capacity of the relevant capital instruments, whichever is lower.

Point 41 of the 2013 Banking Communication requires additionally that "[i]n any case, cash outflows from the beneficiary to the holders of such securities must be prevented to the extent legally possible". This open wording is not in conflict with the results required in Article 60(1) of the BRRD, whereby under the conditions of the 2013 Banking Communication, similar results with Article 60 of the BRRD could be

[261] *Dewatripont* 2014, page 39.

imposed. Concluding, the major restrictive difference in the potential scopes of application of bail-in between the 2013 Banking Communication and Articles 59 and 60 of the BRRD is only that pursuant to the BRRD, senior debt holders may be affected whereas the 2013 Banking Communication leaves senior debt holders intact. This difference in scope can increase the attractiveness of applying loopholes in order to spare senior creditors.

4.2.3 Article 44 of the BRRD: scope and application of the bail-in tool

Write-down or conversion of relevant capital instruments pursuant to Article 59 may be required by the designated authority even if resolution is not triggered, and prior to or together with the application of a resolution tool. The bail-in tool is one of the resolution tools[262] enacted in the BRRD. The bail-in resolution tool enacted in Article 44 of the BRRD enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity[263]. Application of the bail-in resolution tool is not mandatory in case of resolution; resolution authorities may apply the resolution tools individually or in any combination except for the asset separation tool which may only be applied together with another resolution tool. When applying the resolution tools, resolution authorities shall have regard to the resolution objectives, and choose the tools and powers that best achieve the objectives that are relevant in the circumstances of the case.[264] Arguably the bail-in tool is the most appropriate resolution tool to be used where an institution must specifically be recapitalised. This is because the bail-in tool is designed to raise capital, whereas the other resolution tools aim for example at cutting cost structure via mergers, or at improving asset quality via asset management.

The bail-in tool applies to *eligible liabilities*, meaning instruments that do not qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments and which are not

[262] As listed in Article 37 of the BRRD, the other resolution tools are:
– the sale of (or part of a) business;
– establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity); and
– asset separation (the transfer of impaired assets to an asset management vehicle). See Council of the European Union Press release: Council agrees position on bank resolution. http://europa.eu/rapid/press-release_PRES-13-270_en.htm . 2013. (Last accessed 14.2.2018.)
[263] EC – Press release: EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions. http://europa.eu/rapid/press-release_MEMO-14-297_en.htm . 2014. (Last accessed 14.2.2018.)
[264] Articles 37(4)-(5) and 31(1) BRRD.

excluded explicitly from the scope of the bail-in tool by virtue of Article 44(2)[265]. The write-down or conversion power exercised pursuant to Article 59 does not allow exemptions over instruments from its scope of application, whereas the bail-in resolution tool leaves an option to exempt certain liabilities by discretion as well.[266] Regardless of such discretionary exclusion under BRRD Article 44(3) from the scope of the bail-in tool, institutions are required to hold sufficient eligible liabilities that can be bailed-in. This minimum requirement for own funds and eligible liabilities (MREL) to be held by an institution applies even if the bail-in tool is never applied, meaning the MREL funds would never be bailed-in.[267]

The objectives which the bail-in tool is available for to resolution authorities are for example to ensure the continuity of banks' critical functions, to avoid adverse effects on financial stability, to protect public funds by minimising reliance on extraordinary public financial support to failing institutions and to protect covered depositors, investors, client funds and client assets.[268] If the bail-in tool is used specifically to recapitalise an institution to restore its ability to comply with the conditions for authorisation[269], it is required that in addition to the specific resolution objectives enacted in Article 31 of the BRRD, *there to be a reasonable prospect that the institution's financial soundness and long-term viability can be restored*[270]. Meanwhile, any part of the bank that cannot be made viable again goes through normal insolvency proceedings.[271]

As stated, *in exceptional circumstances*, certain liabilities may by discretionary exemption be excluded or partially excluded from the application of the bail-in tool. This exclusion may take place for example where the exclusion is "strictly necessary

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[265] Article 2(1)(71) of the BRRD. According to Article 44(2), explicitly excluded liabilities, as a summary, include covered deposits, covered bonds, client assets, liabilities arising by virtue of a fiduciary relationship, liabilities with an original or remaining maturity of less than seven days, liabilities of a social nature and deposit guarantee schemes.

[266] *EBA*: Single Rulebook Q&A: Question ID 2016_2956.

[267] Article 45 of the BRRD. The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution.

[268] Recital (45) of the BRRD.

[269] Article 43(2)(a) of the BRRD.

[270] Article 43(3) of the BRRD. Restoring the viability of the institution should be achieved by the application of the bail-in tool together *with other relevant measures including measures implemented in accordance with the business reorganisation plan required by Article 52*.

[271] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/bank-recovery-and-resolution_en . (Last accessed 21.2.2018.)

and proportionate *to avoid giving rise to widespread contagion*[272], in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, *in a manner that could cause a serious disturbance to the economy of a Member State or of the Union"*[273]. It has been proven that assets which give rise to contagion are especially those which are considered to be *interbank exposures,* rather than deposits held by natural persons or SMEs. Banks which are not very active in the interbank markets are less likely to cause contagion. Therefore, if the exemption right from the scope of the bail-in tool is exercised, it would be beneficial to exempt assets which can be considered to pose interbank exposures and the write-down or conversion of which would most likely cause contagion by in practice defaulting on a counterparty.[274] Exemption of such interbank liabilities therefore makes sense in practice. However, exempting interbank liabilities could again leave as eligible liabilities instruments held exclusively by natural persons, micro-enterprises and SMEs, which goes against the purpose of the aforementioned exemption clause. Consistent exemption of interbank liabilities from the scope of the bail-in tool would furthermore not help solve the interconnectedness problem of banks. Moreover, forcing bail-in on "average" customers can give rise exactly to the problem of shifting liability from tax-payers to another undeserving set of individuals as described in a previous chapter.

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[272] According to recital (83) of the BRRD, resolution authorities should be able to apply the bail-in tool only partially where an assessment of the potential impact on the stability of the financial system in the Member States concerned and in the rest of the Union demonstrates that its full application would be contrary to the overall public interests of the Member State or the Union as a whole.

[273] This is sub-paragraph 3(c) of Article 44 of the BRRD. The other exceptional circumstances are: (a) it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority; (b) the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions; and (d) the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in. Exclusions may be applied either to completely exclude a liability from write down or to limit the extent of the write down applied to that liability. When exercising these discretions, resolution authorities shall give due consideration to: (a) the principle that losses should be borne first by shareholders and next, in general, by creditors of the institution under resolution in order of preference; (b) the level of loss absorbing capacity that would remain in the institution under resolution if the liability or class of liabilities were excluded; and (c) the need to maintain adequate resources for resolution financing

[274] *Zedda – Cannas – Galliani – De Lisa* 2012. See also *Drehmann – Tarashev* 2013, page 587. *Drehmann – Tarashev* conclude on the basis of their empirical analysis that "interconnectedness is a key driver of banks' systemic importance". They state that "interbank linkages raise materially the measured level of system-wide risk and, by extension, the portions of this risk allocated to individual banks". "Thus, systemic importance rises in the presence of an interbank market, with the rise being greater for banks with greater interbank market activity."

According to the objectives of resolution set in Article 32 of the BRRD, a resolution action can be taken only if the bank has been assessed as failing or likely to fail, no alternative private or supervisory intervention measures would prevent failure, and resolution is necessary in the public interest. Thus, to proceed with a bail-in, a supervisory authority should compare its consequences with other possible interventions, such as liquidation, private intervention and public bail-out.[275] An effective implementation of the bail-in tool requires clearly identifying its limits. This, in turn, according to *Navaretti – Calzolari – Pozzolo,* implies defining transparent and credible triggers for activating “mutualised fiscal backstops and interventions with public funds when bank runs and systemic crisis are likely”[276].

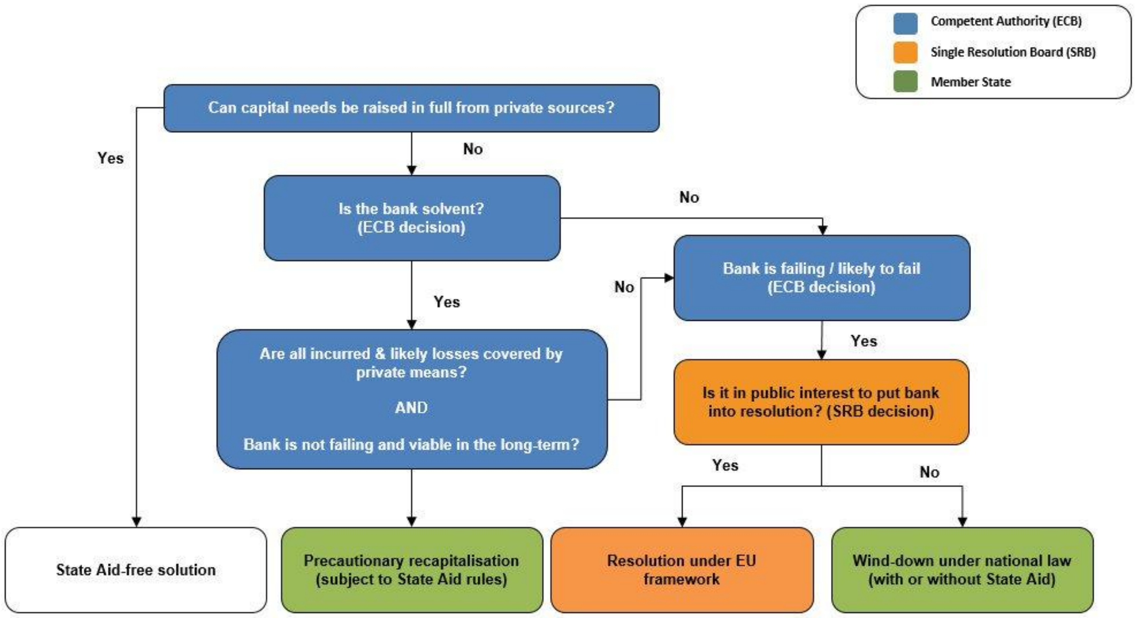
Where a resolution authority decides to exclude an eligible liability, and the losses that would have been borne by those liabilities have not been passed on fully to other creditors, a resolution financing arrangement may make a contribution. The resolution financing arrangement, e.g. a resolution fund, may make a contribution only where *a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of the total liabilities including own funds of the institution, measured at the time of resolution action, has been made* by the shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise.[277]

Resolution financing arrangements such as national resolution funds should absorb losses only in exceptional circumstances. The main use of the resolution funds should be limited to, for example, providing loans to a bridge institution, purchasing specific assets of an institution under resolution, or to guarantee certain assets or liabilities of the institution under resolution. Therefore, where the 8% benchmark of total liabilities has

[275] *Paolo – Parisi* 2017.
[276] *Navaretti – Calzolari – Pozzolo* 2016: “A fully safe banking system will always require the backing of taxpayer money. Pretending that taxpayer money shall never be used is not the most effective way of making its use least likely. Fairness by itself can strengthen, but not fully restore safety. An effective bail-in regime requires that the option of bailout is not ruled out by assumption, but that it is made clear when and under what circumstances it may be credibly activated.”
[277] The resolution financing arrangement may alternatively make a contribution where: 1) the contribution to loss absorption and recapitalisation is equal to an amount not less than 20 % of the RWA of the institution concerned; 2) the resolution financing arrangement of the Member State concerned has at its disposal, by way of ex ante contributions (not including contributions to a deposit guarantee scheme) raised an amount which is at least equal to 3 % of covered deposits of all the credit institutions authorised in the territory of that Member State; and that 3) the institution concerned has assets below € 900 billion on a consolidated basis. It is left unclear whether the wording of “on a consolidated basis” restricts the application of this derogation only to banking groups.

been reached, bail-in of shareholders and unsecured creditors should still ideally continue further. The bail-in could be discontinued after reaching the benchmark only in exceptional circumstances and where strictly necessary for financial stability.[278] The contribution of the resolution financing arrangement cannot exceed 5% of the total liabilities including own funds of the institution. In principle, after the use of the resolution fund up to the 5% cap, the bail-in should continue again as well.[279] In extraordinary circumstances anyhow, when the 5% cap has been reached, resolution authorities may seek further funding from alternative financing sources, such as the ESM's direct bank recapitalisation instrument in the case of euro area Member States.[280] This is possible only after all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full.[281]

The provision of State aid in the BRRD can be presented in a graph as follows:



Graph 2. Channels of access to extraordinary public financial support in the BRRD framework[282].

