1. Introduction

The global financial crisis has impacted heavily on the banking system in many EU countries. Recent months have seen a general erosion of confidence within the banking system. The pervasive uncertainty about the credit risk of individual financial institutions has dried up interbank lending and has consequently made access to liquidity progressively more difficult for financial institutions across the board, even those that did not engage in unsound business practices and that are fundamentally sound.

In both areas — State aid and mergers — the EU has applied strict policies to ensure that the benefits of competition are not lost as a result of protectionism, “beggar thy neighbour” policies, or the creation of national champions.

In view of the exceptional circumstances, there have been calls in recent months for the Commission to considerably “relax” or even “suspend” EU disciplines in the area of State aid or merger control, at least as long as the financial crisis lasts. This has never been an option. On the contrary, EU competition policy is not part of the problem, but part of the solution. Abandoning EU competition discipline at this time of crisis would have risked disintegration of the European single market for banking and financial services.

2. State aid measures targeting the financial sector

2.1 General principles

State interventions during the financial crisis are aimed primarily at ensuring financial stability and to some extent at ensuring the availability of adequate levels of lending to the real economy. In this way such interventions contribute to the achievement of objectives of common interest. However, they are also likely to create distortions of competition, which need to be minimised through the instrument of State aid control.

First, distortions can appear between States where banks are given an undue competitive advantage over banks in other Member States. Access to funding or capital or other forms of support at considerably lower rates than in other Member States may have a substantial impact on the competitive position of a bank in the wider single European market. Excessive aid in one State could also prompt a subsidy race among States and create difficulties for the economies of States that have not introduced similar support schemes.

Secondly, distressed or less-performing banks may receive an undue advantage compared to banks which are better-performing if the measures are available to all banks within a State without an appropriate degree of differentiation between beneficiary banks according to their risk profiles. This will distort competition on the market, distort incentives, increase moral hazard and weaken the overall competitiveness of banks.

Thirdly, public schemes which crowd out market-based operations would frustrate the return to normal market functioning. Thus 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.

Experience from recent State interventions to recapitalise banks or to provide guarantees has illustrated possible anti-competitive effects at each of these three levels. Nevertheless, the EU in its communications and case assessment has shown that it is possible to strike a balance between these competition concerns and the objectives of restoring financial stability and ensuring adequate levels of lending to the real economy.

The application of State aid rules has ensured, and continues to ensure, that State support is granted on conditions that are sufficiently favourable to provide beneficiaries with effective access to capital, whilst preserving a level playing field and paving the way for a return to normal market conditions in the longer term. State interventions have accordingly been designed in a way that is proportionate and temporary in the sense that they provide incentives for banks to exit from reliance on State support as soon as market circumstances permit, in order for a competitive and efficient European banking sector to emerge from the crisis.

Finally, emergency rescue of banks (or more generally support for banks in difficulty) has hitherto

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(1) This is a shortened version of the European Commission note to the OECD Competition and Financial Markets roundtable on Crisis — The Role of Competition Policy in Financial Sector Rescue and Restructuring. The full version of this contribution may be found at http://ec.europa.eu/competition/international/multilateral/2009_feb_roundtable2.pdf
had the effect of protecting the providers of funds (owners and creditors) and managers of banks from the consequences of past (excessive) risk taking and led to a problem of moral hazard. Measures aimed at financial stability should thus also be designed so as to mitigate problems of moral hazard. Restructuring of ailing banks has an important role to play in this respect, to ensure that incumbent owners, creditors and managers are not subsidised (given their institutional responsibility for the decisions leading to distress).

For many years, the Commission has applied rules to assess State aid to firms in difficulty. These rules are set out in the Community guidelines on State aid for rescuing and restructuring firms in difficulty (3) hereafter “R&R guidelines”). The R&R guidelines are of general application, including to financial institutions in difficulty. In the light of the seriousness of the current crisis in the financial markets and the specific characteristics of the financial sector, restructuring banks in difficulty will become necessary to avoid serious disturbances in the economy of Member States. The Commission has in recent months adopted additional guidance, in the form of Communications, setting out standards and safeguards for the application of State aid rules in the financial sector.

The Commission’s approach in its Communications and its decisions in individual cases is based on the general principles underlying the State aid rules of the Treaty. These principles require that the aid granted is well targeted, that it does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible.

2.2 Translation of the general principles into policy

Past experience shows that the resolution of a financial crisis generally involves three steps:

1) Stop/prevent runs on financial institutions;
2) Recapitalisation;
3) Clean up financial institutions’ balance sheets by removing toxic assets and underperforming loans and restructuring.

Initially, Member States adopted measures they considered most appropriate to deal with the problems they were facing at national level. In doing so they did not always fully take into account the effects their measures had on financial markets in other Member States. To mitigate the competition risks linked to uncoordinated public action, the Commission adopted in October 2008 a Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis.

The second step to be taken concerns the recapitalisation of financial institutions. Such recapitalisation is necessary to restore the financial stability and the confidence needed to support lending to the real economy. The Commission adopted in December 2008 its Communication on the recapitalisation of financial institutions (4). This Communication provides guidance to governments and enterprises as to the conditions under which recapitalisation would be acceptable under State aid rules.

As regards the third step, the Commission adopted in February 2009 guidance for the treatment of impaired assets