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278 EC – Press release: EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions. http://europa.eu/rapid/press-release_MEMO-14-297_en.htm . 2014. (Last accessed 14.2.2018.)
279 *EBA*: Single Rulebook Q&A: Question ID 2015_2172.
280 Several qualitative criteria apply in order to be eligible for direct recapitalisation via the ESM. With regard to the beneficiary institution, it should have systemic relevance or pose a *serious* threat to the financial stability of the euro area as a whole or of the requesting ESM Member. With regard to the requesting Member, it should be unable to provide financial assistance to the institutions in full without *very adverse* effects on its own fiscal sustainability. Furthermore, providing financial assistance to the benefit of the requesting Member should be *indispensable to safeguard financial stability* of the euro area as a whole or of its Member States. See ESM Guideline on Financial Assistance for the Direct Recapitalisation of Institutions, Articles 3 and 8.
281 Article 44(7) of the BRRD. See also ESM Guideline on Financial Assistance for the Direct Recapitalisation of Institutions, Article 8.
282 https://twitter.com/EuroBanks/status/880094345336156162 . 2017. (Last accessed 21.2.2018.)

With regard to the SAAP balancing test, should the write-down and conversion powers be used and/or the resolution tools exhausted in full prior to the granting of State aid, it may well be assumed that State aid indeed is the appropriate measure of addressing any remaining capital shortfall. This is because the exhaustion of the relevant measures available in the BRRD in order to absorb losses minimises chances of resorting to State aid and therefore should ensure State aid indeed is the last available option to cover any residual capital shortfall. State aid can also be argued to be a proportional measure because the exhaustion of the relevant ex ante measures enacted in the BRRD should result in limiting the amount of aid to what is strictly necessary in order to cover any residual capital shortfall. Moreover, as it may be assumed that State aid is at this point in time the only measure left available in order to cover the capital shortfall, it can reasonably be expected that the aid measure will provide the incentive of attaining the defined common objective of maintaining financial stability. Therefore the positive and negative effects of the aid only need to be weighed. The negative effects will of course greatly have been diminished due to the thorough exhaustion of relevant requirements set in the BRRD.

4.3 Precautionary recapitalisation: BRRD Article 32(4)(d)(iii)

4.3.1 Conditions for resolution

According to the FSB Key Attributes, resolution should be initiated when a firm is *no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so*[283]. FSB here refers to resolution as meaning a process where the troubled institution shall be wound down. However, if the institution instead will be kept going-concern, and the bail-in tool enacted in Article 44 of the BRRD is used to recapitalise the institution as part of the going-concern resolution process, it is required that in addition to achieving the resolution objectives set out in Article 31 of the BRRD, there to be *a reasonable prospect that the institution's financial soundness and long-term viability can be restored*.

[283] FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, pages 6-7: "There should be clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution."

The determination whether an institution will be viable in the long-term is therefore key in order to make the correct decision whether to keep an institution going-concern or not. In a working document of the DG Internal Market and Services for a possible EU resolution framework from 2011, it was stated that "[m]easures that maintain the entity as a going-concern – such as the power to write down debt or convert it to equity – should be a last resort, and only used in justified cases". In the working document it is emphasised that where an institution is close to failure, it should primarily be wound down according to national insolvency proceedings. If this is not possible due to reasons of public interest, the distressed institution should be wound down in a resolution process. Only where even this is not possible due to reasons of public interest should the distressed institution be kept going-concern subject to a resolution process.[284] Such a clear order of priority in resolution processes between gone-concern and going-concern is not visible in the BRRD.

There should be timely entry into resolution before a financial institution is balance-sheet insolvent and before all equity has been fully wiped out.[285] According to Article 32(1) of the BRRD, the following cumulative conditions must be met in order to take resolution action:

a) the institution is *failing or likely to fail*;
b) having regard to timing and other relevant circumstances, *there is no reasonable prospect that any alternative private sector measures or supervisory action*, including early intervention measures or the write down or conversion of relevant capital instruments, *would prevent the failure of the institution within a reasonable timeframe*;
c) resolution action is *necessary in the public interest*.[286]

An institution shall be deemed failing or likely to fail in one or more of the following circumstances enacted in Article 32(4) of the BRRD:

[284] DG Internal Market and Services WORKING DOCUMENT. TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 2011, pages 8-10. An excellent graph of the priority order of national insolvency proceedings and gone-concern and going-concern resolution processes is included in the working document.
[285] Recital (41) of the BRRD.
[286] These are so-called "soft triggers", leaving room for discretion whether resolution action should be taken, as opposed to "hard triggers". The benefit of hard triggers would be to bring transparency to the resolution framework by making it known ex-ante to all stakeholders when a possible public intervention might be prompted. "This would leave less room for disputes about the necessity of a resolution and thus it would be more difficult for stakeholders (i.e. shareholders) to block or hinder the resolution. It would also reduce scope for divergence in the single market across resolution authorities' practices. On the other hand, hard triggers have a number of disadvantages. They could provide opportunities for regulatory arbitrage on the part of banks. Hard triggers might also reduce supervisors' incentives to maintain comprehensive oversight of financial institutions. Moreover, it is difficult to identify single indicators to detect every possible problem that could cause the failure of banks." See SWD(2012) 167 final, point 4.3.1.

a) *the institution infringes* or there are objective elements to support a determination that the institution will, in the near future, infringe the *requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority* including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds[287];
b) *the assets of the institution are* or there are objective elements to support a determination that the assets of the institution will, in the near future, be *less than its liabilities*;
c) *the institution is* or there are objective elements to support a determination that the institution will, in the near future, be *unable to pay its debts or other liabilities as they fall due*;
d) *extraordinary public financial support is required*, unless certain exceptional conditions are met.

Pursuant to Article 59(4) of the BRRD, an institution is deemed *no longer viable* where two conditions are met: 1) the institution or the entity is failing or likely to fail; and 2) having regard to timing and other relevant circumstances, there is no reasonable prospect that any action, other than the write down or conversion of capital instruments, independently or in combination with a resolution action, would prevent the failure of the institution or the entity within a reasonable timeframe. Pursuant to Article 32(1) of the BRRD, resolution action may be taken where 1) an institution is determined failing or likely to fail; 2) not even exercising write down or conversion power would prevent the failure of the institution; and 3) action is necessary in the public interest. Concluding, where conditions 1) and 2) of Article 32(1) BRRD would be met, an institution would have to be deemed no longer viable under Article 59(4). This is because the state described under condition 2) of Article 32(1) is more severe than the state described under condition 2) of Article 59(4) BRRD . Such a conclusion of non-viability is problematic because it was previously concluded that the determination whether an institution is viable or not is key in order to make the correct decision whether to keep the institution going-concern. Justified solely on the grounds of being necessary in the public interest, a presently unviable institution may therefore be kept going-concern.

Resolution action shall be treated as in the public interest if it is necessary for the achievement of and is proportionate to one or more of the resolution objectives set in the BRRD and winding up of the institution under normal insolvency proceedings

[287] Recital (41) of the BRRD: "*The fact that an institution does not meet the requirements for authorisation should not justify per-se the entry into resolution, especially if the institution is still or likely to still be viable.* An institution should be considered to be failing or likely to fail when it infringes or is likely in the near future to infringe the requirements for continuing authorisation".

would not meet those resolution objectives to the same extent.[288] The resolution objectives are: (a) *to ensure the continuity of critical functions*; (b) *to avoid a significant adverse effect on the financial system*, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) *to protect public funds by minimising reliance on extraordinary public financial support*; (d) *to protect depositors covered* by Directive 2014/49/EU *and investors covered* by Directive 97/9/EC; and (e) *to protect client funds and client assets.*[289] In the original proposal for the BRRD, the equivalent for objective b) read: "to avoid significant adverse effects on *financial stability*, including by preventing contagion, and maintaining market discipline"[290]. Judging on the basis of the original wording of objective b), "to avoid a significant adverse effect on the financial system" equals to avoiding significant adverse effects on financial stability. Concluding, a presently unviable institution can be kept going-concern in order to avoid significant adverse effects on financial stability. Careful consideration must therefore be put into whether viability and financial soundness truly can be restored as required from going-concern resolution where the bail-in resolution tool is used. Only after a successful resolution process would it be feasible to cover any residual capital shortfalls with State recapitalisation aid, should triggering bail-in according to Article 44 of the BRRD not raise enough capital.

4.3.2 Extraordinary public financial support and the requirements for a precautionary recapitalisation

Extraordinary public financial support in the context of the BRRD means *State aid* falling in the scope of Article 107(1) TFEU or any other public financial support at supra-national level, which, if provided for at national level, would constitute State aid, *that is provided in order to preserve or restore the viability, liquidity or solvency of an institution or entity.*[291] Only R&R aid may therefore be considered. Pursuant to Article 32(4)(d) of the BRRD, the need for extraordinary public financial support should in principle entail that an institution is failing or likely to fail. Furthermore, pursuant to Article 59(3) of the BRRD, resolution authorities should in principle exercise write down or conversion powers without delay in relation to relevant capital instruments where extraordinary public financial support is required. However, exceptionally when

[288] Article 32(5) of the BRRD.
[289] Article 31(2) of the BRRD.
[290] COM(2012) 280 final, Article 26.
[291] Article 2(1)(28) of the BRRD.

the support takes certain forms and is required in order *to remedy a serious disturbance in the economy of a Member State and preserve financial stability*, the institution may not be held failing or likely to fail, nor would write down or conversion measures be imposed on the institution. These forms of support are:

(i) a State guarantee to back liquidity facilities provided by central banks according to the central banks' conditions;
(ii) a State guarantee of newly issued liabilities; or
(iii) an injection of own funds or purchase of capital instruments at prices and on terms that *do not confer an advantage upon the institution*, where *neither the circumstances described in points (a), (b) or (c) where an institution or entity shall be deemed failing or likely to fail nor the circumstances where the exercise of the write-down or conversion power in relation to relevant capital instruments is required are present at the time the public support is granted*.

The measure described in point d(iii) is called a *precautionary recapitalisation*.

Recapitalisations by nature address solvency issues whereby the first two forms of support are rather suitable to address liquidity issues. With regard to each form of support, the measures should *be of a precautionary and temporary nature*. Precautionary in nature would logically mean the issues with either liquidity or solvency would only be potential. Support would be granted in order to reduce the probability of liquidity or solvency issues materialising.[292] The requirement of "temporary" is not well-suited for recapitalisations, because such measures cannot be withdrawn similar to guarantees. The application of this requirement is therefore left unclear. An appropriate interpretation could be to connect "temporary nature" to a complete eventual repayment of the aid granted.[293] For example, in its State aid decision SA.43365 (2015/N), the Commission held that "[t]he temporary nature of the aid is ensured by the fact that a high proportion of the aid (75%) is granted in the form of a repayable capital instrument, i.e. CoCos, as well as by the overall objective of the Greek State to exit the capital of the Bank through privatisation" and that "the commitment to complete the sale of Finansbank by […] and the commitment to use the likely resulting

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[292] As a precaution = to prepare for possible capital needs of a bank that would materialise if economic conditions were to worsen. EC – Statement: Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS). http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm . 2017. (Last accessed 21.2.2018.)

[293] In the original 2012 proposal for the BRRD, it was required that the maximum duration of measures (i) and (ii) could be three months. Prior to the adoption of the final version of a temporary nature, an interim proposal for the wording was also "strictly limited in time". See A7-0196/2013, DRAFT EUROPEAN PARLIAMENT LEGISLATIVE RESOLUTION. Measure (iii) was not included in any of the official proposals of the BRRD and so only the final wording of "temporary nature" is applicable. Analogy between measures (i)/(ii) and (iii) is not appropriate for the prior two concern liquidity problems rather than solvency problems. Solvency problems typically take a longer time to solve than liquidity problems; whereas a State guarantee could in theory be withdrawn after three months, repayment of a State recapitalisation will more likely take three years at least.

capital surplus to repay the aid further increase the likelihood that the Bank will repay the aid"[294]. Pursuant to general R&R aid compatibility assessment practice, an aid beneficiary should also be able to exit reliance on State support as soon as possible. If the requirement of "temporary nature" were to be construed in a qualitative manner, then possibly the beneficiary of a precautionary recapitalisation could be required to exit reliance on State restructuring support and so prove long-term viability is restored sooner than under "average" R&R aid conditions granted to banks.

Each form of support should furthermore be *confined to solvent institutions* and shall be *conditional on final approval under the Union State aid framework.* The measures shall be *proportionate to remedy the consequences of the serious disturbance* and shall *not be used to offset losses that the institution has incurred or is likely to incur in the near future*. Concerning exclusively the support measures under point (d)(iii), support *shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises* conducted by the European Central Bank, EBA or national authorities, where applicable, confirmed by the competent authority.[295] This is compatible with the requirement of precautionary nature, for the objective of the aforementioned exercises is to identify potential issues of the future.

As a summary, in order for a precautionary recapitalisation granted under Article 32(4)(d)(iii) of the BRRD to be compatible with the internal market, it must at first fulfill the compatibility criteria under Article 107(3) TFEU, and secondly, fulfill ten conditions[296]:

i. the aid is required "in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability";
ii. the aid measure is either an injection of own funds or purchase of capital instruments;
iii. the aid is granted "at prices and on terms that do not confer an advantage upon the institution";
iv. the aid "shall be confined to solvent institutions";
v. the aid "shall be conditional on final approval under State aid framework";

[294] C(2015) 8930 final (National Bank of Greece), recital (177).
[295] Article 32(4) of the BRRD.
[296] The Commission cannot deem a State aid measure compatible if the measure or the method of its financing, breaches intrinsically linked provisions of Union legislation . See C(2015) 8626 final (Piraeus Bank), recital (160) and C(2015) 8930 final (National Bank of Greece), recitals (158) and (169). Condition ii. has been added based on the division of conditions made by *Mesnard – Margerit – Magnus* 2017: "For instance, a transfer of assets above market prices would not per se be eligible albeit it constitutes indirectly a form of capital support."

vi. the aid "shall be of a precautionary and temporary nature";

vii. the aid "shall be proportionate to remedy a serious disturbance in the economy of the Member State";

viii. the aid "shall not be used to offset losses that the institution has incurred or is likely to incur in the near future";

ix. the aid is "limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, EBA or national authorities";

x. the circumstances referred to in point (a), (b) or (c) of Article 32(4)[297] BRRD and the circumstances referred to in Article 59(3) BRRD are not met[298].

In its decision SA.43364 (2015/N), with regard to condition i., the Commission held that the "assessment of the measures' compatibility with the internal market under Article 107(3)(b) of the Treaty has already shown that the measures are granted to remedy a serious disturbance"[299]. With regard to condition iii., in decisions SA.43364 (2015/N) and SA.43365 (2015/N) the Commission argued that: "aid measures do not confer an undue advantage to the Bank, i.e. an advantage incompatible with the internal market under State aid rules. That outcome is ensured by the compliance with the compatibility conditions for restructuring aid --, in particular the level of remuneration for the aid which is in line with the requirements under State aid rules, and the depth of the restructuring".[300] According to the Commission's State aid practice, conditions i. and iii. are integrated into the general assessment practice of aid compatibility under Article 107(3)(b) TFEU. Therefore, conditions i. and iii. do not set additional criteria for the aid measure's compatibility with the internal market.

Pursuant to condition iv., the aid beneficiary institution must be deemed solvent by the competent authority[301]. According to condition v., aid may not be granted prior to receiving approval from the Commission[302]. Conditions vi. and vii. appear to overlap with the second step of the State aid balancing test; in order to achieve a well-defined

[297] In State aid decisions C(2015) 8626 final (Piraeus Bank) and C(2017) 4690 final (MPS) the wording of the x. requirement actually states "point (a), (b) or (c) of Article 32(4)(d)" which does not make sense because sub-paragraph (d) does not include points a, b and c.

[298] Condition x. means the institution is not deemed to be failing or likely to fail due to infringing requirements for authorisation, due to its assets being less than its liabilities or due to not being able to pay its debts as they fall due and that the circumstances where the exercise of the write-down or conversion power in relation to relevant capital instruments is required are not present.

[299] C(2015) 8626 final (Piraeus Bank), recital (163).

[300] C(2015) 8626 final (Piraeus Bank), recital (164); C(2015) 8930 final (National Bank of Greece), recital (173). The Commission cited the original phrasing "do not confer an advantage" in the decisions but in its argumentation instead used the phrasing of "do not confer an *undue* advantage". See *Mesnard – Margerit – Magnus* 2017, page 2.

[301] In C(2017) 4690 final (MPS), recital (128), the Commission stated a letter from ECB was received confirming the solvency of Monte dei Paschi.

[302] C(2015) 8626 final (Piraeus Bank), recitals (163)-(173).

objective of common interest, a suggested aid measure must be appropriate, provide an incentive and be proportional for this. Conditions ii. and ix. set specific restrictions to which kinds of measures can be considered appropriate: injections of own funds or purchases of capital instruments limited to injections necessary to address capital shortfall established in a relevant stress exercise on either a national or supranational level. In order to be considered appropriate, or in other words suitable, the aid measures should also be of a precautionary and temporary nature. What exactly constitutes as "precautionary" and "temporary" is left to discretion, provided that the restrictions set in conditions ii. and ix. are complied with. The requirement of proportionality sets a discretionary limitation on the amount of aid granted. Only aid which is limited to minimum and what is strictly necessary to remedy a serious disturbance in the economy of the Member State may be deemed compliant with the principle of proportionality. Consequently, conditions vi. and vii. overlap with condition i. With regard to the balancing test, condition i. sets the objective of common interest to be attained but condition vii. brings no additional value to the assessment of State aid compatibility comparing to only using the balancing test, for the balancing test already requires aid to be proportional in order to attain the defined objective of common interest. Conditions ii., vi. and ix. however set qualitative criteria for what may be considered "appropriate" and "proportional" compared to only using the balancing test for assessment.

For condition viii., it should be demonstrated that the beneficiary bank uses other means, such as private means available at the bank, than the potential aid in order to offset losses. There should be an estimation of future losses and a demonstration of how to cover them.[303] It was also pointed out with regard to the balancing test that "Member States should also be able to demonstrate aid is not used to subsidise costs a company would in any case incur"[304]. One interpretation could be that as the aid granted under Article 32(4)(d)(iii) of the BRRD should be of a precautionary nature and cover a potential capital shortfall, the granted aid should be used in order to build stronger

[303] C(2017) 4690 final (MPS), recital (133). This conclusion has been made based on this one State aid decision only. *Véron* notes that this condition is "widely open for interpretation": "The intent of the co-legislators appears to be to refer to losses "incurred" since the end of the previous reporting period (e.g. last published audited or verified financial statements) and "likely to be incurred in the near future" before the end of the current reporting period, but this is not made explicit in the legislative text. Also, the verb "offset" is not specifically defined, even though its intended meaning appears to be that any such losses should be matched by capital-strengthening measures other than precautionary recapitalisation." See *Véron* 2017, page 6.

[304] COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 32-33.

capital buffers. For reference, in SA.43365 (2015/N), the Commission stated the following: “The aid injected into the Bank is of a precautionary and temporary nature as covering the capital shortfall identified by the ECB by raising capital *will result in the creation of prudential buffers* in the Bank. They will improve the resilience of its balance sheet and capacity to withstand *potential* adverse macroeconomic shocks”[305].

In order to demonstrate compatibility with condition ix., the relevant exercise and its result should be identified.[306] Interestingly however, in the Commission’s 2017 country report on Italy, it is stated the following: “The ‘precautionary recapitalisation’ is one exception within the Bank Resolution and Recovery Directive (BRRD) to the principle that State aid can be given to a bank only if that bank undergoes resolution (Article 32(4)(d)(iii) of the BRRD). *It involves the state injecting capital in a bank which has a capital shortfall in the adverse scenario of a stress test or asset-quality review, but which is solvent in the baseline scenario*.”[307] In the report there are qualitative criteria set with regard to the nature of the detected capital shortfall to be covered with State aid; capital shortfalls detected in baseline scenarios would not justify granting a precautionary recapitalisation. Such an interpretation is not derived from the exact wording of Article 32(4)(d)(iii) of the BRRD, which does not set any requirements with regard to the severity of scenarios. If a capital shortfall under a baseline scenario indeed is considered to restrict the use of precautionary recapitalisations, it sets an additional requirement into the list of ten conditions presented.

Article 32(4)(d)(iii) of the BRRD was among the most heavily debated Articles of the directive. The option of a precautionary recapitalisation was only added into the BRRD in the legislative process whereas the options in points (i) and (ii) of Article 32(4)(d) were already stipulated in the initial proposal published by the EC in early June 2012. The addition of the option of a precautionary recapitalisation, according to *Véron*, appears to have been motivated by two main considerations, which are distinct but partly overlap: a transitional motivation and a permanent motivation. In the transitional context, the possibility of precautionary recapitalisation can be viewed as additional flexibility to handle heterogeneous national situations during a protracted period when the vision of a level playing field under common rules is bound to remain unfulfilled.

305 C(2015) 8930 final (National Bank of Greece), recital (177).
306 C(2017) 4690 final (MPS), recital (135).
307 SWD(2017) 77 final, footnote 25.

The transition from a bail-out regime into a bail-in one is a complex and time-consuming one. The banking union (currently consisting of the euro area) remains incomplete with no common deposit guarantee scheme. At the same time, non-eurozone Member States are not governed by uniform legislation with either the banking union nor with each other as they have implemented national approaches to crisis management under the BRRD. While this transitional motivation is very much justified, *Véron* argues that in a permanent context, the option for public intervention may remain valid in particularly severe situations of financial instability.[308] This is valid as long as these situations are truly ones that could not have been foreseen in any worst case stress testing scenario and so for which an institution could not have prepared by sound capital planning. The effects of a shock for the limiting of which any precautionary measure under Article 32(4)(d) of the BRRD would be taken must come from an external source, not amplified or caused by an endogenous failure of an inefficient or unsustainable business model.

With regard to the State aid balancing test, the precautionary recapitalisation measure poses problems. The identified *objective of common interest* to be achieved here is to remedy a serious disturbance in the economy of a Member State and preserve financial stability. The threat to financial stability is assumed to be caused by the identification of a capital shortfall – even only under an adverse scenario if the considerations of the Commission's 2017 country report on Italy are valid. The *objective on an institutional level*, subject to the restriction in condition viii., would be to improve the resilience of the bank against potential stress of the future.

The first problem occurs with the identification of a market failure. Where State intervention in competition would be justified according to ordoliberal principles is if a genuine market failure is present. This would mean that the market mechanism in a self-coordinating manner is not able to bring about an optimally efficient solution in the markets. For example in the case of a credit crunch, deteriorated trust in the markets results in overtly heightened risk sensitivity, leading to a situation where investments are not made to an optimal extent. A market failure is therefore a present state rather than a potential one. As opposed to this, a capital shortfall is a purely hypothetical scenario of the future – even more so under an adverse scenario. With regard to a

[308] *Véron* 2017, pages 3-4.

genuine market failure, does a capital shortfall truly correspond to a situation where risks to financial stability *at the present moment* are heightened? A credible link must be established in order to determine whether the potential capital shortfall has the capability of affecting the surrounding economy in such a negative manner that financial stability would be considered endangered. It is only then that a serious disturbance in the economy of a Member State could be deemed to exist.

In the 2008 MoU discussed in a previous chapter concerning the definition of a serious disturbance, it is stated that: "Public intervention, in particular when public money is at risk, should only occur when there is a clear systemic risk, i.e. when there is a serious disturbance of the financial system that, as a result, *may have a major impact on the real economy*"[309]. The relevant factors discussed in the chapter by which the extent of disturbance in relation to the real economy may be assessed were stated to be: "the reduction in the financial wealth of non-financial economic agents and their restricted access to financial services". We see this is a description of the effect of a credit crunch for the real economy. In order to establish whether the financial institution at hand has "enough systemic risk potential in order to disrupt the financial system in a manner of potentially having '*serious negative consequences* for the internal market and the real economy'", the institution should somehow be connected to the maintenance of a financial system's critical components and parts. Establishing this would require an analysis of the beneficiary institution's systemic relevance in relevant product and geographical markets.

The creation of a prudential capital buffer will only address what was addressed in the MoU as the extent of disturbance of a financial system's component, here the extent of disturbance of a specific financial institution. In the MoU it was argued that the "extent of disturbance will be influenced by the presence and effectiveness of risk mitigating factors, such as capital buffers, deposit guarantees and regulation". As the institutional level objective of granting a precautionary recapitalisation is to improve the resilience of the bank against potential stress of the future, the creation of an additional capital buffer will achieve this objective and mitigate the probability of future materialization of risk. However, this is achieved with no regard paid to the context of the financial system and economy which the aided financial institution is part of. Granting a

[309] ECFIN/CEFCPE(2008)REP/53106 REV REV, page 34.

precautionary recapitalisation to an institution which is not capable of causing systemic stress is not appropriate, necessary nor proportional. The identification of a genuine market failure is crucial especially in order for the precautionary recapitalisation to be considered "good aid" under the SAM plan; aid which is *well-designed, targeted at identified market failures and objectives of common interest, and least distortive.*

Second of all, where a market failure indeed was deemed existent, there are still problems with regard to the assessment of appropriateness, necessity (incentive) and proportionality. Comparing to a situation where full debt write down or conversion is exercised or resolution tools would be exhausted, it can be questioned whether in the case of a precautionary recapitalisation, where State aid objectively is not *the option of last resort available* to cover a capital shortfall, the criteria of appropriateness, necessity (incentive) and proportionality would be fulfilled. Are there truly no other means available in order to address the identified capital shortfall which would at least to an equal extent attain the objective of preserving financial stability? After all, it was stated by *Michael Barnier*, on behalf of the Commission, that "[s]trengthening the capital base is only one of many supervisory measures that the supervisor may require or recommend a bank to take to remedy a potential capital shortfall"[310].

According to condition x., the institution in question cannot be deemed failing or likely to fail pursuant to Article 32(4). Moreover, none of the circumstances in which resolution authorities could exercise the power to write down or convert relevant capital instruments can be present. This means that the conditions for resolution cannot be fulfilled and that the institution must be considered viable to an extent where exercising the write down or conversion power would be unnecessary in order to maintain viability. If we consider the circumstances by which an institution is deemed failing or likely to fail, these circumstances essentially correlate with what could objectively be described as "solvency"; the institution cannot infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation; the assets of the institution may not be less than its liabilities and; the institution cannot be unable to pay its debts or other liabilities as they fall due. Concluding, an institution eligible for a precautionary recapitalisation is presently a firmly viable and solvent institution. A precautionary recapitalisation would therefore be granted in order to strengthen a

[310] 2014/C 312/01: E-001770/14 by *Werthmann* to the Commission. Subject: Negative consequences of stress tests.

presently viable institution's additional capital buffer with tax-payer money. While granting State aid to a *failing* institution results in moral hazard, a situation in which State aid is granted to an undertaking which is not failing is hardly justifiable either. A viable institution should be able to raise private capital from the markets in order to cover a capital shortfall. Should attempts of raising capital via private means be unsuccessful, resort to public funds should still not be possible as the institution would continue to hold sufficient regulatory capital. Under an adverse scenario especially solvency problems of the near future would be unlikely.

In order to prevent such scenarios from materialising where viable institutions become unable to raise funding from private markets, "constructive ambiguity" can prove useful with regard to containing the negative effects of publishing stress test results. Results would accordingly not be made public where an estimation would be made that the institution experiencing a capital shortfall is viable and therefore would be able to raise sufficient capital in the private markets to remedy the capital shortfall. A viable institution should not suffer deterioration of trust, possibly leading to liquidity problems through bank runs and subsequently even to solvency problems, due to hypothetical scenarios. Publishing stress tests results can leave less educated investors and depositors with a wrong impression of a bank's capital position. As with "constructive ambiguity" such artificial problems a bank may experience could be avoided, the option of granting precautionary recapitalisations could become unnecessary. Only where the problems of raising private capital are not the result of negative effects of publishing stress test results, would a precautionary recapitalisation possibly be an appropriate measure to address a capital shortfall. Raising private capital may for example be difficult due to the expectation of investors that investing in banks in general is not very lucrative; banking has in reality become less and less profitable due to increasing regulation. Still it could be argued that in order to improve the resilience of a bank against potential stress of the future, more appropriate means than public recapitalisation such as cutting down in size and capacity could achieve the same results. Most likely such structural measures would in any case be required to take in conjunction with granting State aid.

As according to condition v. for a precautionary recapitalisation, the aid measure "shall be conditional on final approval under State aid framework", it is in the end up to the Commission to decide whether a precautionary recapitalisation should be approved or not. If the Commission would deem the suggested aid measure as incompatible with the internal market and subsequently therefore deny the precautionary recapitalisation, uncertainty of consequences will arise. If the institution is not granted precautionary recapitalisation, should it have to try to raise private capital again or should the institution be subject to debt write down or conversion under Article 59(3) of the BRRD in order to maintain viability? Should the institution even be considered failing pursuant to Article 32(4)(d)? A determination of failure would be quite far-fetched as an institution has necessarily been deemed viable prior to applying for a precautionary recapitalisation. Most likely the Commission would instead ask to modify the proposed recapitalisation aid measure than to actually fully oppose to it. Where an institution would be experiencing solvency problems which would result in a determination of the institution being failing or likely to fail, the appropriate measure to be taken would be to apply the bail-in resolution tool under Article 44 of the BRRD, provided of course that it is in the public interest not to wind the institution down. In order to decrease likelihood of contagion when using the bail-in resolution tool, the appropriate measure to take would be to exempt risky liabilities from the scope of bail-in.

4.3.3 The definition of solvency

"Solvency" lacks clear definition. It is not defined in the BRRD, CRD, nor in the CRR. Solvency is required from an institution which is eligible for a precautionary recapitalisation. What evidently cannot be considered as "solvency" is insolvency, but what is the scope of either "solvency" or "insolvency" in the context of the BRRD? Provided the term "insolvency" would be construed in a narrow manner and bound by its legal definition, this would necessarily mean that any institution which has not been deemed insolvent through insolvency proceedings would still be considered solvent. Such an interpretation would bring little qualitative value to the conditions for a precautionary recapitalisation.

An apparent interpretation of solvency would be compliance with minimum regulatory capital requirements. This appears to be the stance of the Commission. For example in SA.43364 (2015/N), the Commission noted that: "*aid is confined to a solvent institution as the Bank complied with the capital requirements when the aid measures are granted*, following in particular the private capital increase and the 2015 LME, and as assessed by the competent supervisory authority."[311] Furthermore, in SA.47677 (2017/N), it was stated that: "The letter concluded that the *Bank was solvent* (at the day of sending the letter) *from the point of view of compliance with the Pillar 1 minimum capital requirements – as per Article 92 of Regulation (EU) No 575/2013 ('CRR').*"[312]

An alternative interpretation of solvency could be to mean anything that is not considered "failing or likely to fail". Any of the circumstances described under Article 32(4) of the BRRD at least could not objectively be considered as improving the economic outlook of an institution. Locking the interpretation of solvency as the opposite of failing or likely to fail would bring the boundaries of solvency closer to insolvency; in the original 2012 proposal for the BRRD, with regard to the point in time where resolution should be triggered, it was provided that "[i]n order to safeguard existing property rights, a bank *should enter into resolution at a point very close to insolvency, i.e. when it is on the verge of failure*"[313] and that "[t]he authorities shall be able to *take an action when an institution is insolvent or very close to insolvency to the extent that if no action is taken the institution will be insolvent in the near future*"[314]. In other preparatory work for the BRRD, a clear gap between insolvency and meeting minimum regulatory capital requirements was acknowledged implicitly: "The current EU financial stability framework is focused on ensuring that banks are adequately capitalised. The Capital Requirements Directive (CRD) contains provisions aimed at stabilising capital within banks, but it is not prescriptive in case the banks fail to meet the 8% minimum capital threshold. *The handling of situations when a bank does not meet the requirements of banking laws (8% CAR) but is still not insolvent is left to national legislation*."[315]

A third alternative for the definition of solvency, based on the decision SA.43364 (2015/N), would be that solvency is a stricter requirement than solely meeting regulatory capital requirements at the present moment: "The ECB noted in the report of the 2015 CA that covering the shortfalls by raising capital would then result in the *creation of prudential buffers in the four Greek banks, keeping thus an adequate level of*

311 C(2015) 8626 final (Piraeus Bank), recital (165). The same reasoning has also been implemented for the National Bank of Greece. See C(2015) 8930 final (National Bank of Greece), recital (174).
312 C(2017) 4690 final (MPS), recital (22).
313 COM(2012) 280 final, page 5.
314 Ibid, point 4.4.7: Resolution conditions, Article 27.
315 SWD(2012) 167 final, point 3.2.

solvency."[316] An "adequate level of solvency" would therefore require the bank to maintain such capital buffers that its capital position would remain on legally required minimum levels even in the case of an adverse shock. In this regard, fulfilling the condition of "solvency" at the present moment would be subject to stricter requirements than meeting *minimum* capital requirements, encompassing at least all regulatory capital requirements outside of the scope of Article 92(1) CRR. Such requirements would include maintaining additional capital buffers. Additionally this could include any capital guidance-based recommendations provided by supervisory authorities in the SREP (TSCR). In recital (41) of the BRRD, it is provided ambiguously that: "Furthermore, the provision of extraordinary public financial support should not trigger resolution where, as a precautionary measure, a Member State takes an equity stake in an institution, including an institution which is publicly owned, *which complies with its capital requirements*." Compliance with "its capital requirements" could mean anything from only minimum regulatory capital to higher institution-specific requirements set by supervisors. In the end however, the application of this definition of solvency would probably hamper the whole idea of a precautionary recapitalisation, which should lead to an increase in additional capital buffers.

Pursuant to the BRRD, the solvency of an institution is determined by the competent authority which means the relevant supervisory authority.[317] The Commission however should have exclusive competence in the field of State aid policy. This exclusive competence is in the context of any measures granted under Article 32(4)(d) of the BRRD disrupted to a certain extent by the competent authorities, for deeming a bank solvent is a precondition for a positive State aid decision. In order to solve these competence issues it would be preferable that the Commission would conduct a more extensive evaluation of solvency from its own standing point. In its recent decision SA.47677 (2017/N), the Commission took a cautious step towards such independent evaluation of solvency: "Based on the available information, there are no elements which would give rise to serious doubts as to the ECB's underlying analysis of the

[316] C(2015) 8626 (Piraeus Bank), recital (172).
[317] Since according to Article 32 of the BRRD the competent authority will decide whether an institution is failing or likely to fail, this will conversely mean also that the competent authority determines whether the institution is solvent. Article 4(1)(40) of the CRR: "competent authority means a public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned".

solvency criterion."[318] Therefore there might be prospects of the Commission even contesting evaluations made by supervisory authorities.

4.4 Point 45 of the 2013 Banking Communication: exception to the burden-sharing requirements

Under the 2013 Banking Communication, the Commission can make an exception to the burden sharing requirements set by points 43 and 44 when the implementation of conversion and/or writing down measures described in these points would *endanger financial stability* or would lead to *disproportionate results*. This exception could cover cases where the aid amount to be received is small in comparison to the bank's RWA and the capital shortfall has been reduced significantly in particular through private capital raising measures. Disproportionate results or a risk to financial stability could also be addressed by reconsidering the sequencing of measures to address the capital shortfall.[319] This would mean circumstances in which the State would not find it optimal or adequate to inject capital only after conversion or write down of debt but rather make the capital injection at the same time – meaning conversion and/or write-down and a capital injection would occur simultaneously, not consecutively.[320] *Nicolaides* provides that the application of points 43 and 44 might also lead to disproportionate results in relation to shareholders and subordinated creditors and so through the application of point 45 the extent to which they are bailed-in could be reduced if the costs they bear are excessive in relation to other creditors.[321] Creditors are still protected explicitly by the "no creditor worse off" principle adopted in point 46 of the 2013 Banking Communication[322]. The Commission would decide on the application of point 45 on a case-by-case basis.[323]

The application of the exemption in point 45 must be very narrow. Even if the exemption would be applied, it should not relieve the aid beneficiary from carrying an own contribution to the costs of restructuring in accordance with the principle of aid

[318] C(2017) 4690 final (MPS), recital (128).
[319] 2013 Banking Communication, point 45.
[320] *Lienemeyer – Kerle – Malikova* EStAL 2/2014, page 282.
[321] *Nicolaides* 2017.
[322] "[S]ubordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted."
[323] EC – Press release: EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions. http://europa.eu/rapid/press-release_MEMO-14-297_en.htm . 2014. (Last accessed 14.2.2018.)

required to be limited to the minimum. The exemption does not relieve the aid beneficiary from implementing all necessary private capital raising measures as long as viability is not endangered.[324] Equally the current board of an institution should normally be replaced and management salary caps introduced regardless of whether point 45 is applied or not.[325] This would be required by the BRRD as well[326]. The application of point 45 should therefore not reduce incentives to primarily rely on the bank's own efforts to overcome capital shortfalls.[327] As an example of disproportionate results of imposing bail-in in the 2013 Banking Communication is exactly that "the capital shortfall has been reduced significantly in particular through private capital raising measures", should a bank be unable to raise any or hardly any private capital from the markets in order to address the capital shortfall, exemption from the application of points 43 and 44 should not be considered unless the required aid amount truly is very small compared to the bank's RWA. The application of point 45 due to disproportionate results could be justified where a full bail-in has already been imposed pursuant to Article 44 of the BRRD for this should have resulted in a situation where resorting to State aid is a measure of last resort.

Whereas point 45 of the 2013 Banking Communication sheds some light on the circumstances in which the application of points 43 and 44 might lead to disproportionate results, it leaves open-ended the possibility of exemption where financial stability could be endangered. As safeguarding financial stability is the overarching objective of any crisis management regime, application of this condition in point 45 could in theory mean that when the conditions for a precautionary recapitalisation pursuant to the BRRD would be met[328] and the troubled bank would consequently avoid the imposition of the bail-in provisions set in Articles 59(3) and 44 of the BRRD, the bank could even avoid the imposition of the less strict burden-sharing requirements set by the 2013 Banking Communication and so not be subject to any level of bail-in. While safeguarding financial stability is prioritised over the protection of tax-payer money in crisis management, the application of this particular exemption would lead to extremely adverse results with regard to the generation of moral hazard. Such a scenario could hardly be accepted from the point of view of the economic

[324] 2013 Banking Communication, point 35.
[325] 2013 Banking Communication, points 37-38.
[326] 11148/1/13 REV 1, point 46.
[327] *Lienemeyer – Kerle – Malikova* EStAL 2/2014, page 282.
[328] The objective of granting a precautionary recapitalisation is equally "to remedy a serious disturbance in the economy of a Member State and *preserve financial stability*".

liability principle in ordoliberalism. So far the Commission has not approved any exception to burden-sharing on the grounds of point 45 of the 2013 Banking Communication[329], which is important for ensuring the credible enforcement of the essential principle in R&R State aid policy of aid being limited to minimum. Aid being limited to minimum is also a requirement for granting a precautionary recapitalisation under the conditions of iii., v., vi., vii. and ix. presented in a prior chapter.

It could still be questioned why the fulfillment of the fairly strict conditions for a precautionary recapitalisation does not consequently justify also the application of point 45 of the 2013 Banking Communication. This may be due to the fact that the burden-sharing requirements set by the 2013 Banking Communication are less strict and significantly less detailed than any provisions of bail-in set in the BRRD and so allow for a "softer" solution of bail-in[330]. As a result, where the need for extraordinary public financial support would exist but not to the extent which would justify the application of Articles 59(3) or 44 of the BRRD, the aid beneficiary would at least be subject to some level of bail-in. However, avoiding the imposition of bail-in could result in more extensive ex post measures in the form of structural measures and behavioural measures to be imposed on the aid beneficiary. As it has been assessed, the imposition of structural measures which exceeds what is necessary in order to restore an aid beneficiary's long-term viability can be seen to have punitive features. The nature of behavioural measures again is purely punitive as such measures restrict the aid beneficiary's ability to compete.

As it has been deemed here that solvency in the context of the BRRD is equivalent to being able to maintain capital ratios at a legally required minimum level, and solvency is one of the conditions for granting a precautionary recapitalisation, the applicable point to deem the appropriate level of bail-in in the 2013 Banking Communication would be point 43: "Where the capital ratio of the bank that has the identified capital shortfall remains above the EU regulatory minimum, the bank should normally be able to restore the capital position on its own, in particular through capital raising measures as set out in point 35. If there are no other possibilities, including any other supervisory action such as early intervention measures or other remedial actions to overcome the

[329] *Nicolaides* 2017.
[330] In particular, application of the 2013 Banking Communication requirements allows protecting senior creditors from bail-in.

shortfall as confirmed by the competent supervisory or resolution authority, then subordinated debt must be converted into equity, in principle before State aid is granted." Therefore where a bank is granted a precautionary recapitalisation, the bank "should normally be able to restore the capital position on its own"[331], meaning bail-in would only affect shareholders if private capital measures cannot cover an identified capital shortfall. Creditors would be "spared" from bail-in unless no other supervisory measures than subordinated debt conversion into equity would be available any longer.

Application of debt write down according to point 44 of the 2013 Banking Communication would only be required where a bank no longer fulfills minimum regulatory capital requirements, such as would be in the case of resolution, as it has been deemed that "failing or likely to fail" is closer to insolvency than solvency. If the bail-in tool under Article 44 of the BRRD would be applied as part of the resolution process, another bail-in under points 43 and 44 of the 2014 Banking Communication would most likely not be proportionate or even possible. Application of point 45 of the 2013 Banking Communication might therefore be appropriate and proportional. Where there would be a need for extraordinary public financial support but the bail-in resolution tool would not be applied, resolution authorities should still in principle apply the write down and conversion powers enacted in Article 59(3) of the BRRD. As the bail-in requirements under this Article are not as extensive as under Article 44 of the BRRD, it is left less clear whether the application of point 45 of the 2013 Banking Communication would be possible. However, as it was evaluated in a previous chapter, the bail-in requirements – with the exception of senior creditors – between Article 59(3) of the BRRD and points 42 and 44 of the 2013 Banking Communication overlap to a great extent. With the exception of leaving senior creditors intact, the application of points 43 and 44 of the 2013 Banking Communication could even lead to very similar results as those entailed in Article 60 of the BRRD. Therefore, where Article 59(3) of the BRRD would is to be applied, application should occur to an extent where the application of points 43 or 44 of the 2013 Banking Communication would no longer be necessary The application of the exemption in point 45 of the 2013 Banking Communication would therefore be justified.

[331] This statement of normally having the ability to raise capital from the private markets also re-enforces the requirement of not creating artificial circumstances by publishing stress test results would prevent successful private capital raising.

5 MORAL HAZARD AND FINANCIAL STABILITY

5.1 Moral hazard and distortions of competition

Moral hazard is a species of what economists refer to as asymmetric information, where one party (principal) to a financial contract has much less accurate information than the other party (agent). The dealings between the parties incentivise the agent to take action that will be to the detriment of the principal. For example a borrower has incentives to shift into projects with high risk in which the borrower does well if the project succeeds but the lender bears most of the loss if the project fails. To reduce moral hazard, lenders must impose restrictions on borrowers and monitor borrowers' activities.[332] With the implementation of bail-in, this monitoring function should be shifted onto a bank's shareholders and creditors for they have been put at risk of loss. In a bail-out scenario, the tax-payers acting as principal do not hold a similar ability to monitor the activities of the agent, the bank. In a bail-out scenario the State as principal has instead given an implicit guarantee to save an institution whose failure would endanger the stability of the financial system and the functioning of the real economy. Any incentive of taking advantage of this implicit guarantee should be eliminated in order to secure a resilient financial sector consisting of institutions built on efficient and sustainable business models. *Coppi* notes that moral hazard will only arise where aid is foreseen and expected[333].

Moral hazard is a form of dynamic inefficiency, which has the potential of manipulating market player incentives in the long-term and which can subsequently result in little or no benefit to consumers. Since any intervention to a financial crisis of acute nature would first and foremost aim to stabilise the markets in the short-term, finding the balance between safeguarding financial stability at all times and providing for a solution which would be equally durable from the point of view of moral hazard is not necessarily simple or even possible. As much emphasis as possible should be put into the ex ante measures of securing both, for in the ex post scenario both most likely cannot be secured at the same time. By ex ante measures here it is meant legislative means of building a stronger financial sector such as ensuring banks have enough

[332] *Mishkin* 2000, pages 2-3.
[333] *Coppi* 2011, page 82.

eligible liabilities to bail-in in order to absorb losses.[334] With ex post measures it is meant structural and behavioural measures by which an institution would have to be restructured because external support is already required. Ex ante legislative measures should ensure each financial institution would already be in such a "shape" where ex post restructuring would not be necessary. Ex ante measures should therefore provide for sustainable business models where ex post measures should only address exogenous effects and distress of unforeseeable magnitude.

The fact that banks which took excessive risks, i.e. became unsustainable, received State aid to absorb the resulting losses poses at least two competition problems. First, the aid might have allowed non-viable banks to stay on the market when in a level playing field market forces would have sanctioned these inefficient players and forced them to exit the market, interfering with the allocation of rents through markets.[335] Beneficiaries could increase their market share at the expense of their competitors, even if they are more efficient. In this case there may be little or no benefit to consumers for example in terms of increased output or lower prices, but rather only increased production costs being met by taxpayers. Still, such static inefficiencies could also be justified if a comprehensive evaluation of the positive and negative effects of aid would be carried out; therefore taking into consideration for example positive externalities. While ex ante legislative means should in principle suffice in order to ensure optimal allocation of resources in the markets, genuine market failures could still occur, in which case well-targeted ad hoc aid may be required. This is true however only where the aid measure would pass the balancing test. Provided the balancing test is passed, then again overtly punitive ex post structural or behavioural measures should not be imposed on the aid beneficiary.[336]

[334] The Chairman of the SRB, *Elke König*, has emphasized the importance of MREL and especially the clear definition of senior debt in that context in securing financial stability. *Brunsden*, Financial Times 8.8.2017.

[335] Draft Communication from the Commission: COMMON PRINCIPLES FOR AN ECONOMIC ASSESSMENT OF THE COMPATIBILITY OF STATE AID UNDER ARTICLE 87.3. Staff working paper, points 44 and 46. The aid may allow the inefficient undertaking to remain in the market at the expense of more efficient competitors (either by causing the exit of more efficient undertakings or by preventing their entry).

[336] Using ex ante legislative means is the most optimal solution to limit moral hazard, but using ex ante means of addressing distortions of competition should also result in the reduced need of imposing ex post structural measures and behavioural measures. As the effects of moral hazard would have been restricted already by prior means of prudential regulation, the need of addressing any distortions of competition by means of actual competition policy would be reduced. Limiting the use of the R&R aid standard toolkit of structural measures would leave the aid beneficiary bank more in a more viable and more competitive position; if for example behavioural measures were excluded, the beneficiary bank would be free to advertise and expand its business.

Secondly, aid granted to banks may have distorted incentives to compete; if the aided banks only reap the benefits of their risk-taking but do not have to carry the burden of the losses, competitors will anticipate that irrespective of their success, they will not be able to drive competitors out of the market[337]. The incentives to compete would equally be manipulated where competitors would expect to receive the same treatment as their rescued equivalents and so take on an excessive level of risk. Such dynamic inefficiencies are more difficult to address and it could even be argued that these dynamic inefficiencies affecting incentives could only be prevented if no State aid would be possible to grant at all. The application of ex ante legislative means in order to prevent resorting to public funding is therefore fundamental in order to address dynamic distortions.

How distortions of competition could be detected in the markets include the following: public intervention could risk crowding out market based operations by putting banks that do not have recourse to public funding, but seek private capital on the market, in a significantly less competitive position.[338] Banks benefiting from explicit or implicit public support can raise funds more cheaply than other banks, as investors factor in the decrease in investment risk arising from the likelihood of State support should the bank run into trouble. This support amounts to an implicit subsidy from the public sector to the banks in question, tilting the playing field to their advantage and generally limiting efficient entry and exit from the market.[339]

The first Crisis Communications distinguished between three types of distortions of competition: *ensuring fair competition between banks, ensuring fair competition between Member States and ensuring a return to normal market functioning*[340]. From a terminological point of view, the focus is evidently on fairness considerations and therefore in addressing static distortions of competition. From a conceptual point of

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[337] 2014/C 249/01 (2014 R&R guidelines), points 7-11.

[338] *De Kok* EStAL 2/2015, page 229.

[339] High-level Expert Group on reforming the structure of the EU banking sector. Chaired by Erkki Liikanen. FINAL REPORT. 2.10.2012, page 91.

[340] Recapitalisation Communication, points 8-10. According to point 10 of the Recapitalisation Communication, “ensuring a return to normal market functioning” means that “public recapitalisation, in particular its remuneration, should not have the effect of putting banks that do not have recourse to public funding, but seek additional capital on the market, in a significantly less competitive position. A public scheme which crowds out market-based operations will frustrate the return to normal market functioning”. Briefly stated this means that access to capital on the market should not be easier for a public aid recipient bank than for unsupported banks. It is fair to say that that the distinction between ensuring fair competition between banks and returning to normal market functioning is difficult to make.

view however, based on the definition in the Recapitalisation Communication, ensuring fair competition between banks also includes addressing dynamic distortions.[341]

In the end a clear divide between ensuring fair competition between banks and ensuring a return to normal market functioning proved difficult to make in practice, and so the 2013 Banking Communication only distinguishes between two types of distortions of competition: 1) competition between banks and 2) competition across and between Member States.[342] Distortions of competition between banks have been addressed comprehensively in this chapter and over the course of this research. Come to think of it, the second type of distortion of competition is actually true for any State aid measure irrespective of the beneficiary sector or type of undertaking as long as trade between Member States is affected. National interventions tend to promote focus on and favour domestic markets. The risks of a subsidy race[343] between Member States, financial protectionism and fragmentation of the internal market should be avoided.[344] This fact is the very core reasoning behind Union-level regulation of State aid; protectionism is against the fundamental EU objective of internal market integration. The appropriate means of promoting the internal market objective is through harmonising legislation across the Union; therefore creating a level playing field by ex ante means. Each market player would compete on the market based on the same set of rules. A level playing field should not be created via ex post measures unless truly economic inefficiencies occur. This is where economic analysis of State aid could help; it assesses aid measures from the point of view of total welfare rather than from the point of view of fairness, which clings onto a restrictive effect-on-rival standard. Producer welfare and customer welfare should equally be taken into account.

[341] Recapitalisation Communication, point 9: "recapitalisation schemes which are open to all banks within a Member State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles may give an undue advantage to distressed or less-performing banks compared to banks which are fundamentally sound and better-performing. *This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of European banks*".

[342] *De Kok* EStAL 2/2015, page 228. See also point 11 of the Recapitalisation Communication.

[343] *Lyons – Zhu* 2013, page 41: "regulation of state aid can limit self-defeating subsidy races in which governments each seek to protect their home firms with 'retaliatory' subsidies".

[344] *De Kok* EStAL 2/2015, pages 228-229.

5.2 Defining and assessing the legal meaning of financial stability

Safeguarding financial stability is the overarching objective in the EU crisis management framework which shall prevail over any other objective. For example *Sjöberg* states that "there is no point" in building a resolution regime if it is not successful in preserving financial stability[345]. Where a distressed financial institution is granted State aid, the overarching objective of safeguarding financial stability may conflict with the objectives of reducing moral hazard and building a crisis management regime in which any institution could be wound-down when unviable. Again, Sjöberg states that "it is not difficult to create financial stability", but the "problem is how to do it without creating moral hazard"[346]. When State aid is required in order to safeguard financial stability, this objective should in the context of the balancing test be "well-defined" and in the common interest. Does "safeguarding financial stability" as an objective fulfill these requirements[347] – in particular, should more attention be paid onto the level of stability required and what qualifies as a state of financial stability?

In a 2004 IMF Working Paper, *Schinasi* identified five key principles for defining financial stability. The first principle is that financial stability encompasses different aspects of the financial system – infrastructure, institutions, and markets. This approach was also adopted in the 2008 EU MoU on cooperation on cross-border financial stability[348]. Disturbances in any of the components can undermine overall stability, for the components are closely interlinked.[349] In *Schinasi*'s second key principle it is acknowledged that financial stability and monetary stability overlap to a great extent; while financial stability implies *resources are allocated in an efficient way*, it should also imply that *systems of payment throughout the economy function smoothly.*[350] According to the third key principle the state of financial stability requires both the absence of a crisis and the ability of the financial system to "limit, contain, and deal with the emergence of imbalances before they constitute a threat". The fourth key

345 *Sjöberg* 2014, page 194.
346 Ibid.
347 COM(2005) 107 final (SAAP) points 10 and 20 for example require that the objective of common interest is defined "clearly" and that the positive impact of aid depends on *how accurately the accepted objective of common interest has been identified*.
348 ECFIN/CEFCPE(2008)REP/53106 REV REV.
349 WP/04/187, page 6.
350 WP/04/187, pages 6 and 9. This requires that fiat (or central bank) money and derivative monies (such as demand deposits and other bank accounts) can adequately fulfill their role as universally accepted means of payment and unit of account.

principle requires that real economy is not affected. Disturbances whose effects are restricted to individual institutions or to the financial markets solely should not be considered to endanger financial stability if the disturbances cannot be expected to damage economic activity at large[351] – meaning whether the disturbances are *serious* enough to have *the capability of affecting the economy of a whole Member State*.

The fifth principle identified by *Schinasi* is that financial stability ought to be thought of as occurring along a dynamic *continuum*. *Schinasi* compares the financial system into a living organism where "some illnesses, even temporarily serious ones, allow the organism to continue to function productively and can have a cleansing effect, leading to greater health". *Schinasi* found the concept of a continuum to be relevant because finance fundamentally involves uncertainty and because the financial system is composed of interlinked and evolutionary components. Accordingly he found that financial stability is "expectations-based, dynamic, and dependent on many parts of the system working *reasonably well*".[352] *Cosmin* describes this continuum as a corridor in which financial systems operate between the opposite ends of stability and instability. Movements towards the instability end of the corridor are the result of either internal weaknesses of the financial system or external shocks.[353] In a time of financial tranquility, the movement along the continuum should be towards stability[354]. This dynamic continuum approach would have to mean that any argument stating the EU would have not yet "returned" to a state of financial stability is incorrect, for there would be no state to successfully *return to* – there would only be states of adequate tranquility and stability depending on present market conditions with "no going back" so to speak. As *Draghi* stated in 2008, "[n]o financial system will be free from crisis whatever the rules of the game"[355].

The ECB describes financial stability as a state where the build-up of systemic risk is prevented.[356] While this description seems to set a strict requirement of having to remove any possibility of contagion, the ECB gladly provides a more lenient description as well: "financial stability means the financial system can withstand shocks without

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351 Ibid, pages 6-7.
352 Ibid, pages 7 and 9.
353 *Cosmin* 2016, page 155.
354 WP/04/187, pages 7 and 9.
355 *Draghi* 2008, page 3.
356 https://www.ecb.europa.eu/pub/fsr/html/index.en.html . (Last accessed 19.2.2018.)

major disruption".[357] This is more in line with *Schinasi*'s third key principle and *Draghi*'s 2008 statement. The ECB defines "systemic risk" as "*the risk that the provision of necessary financial products and services by the financial system will be impaired to a point where economic growth and welfare may be materially affected*". Systemic risk can according to the ECB derive from three sources: an endogenous build-up of financial imbalances; large aggregate shocks hitting the economy or the financial system; or contagion effects across markets, intermediaries or infrastructures.[358]

While there seems to be no universally agreed definition of financial stability, there is still rather wide consensus over what financial stability comprises. The presented ECB view is gladly quite in line with the general opinion. The definition provided by the Commission in the 2013 Banking Communication – *the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy* – manages to catch the essential elements of the popular opinion as well. The defining factors for financial stability which seem to surface in literature are in line with at least the first, third and fourth key principle provided by Schinasi. The elements at least found here over the scope of this research which amount to financial stability are:

- market trust
- efficient allocation of resources in the markets
- financial systems' ability to withstand shocks
- low risk of contagion
- normal operation of payment systems' critical functions[359].

Financial stability should always be assessed with regard to both 1) the components of the financial system and 2) the real economy. Especially where there is no potential deterioration of customer welfare and so no effect on the real economy detected it can be difficult to argue financial stability would be endangered.

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[357] *ECB*: Spotlight on financial stability. https://www.ecb.europa.eu/explainers/tell-me-more/html/financial_stability.en.html . Updated 2016. (Last accessed 19.2.2018.)
[358] *ECB*: Financial Stability Review. November 2017. Foreword.
[359] See for example the opinions of Deutsche Bundesbank and *Duisenberg* from the ECB. WP/04/187, page 13.

Trust is the most essential element of financial stability[360]. If there is no trust, any effort to correct market failures would fail. A credit crunch for example is very much an issue of trust. The financial markets can be gravely impeded by the demise of trust. As it has been shown, the lack of trust towards financial institutions may result in bank runs which can in turn result in liquidity crises for institutions experiencing a rapid withdrawal of deposits. The fear of a liquidity crisis turning into a more severe solvency crisis will then have institutions "hoard" finance away from what could be productive investment opportunities[361] due to heightened sensitivity towards credit and default risk. This credit crunch situation will then impede the real economy – eventually causing economic growth to slow down.[362] Lack of trust is the result of the market failure of asymmetric information. The efficient allocation of resources is closely interlinked with this issue, for it means basically that the deposits banks take in are being transformed into finance for the real economy – also for counterparties. In a credit crunch situation an optimal level of finance is not reached, resulting in a deadweight loss.

Ensuring the ability to withstand shocks is quite self-explanatory and perhaps among the clearest of objectives in any post-financial crisis legislative reform. While the correction of incentives is not specifically mentioned in opinions as an element of financial stability, this requirement of ensuring the ability to absorb shocks must inevitably mean having to restrict the incentives of excessive risk-taking. Building a more robust financial system would subsequently also lower likelihood of contagion. However, restricting excessive risk-taking alone might not sufficiently lower the risk of contagion if banks remain profoundly "too-interconnected-to-fail". To ensure the continuity of critical functions is one of the resolution objectives enacted in Article 31 of the BRRD. "Critical functions" according to the BRRD mean: "activities, services or operations the discontinuance of which is likely in one or more Member States, to lead

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[360] *Finnish Competition and Consumer Authority* 2011, page 93.

[361] See for example opinions of *Mishkin* and *Padoa-Schioppa* in WP/04/187, pages 14-15.

[362] The real economy needs finance and the real economy is where innovation and economic growth will most likely rise from. These efficiency gains of safeguarding financial stability could be further detailed in State aid decisions in the future. Such a presentation might even prove to decrease moral hazard concerns more than any demonstration of structural reforms taking place in order to limit distortions of competition. In the latest issue of the Global Financial Stability Report, it is noted in the Foreword section that the primary mandate of GSIBs is "lending to the real economy". See *IMF*: Global Financial Stability Report October 2017: Is Growth at Risk? Moreover, in the Finnish language version of the 2013 Banking Communication, the translation of "financial stability" is "rahoitusvakaus" of which the direct English translation would be "finance stability" or "stability of finance". This places more emphasis on banks' role as providers of finance to the real economy than the multifold English language version of the term. From this point of view, the benefits to the real economy could and should be addressed to a greater extent in State aid decisions.

to the *disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations*"[363]. Using this definition of critical functions as a basis of a market impact analysis in order to establish a link between a disturbance and its capability of affecting the surrounding economy as a whole could actually prove very useful. A thorough analysis of all of these components of critical functions following the instructions on criticality provided in the 2008 MoU could materially improve the Commission's State aid decisional practice on Article 107(3)(b) TFEU.[364]

As it was noted in the beginning of this research, stability might not go hand in hand with maximum efficiency. *Schinasi* also recognised that in relation to financial systems, there seems to be a trade-off between financial stability and efficiency but that it is difficult to examine this for there are varying concepts for both stability and efficiency.[365] Measures to enhance financial stability often involve weighing the pursuit of an efficient allocation of financial resources against the ability to exclude or absorb shocks to the financial system. *Schinasi* also recognised that policy requirements used in order to safeguard financial stability may be *time inconsistent*, meaning that the need to secure short-term stability may impede long-term stability: "Since the use of some public policy instruments to safeguard financial stability circumvents market forces, the short-term stability gain may come at the cost of a longer-term stability loss. In particular, measures such as the provision of lender-of-last-resort finance or deposit guarantee may undermine market discipline, thereby creating moral hazard or adverse selection. This intertemporal trade-off is a fundamental issue in financial system policymaking."[366] Ordoliberal principles aim to tackle this problem of time-inconsistency by enforcing a fundamental set of constitution-like rules; these rules

[363] Article 2(1)(35) of the BRRD.
[364] Using the definition of critical functions as a basis of analysis for aid compatibility with Article 107(3)(b) TFEU would of course only work in case the aid beneficiary is a credit institution. Possibly if the Article would ever be applied to another sector than the financial sector, the critical functions analysis could possibly serve as analogy. The chances of using analogy would at least be increased compared to the current decision practice.
[365] WP/04/187, page 10.
[366] WP/04/187, page 12.

would work in order to safeguard long-term stability and prevent temptation of embarking ad hoc policy deviations in favour of quick but only short-term benefits.[367]

Coming back to *Schinasi*'s fifth key principle of financial stability being a dynamic continuum, I support this view for it not only takes into account the assessment of future events, it also places emphasis on assessing the present state of the economy without "getting stuck" in the past. By this I mean that there is no going back to exactly the state of the economy existing prior to a financial crisis. Should there be any more State aid decisions pursuant to the Crisis Communications, taking the stance of a dynamic continuum to financial stability would prevent tying the justification of aid to any past economic conditions or market failure. It should no longer be justified to state that the financial crisis which began more than ten years ago is the main driver of financial instability today. Focus on assessing the present economic conditions would create more substance in the Commission's decisional practice of Article 107(3)(b) TFEU.

While the building of a more resilient financial system should continue on, there should still come a point in time where the system would be considered resilient enough to absorb risks at that present point, depending on the present market conditions – and so allow banks to fail in those conditions – while on a higher level building resilience could still continue in order to take into account possible larger risks in the future. Concluding, in legal assessment, there should be significantly more emphasis on the assessment of the present state of the economy rather than comparison to any past state. The evalution of future developments should be on the assessment of towards which direction of the stability continuum the financial system is moving. If the direction is towards stability, the question which should be answered and wisely suggested by *Tucker* is: *what* and *how much* stability is required.[368] Answering this question would better fulfill the objectives of the SAM plan whereby "State aid control should facilitate the treatment of aid which is well-designed, targeted at identified market failures and objectives of common interest, and least distortive" and the balancing test whereby "the aid must contribute *to a well-defined objective of common interest*". The high-level

[367] *Brunnermeier – James – Landau* 2016, pages 86-88.

[368] *Tucker* 2016 : "For many, the priority was reducing the probability of the financial system collapsing. We had to avoid the hardship and economic dislocation brought about by an interruption in the supply of essential payments, credit and risk-transfer services. But for others, the focus was to reduce the incidence of credit and asset price booms that distort the allocation of resources and which can lead to an overhang of debt in the household and business sectors."

statement of “financial stability is endangered” is hardly well-defined for the purposes of the balancing test, which makes it harder to limit aid to minimum necessary in order to address the market failure of financial instability. Therefore, where the objective of common interest in the balancing test is to address a certain market failure, *the requirement of “well-defined” would not only have to include properly identifying the market failure but also identifying the extent of it.*

Most likely the definition of “financial stability is endangered” is left open deliberately in order for it to cover crisis circumstances of a wide scale. However, very high-level objectives can hardly be argued to fulfill the requirements set by the SAM plan and SAAP, which clearly emphasise the importance of a good definition. Proper definition of the objective of common interest is important in order to subsequently determine how well the chosen aid measure can attain the set objective. Pursuant to the SAAP, exactly the fact how well a said objective of common interest can be attained basically determines the extent of the aid’s positive effects. Therefore, even if the poor definition of a set objective would allow for a wider scale of crisis events to be addressed, the poor definition would eventually backfire in effects analysis; it will be more difficult to assess the positive effects of the aid because the aid is not targeted at any clear objective. Concluding, a more detailed definition might prevent the use of State aid more easily but in those circumstances in which State aid truly would be considered the most suitable measure to address the well-defined objective of common interest, the selected aid measure’s positive effects would accordingly be measured to be greater.[369]

6 CONCLUSION

6.1 Duration of the Crisis Communications

The only binding legal rules for assessing State aid compatibility are Articles 107-108 TFEU. In the field of R&R aid, the Crisis Communications are only meant to remain in force until the extraordinary market circumstances caused by the financial crisis would cease to exist. Any guidelines, such as communications, on the interpretation of the

[369] COM(2005) 107 final (SAAP), point 20: “In general, the positive impact of an aid depends on: i) how accurately the accepted objective of common interest (whether social, regional, economic or cultural) has been identified, ii) whether state aid is an appropriate instrument for dealing with the problem as opposed to other policy instruments and iii) whether the aid creates the needed incentives and is proportionate.”

primary law only bind the Commission in its assessment practice. Member States retain the right to notify aid measures which do not comply with specific guidelines to the Commission for compatibility assessment under the primary law.[370] Two questions are left open in terms of the role of extraordinary public financial support in crisis management: 1) when and under which circumstances shall the applicability of the temporary rules of interpretation set in the Crisis Communications be repealed? Secondly; 2) which rules shall become applicable following this? Ultimately of course what should be asked – in the light of the objective of eliminating moral hazard – is whether extraordinary public financial should have any role in crisis management.

In the first four Crisis communications their temporary nature was highlighted;[371] it is stated in each of these communications that any aid measure granted pursuant to the guidelines can only be justified as an emergency response to the unprecedented stress in financial markets and only as long as the exceptional circumstances prevail.[372]

In the most acute stage of the crisis, the condition of a serious disturbance was unquestionably met across the Union. However, already in the first Prolongation communication issued in 2010, the existence of a serious disturbance in the economy of all Member States was deemed no longer as self-evident as in the initial stages of the crisis. In spite of these considerations, it was stated that: “the re-emergence of tensions

[370] C-526/14 (Kotnik), points 37-41 and 43. The assessment of the compatibility of aid measures with the internal market, under Article 107(3) TFEU, falls within the exclusive competence of the Commission. In that regard, the Commission enjoys wide discretion. In the exercise of that discretion, the Commission may adopt guidelines in order to establish the criteria on the basis of which it proposes to assess the compatibility. In accordance with settled case-law, in adopting such guidelines and announcing by publishing them that they will apply to the cases to which they relate, the Commission imposes a limit on the exercise of that discretion and cannot, as a general rule, depart from those guidelines, at the risk of being found to be in breach of general principles of law, such as equal treatment or the protection of legitimate expectations. That said, the Commission cannot waive, by the adoption of guidelines, the exercise of the discretion that Article 107(3)(b) TFEU confers on it. The adoption of a communication such as the Banking Communication does not therefore relieve the Commission of its obligation to examine the specific exceptional circumstances relied on by a Member State. It follows from the foregoing, on the one hand, that the effect of the adoption of the guidelines contained in that communication is equivalent to the effect of a limitation imposed by the Commission on itself in the exercise of its discretion, so that, if a Member State notifies the Commission of proposed State aid which complies with those guidelines, the Commission must, as a general rule, authorise that proposed aid. On the other hand, the Member States retain the right to notify the Commission of proposed State aid which does not meet the criteria laid down by that communication and the Commission may authorise such proposed aid in exceptional circumstances. See also *Micossi – Bruzzone – Cassella* 2016.

[371] Despite long-running application, the Crisis Communications are still referred to as “temporary rules” on the Commission’s official website. http://ec.europa.eu/competition/state_aid/legislation/temporary.html . Last update 31.07.2013. (Last accessed 21.2.2018.)

[372] Prolongation Communication, point 2. However, only the Restructuring Communication originally had a specific date of expiration.

in sovereign debt markets forcefully illustrates the continued volatility in financial markets. *The high level of interconnectedness and interdependence within the financial sector in the Union has given rise to market concerns about contagion*. The high volatility of financial markets and the uncertainty about the economic outlook justifies maintaining, as a safety net, the possibility for Member States to argue the need to have recourse to crisis-related support measures on the basis of Article 107(3)(b) of the Treaty."[373] The initial financial crisis had developed into the sovereign debt crisis in some of the members of the EMU, affecting the growth and stability of the whole eurozone. The exacerbation of tensions in sovereign debt markets that took place in 2011, and which highlighted risks continued to persist, put the EU banking sector under increased pressure, particularly in terms of access to term funding markets.[374] In the second Prolongation Communication, the Commission stated that it "will keep the situation in the financial markets under review and *will take steps towards more permanent rules for State aid* for rescue and restructuring of banks, based on Article 107(3)(c) of the Treaty, *as soon as market conditions permit"*.[375]

In the 2013 Banking Communication, the Commission argued economic recovery had remained very fragile and uneven across the EU. The financial sectors in some Member States were still facing challenges in accessing term funding and in managing asset quality, stemming from the economic recession and public or private debt deleveraging. Risks of wider negative spill-over effects were still deemed to persist.[376] However it was equally stated that the application of the Crisis Communications remained possible only as long as the crisis situation persisted, *creating genuinely exceptional circumstances where financial stability at large would be at risk.*[377]

In addition to these growth and fragility concerns, it was argued in the 2013 Banking Communication that the reforms which would follow its issuance, such as the

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[373] Prolongation Communication, points 4-6.
[374] C(2016) 6573 final (Attica Bank), recital (26).
[375] Second Prologation Communication, points 3-4. See also *Pesaresi – Mamdani* EStAL 4/2012, page 770: "the Commission makes clear that it will take steps to introduce a more permanent, post-crisis regime as soon as market conditions permit an approach which not only supports the political commitment given by the Ecofin Council of 2 December 2009 to ensuring that extraordinary public support measures do not stay in place any longer than is strictly necessary, but also recognises the exceptional nature of the legal base and the parallel development of a regulatory framework for bank failure prevention, management and resolution".
[376] The 2013 Banking Communication follows the exact wording of the points 4-6 of the Prolongation Communication.
[377] 2013 Banking Communication, points 4-6.

enforcement of the BRRD, would still need to be "tried and tested" before the safety net of the Crisis Communications could be removed. New rules inevitably involve a degree of *phasing-in*[378], meaning there is a transitional motivation in keeping the Crisis Communications in force. The new recovery and resolution framework of course will need to prove its functioning by way of application by relevant authorities. At the same time however, the objective of the newly enacted reforms aim to build a stronger and more robust financial sector in which ideally not many institutions would fail (even though preventing the failure of institutions is not an objective of the reform, only preventing disorderly failures is), which would subsequently not allow the crisis framework to be tried and tested comprehensively.

Should it be deemed that the market conditions no longer justify the application of Article 107(3)(b) TFEU, the applicable guidelines for assessing the compatibility of aid measures under Article 107(3)(c) TFEU could be the 2004 R&R guidelines. [379] This is due to the fact that financial institutions are explicitly excluded from the scope of application of the 2014 R&R aid guidelines. The 2004 guidelines however are no longer in force, replaced by the 2014 R&R aid guidelines. While it does not seem likely that the Crisis Communications would either be repealed or updated to align with the BRRD in the near future[380], facing these circumstances of a possible legal "vacuum" if the communications indeed were repealed, new guidelines specific to the application of Article 107(3)(b) TFEU should be introduced if it were ideal to continue to have guidelines for the application of this legal basis in any other context than the 2008 financial crisis. This would improve legal certainty. If no new guidelines concerning State aid granted to the financial sector – regardless of legal basis – are introduced, compatibility assessment would happen on a purely ad hoc primary law basis, leaning on for example the general legal principle of proportionality, included in the balancing test. Even if the Crisis Communications would not be repealed, using the ad hoc approach would also be necessary where according to the assessments made in this

[378] Ibid, points 12-13.

[379] 2004/C 244/02. The 2004 R&R guidelines already allowed certain easements on conditions of rescue aid for the banking sector. See point 25, footnote 3.

[380] According to the current EU commissioner in charge of competition policy, *Margrethe Vestager*, the alignment (or updating) of the current Crisis Communications with the BRRD will not be happening any time soon. *Valdis Dombrovskis*, the EU commissioner for financial-serivices policy, has said that the state aid rules for banks could be revisited once firms have built up sufficient buffers of loss-absorbing debt. Until then, the whole bank-failure regime is in a "transitional phase". *Weber – Groendahl*, Bloomberg 7.7.2017. In August 2017 the Financial Times published an interview with *Elke König*, the Chair of the SRB. In the interview she said that 'state aid guidelines adopted by the European Commission in 2013 were in effect out of date'. *Brunsden*, Financial Times 8.8.2017.

research the conditions for a serious disturbance in the economy of a Member State would not be fulfilled; consequently not justifying the application of the Crisis Communications whose legal basis is Article 107(3)(b) TFEU.

6.2 Final remarks

With regard to the whole crisis management framework, there are reasons for and against preserving the backstop of State recapitalisation aid. Arguments can roughly be divided into two categories: 1) transitional/temporary arguments; and 2) permanent arguments.

The most evident transitional argument is that the crisis framework has been applicable law for only a short amount of time still. It will inevitably take time for law to develop into practice. In fact, with regard to triggering resolution on a supranational level, the SRB has only made one positive decision so far, in the case of the Spanish bank Banco Popular, which was sold to another Spanish bank, Santander[381]. There is not exactly a pile of decisions available from national resolution authorities either, especially with regard to the *full application* of the BRRD; application of the bail-in requirements for example only became mandatory in the beginning of 2016.[382] Furthermore, the BRRD requires Member States to achieve regulatory target levels of their resolution financing arrangements only by the end of 2024[383], which could potentially hamper the full application of the bail-in resolution tool under Article 44 BRRD until the year of 2025. In the context of the Banking Union, the planned three-pillar structure[384] remains incomplete as the process of enacting a common deposit guarantee scheme is stagnant.

In the transitional phase, questions on the adequacy and efficiency of the harmonisation level and on the sufficiency of the set requirements need to be answered[385] on the basis

[381] SRB/EES/2017/08.
[382] For some recent case studies see *World Bank*: Bank Resolution and "Bail-In" in the EU: Selected Case Studies Pre and Post BRRD.
[383] Article 102 of the BRRD.
[384] 1. the single supervisory mechanism, 2. the single resolution mechanism and 3. the common deposit guarantee scheme.
[385] According to recital (108) of the BRRD ensuring effective resolution of failing institutions within the Union is an essential element in the completion of the internal market. Thus, an efficient single financial market should have a harmonised set of core rules: "Ensuring effective financing of the resolution of those institutions across Member States is not only in the best interests of the Member States in which they operate but also of all the Member States in general as a means of ensuring a level competitive playing field and improving the functioning of the internal financial market. Setting up a European

of experience gained in order to move onto a permanently durable crisis management regime. Harmonised regulation solely is not enough; also the harmonised implementation and application of the common rules must be ensured; both on the level of authorities and institutions. Two-speed integration in the financial sector presented by the division between the banking union and non-BU-members is a relevant concern of internal market fragmentation.[386] As case practice accumulates, it will hopefully become clearer whether the Union can truly function on two-speed integration or if optimally all Member States would have to opt into the BU via close cooperation.[387]

Where the new framework would be put into the ultimate test is where a large cross-border banking group would be resolved pursuant to the rules adopted in the BRRD or the SRMR, especially if this banking group were to be wound down instead of being kept going-concern. As long as there remain doubts on whether such large banking groups could actually be wound down in an orderly manner, it can be argued these groups still have an incentive to take on high-risk activities.[388] Therefore, as long as this test of winding down a cross-border banking group has not been taken and passed[389], the BRRD rules have not truly been proven to work as expected. In a sense, the transitional phase of implementing the crisis reform rules can last until this "large-group-test" has been passed. While it is desirable that large institutions and banking groups would fully operate on sustainable business models, in case the opposite judgment would be made, it is crucial for the credibility of the BRRD rules not to allow such unsustainable institutions or groups on the verge of failure to continue as going-

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system of financing arrangements should ensure that all institutions that operate in the Union are subject to equally effective resolution financing arrangements and contribute to the stability of the internal market."

[386] CRR, recital (9): "For reasons of legal certainty and because of the need for a level playing field within the Union, a single set of regulations for all market participants is a key element for the functioning of the internal market. In order to avoid market distortions and regulatory arbitrage, prudential minimum requirements should therefore ensure maximum harmonisation."

[387] Close cooperation is an application of the principle of flexibility which has affected the interpretation practice of the principle of subsidiarity. *Raitio* has noted that the principle of flexibility represents political realism in a union of several States as it allows for deeper integration without having to "force" all Member States to join – subsequently increasing likelihood of disagreement. However, *Raitio* also notes that the principle of flexibility should not be interpreted to mean that Member States can "pick and choose" which parts of the process of European integration they wish to take part in; nor should the principle of flexibility be interpreted in a way that would lead to such a differentiation in integration that it would be considered perpetual rather than temporary. See *Raitio* 2013, pages 249-250.

[388] *Jokela – Kotilainen – Tiilikainen – Vihriälä* 2014, page 74.

[389] In the latest edition of the Global Financial Stability Report, it is still acknowledged that even a single GSIB could still generate systemic stress and that banks representing approximately one-third of all GSIB assets (circa $ 17 trillion) may continue to generate unsustainable returns even in 2019. See IMF: Global Financial Stability Report October 2017: Is Growth at Risk? Executive summary, page xi.

concern and be granted public support. Only where bail-outs cannot even implicitly be presumed, moral hazard can cease to exist.

There are really no permanent arguments in favour of prolonging the enforcement of the Crisis Communications. The Commission has deemed them as temporary in nature. Moreover, one of the reasons why specifically the 2013 Banking Communication was issued was to provide a smoother transition into the BRRD regime. Ever since the BRRD was fully enforced, for reasons of consistency it would have been appropriate to update the Crisis Communications into the "post-BRRD-era". The crisis management regime now consists of new prudential regulation and old competition rules, which is an unfitting combination.

If the definition and scope for a "serious disturbance in the economy of a Member State" would be clarified a bit further, the application of Article 107(3)(b) TFEU would likely become more restricted. The current state of practice equally offers no legal certainty for later application of Article 107(3)(b) TFEU, should disturbance-like circumstances emerge in any Member State economy in the future.

Further clarification of what amounts to financial stability is also required as the SAM plan and SAAP set a requirement whereby aid should be targeted at well-defined objectives of common interest. An ordoliberal view of competition policy would only allow State intervention in markets if a genuine market failure occurs. Therefore the preservation of financial stability has been assessed from the point of view of being an efficiency objective rather than an equity objective. Pursuing the most efficient solution would mean that an outcome which amounts to the most of a selected welfare standard should be selected.[390] Here the selected welfare standard has been total welfare; taking equally into account the benefits of consumers, producers and rivals.[391] This approach has especially allowed for more consideration towards producer welfare than what seems to be tradition in State aid policy. Taking into account the producer welfare standard is especially important in restricting the use of punitive-like ex post structural and behavioural measures which do not have an economic reasoning. More attention

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[390] *Kanniainen – Määttä* 2001, pages 81-82.

[391] With regard to State aid, also the shadow costs of taxation could be taken into account when determining the amount of total welfare. How the application of this standard is visible in this work is that the amount of ad hoc State aid granted should be restricted to the minimum possible. Where no State aid is granted, no shadow costs of taxation will occur.

than tradition has also been drawn towards the positive effects aid can have on rivals – the so-called positive externalities of aid.

Where total welfare would be the lowest is if inefficient undertakings are artificially kept going-concern in the markets. This would both result in increased costs and hurt incentives to compete. Therefore, where State aid is granted in order to keep a bank in business, the business model cannot be the reason why the bank has ended up in economic trouble. It is up to ex ante legal rules to ensure banks' business models are optimised in a manner which promotes both efficiency and stability while still ensuring adequate possibilities to gain profit in order to maintain incentives to compete. If it can be proven that a bank's distress is the result of inherent endogenous problems with risk management or capital planning, and the bank is kept going-concern, there are few winners welfare-wise. If however the institution is experiencing economic distress due to an external shock to which the institution could have not prepared for by taking legally required precaution, keeping the bank going-concern may have more positive than negative effects. This is especially where the institution in question has systemic relevance, meaning its market exit could have negative externalities for both the real economy and its rivals/counterparties.

What if preserving financial stability would not be an efficiency objective after all but rather an equity objective? *Nicolaides* for example has argued it is not realistic to assume that all aid which is not targeted at market failures would be prohibited[392]. *Coppi* argues indeed that R&R aid is usually targeted at equity objectives[393]. Equity objectives have an income distributional nature; "The distribution of income as provided by the market mechanism may not be in line with what society considers just and fair."[394] *Kanniainen – Määttä* state that equity objectives are better solved by other means than competition policy[395]. If safeguarding financial stability therefore would be an equity objective, it would be difficult to argue that State aid according to the balancing test would be the most appropriate means of achieving any set objective of

[392] *Nicolaides* 2008, page 85.
[393] *Coppi* 2011, page 78.
[394] *Schina* 1987, page 3.
[395] *Kanniainen – Määttä* 2001, page 91. Moreover, *Kuoppamäki* states that income distributional effects may well-arguably be left out of the scope of economic analysis because income distribution is inherently a political question rather than an economic one. See *Kuoppamäki* 2008, page 1087. Finally, even the SAAP takes a stance whereby State aid is to primarily address market failures. Aid measures could "also" address social objectives. See SAAP, point 10.

common interest.[396] This is especially true with regard to ad hoc type of aid measures such as crisis aid; achieving social objectives would presumably be subject to well-thought planning rather than addressing sudden shocks. For example State aid to support research and development would likely be pre-planned as part of any State's budget expenditure. Pre-planned capitalising of banks from a State budget in order to maintain financial stability would not seem be justifiable in a similar manner for reasons of fairness nor would such an economic strategy make any sense. If safeguarding financial stability would be considered an equity objective, there would be stronger arguments for choosing another measure to address the objective than where safeguarding financial stability is considered as an efficiency objective. Concluding, economic analysis is well-suited for assessing compatibility of banking restructuring aid with the internal market. The equity considerations however prove that ex ante prudential regulation should be the prioritised and appropriate response to tackle crisis conditions. State aid policy should only intervene exceptionally if these ex ante rules fail to provide an efficient market outcome.

Regardless of whether more clarity is provided on the assessment of the components of "a serious disturbance in the economy of a Member State", any disturbances cannot stay "serious" indefinitely – considering especially the fact that substantial efforts are being made in order to build a more robust financial sector free of major systemic risk. Should economic conditions not even change in the long run, the conditions would then have to be interpreted as normal market conditions eventually. Financial stability has to be on an *adequate level* at some point in the future, in accordance with *Schinasi*'s fifth key principle of a continuum. It is unlikely that any macro-prudential assessment would ever end in the result of deeming the EU completely free of any systemic risk. This should not even happen as this would seem like a very poor and superficial judgment only giving an impression of an incomprehensive assessment. Therefore adequate stability should not mean perfect financial stability, but rather conditions where risks are "under control"; if disturbances did occur, they would not be considered "serious" as in contagious in a severe manner.

[396] *Coppi* 2011, page 83.

As even EU secondary legislation is not easily or quickly amended[397], the option of a precautionary recapitalisation is in regulatory terms permanent. Its application is however very much tied to the wording of Article 107(3)(b) TFEU as a precautionary recapitalisation can only be approved to prevent a serious disturbance in the economy of a Member State from materialising. Accordingly, if the application of Article 107(3)(b) TFEU would not be justified based on the present market conditions, no precautionary recapitalisation could be granted. The option of a precautionary recapitalisation was most likely enacted into the BRRD because the economic conditions in the EU were still fragile and prospects of growth uncertain during the legislative process. The motivation for adopting the option would therefore have been transitional; risks were not deemed controllable to an extent where bail-outs could have been ruled out completely.

While the motivation of adoption might have been transitional, permanent enforceability of the precautionary recapitalisation provision may still be justified in order to address sudden and dire crisis circumstances of an unforeseen extent.[398] It can genuinely be difficult or even impossible to predict all economic events and their correlations in a way where the financial system would be immune to unexpected external shocks. The problem there is that asymmetric information is not likely to ever disappear from any credit market – it is inherent. States cannot make sure banks are only exposed to external shocks and not to internal ones caused by excessive risk-taking. Under a pessimistic scenario, as long as bail-outs to any slightest extent remain a legal means of crisis intervention, moral hazard will arise as risk-taking is incentivised by counting on the implicit promise of a guarantee enacted in law.

In the 2013 Banking Communication, it is stated that “financial stability cannot be ensured without a healthy financial sector”[399]. What does “healthy” mean in this context? Does it mean that the financial sector will have to be free from bad loans?[400] Does it mean that financial institutions need deep restructuring and re-organizing to

[397] *Barber*, Financial Times 14.11.2017.
[398] *Véron* 2017, page 9.
[399] 2013 Banking Communication, point 8.
[400] The EU continues to especially struggle with poor bank profitability of which the major root cause is a a high NPL ratio. See for example ECB: Financial Stability Review. November 2017, Overview and EBA: EXECUTIVE SUMMARY OF THE ANNUAL REPORT 2016, pages 8-9. See also EBA’s press release on Q3 2017 risk dashboard key findings in https://www.eba.europa.eu/-/the-eba-risk-dashboard-confirms-steady-improvements-in-the-eu-banking-sector-but-banks-profitability-and-business-model-sustainability-remain-key-chal?doAsGroupId=10180 . 2018. (Last accessed 20.2.2018.)

build sustainable business models? Are both required? Is something more required? As pointed out, it should not be assumed that the EU could ever be completely free of any systemic risk. "Healthy" should mean the combination of the elements which contribute to financial stability – market trust, efficient allocation of resources, ability to withstand shocks, low risk of contagion and normal operation of payment systems' critical functions – and moral hazard limited to minimum. In a healthy banking sector the objectives of preserving financial stability and eliminating moral hazard would therefore not conflict. This would be ensured by not granting aid to banks which operate on an unsustainable business model. A credible crisis management regime will reduce moral hazard on an ex ante regulatory basis rather than on an ex post competition policy basis. Concluding, already in the 1998 Crédit Lyonnais decision it was noted that: "The disappearance of banking institutions should not be regarded as indicative of the inadequacy of existing supervisory mechanisms, but as a sign that market forces are at work and that banks are no more protected than any other enterprise. The objectives of competition policy and those of prudential banking policy cannot be mutually incompatible, since both are designed to achieve a common end, namely the development of a competitive, *healthy* banking sector."[401]

[401] 98/490/EC (Crédit Lyonnais).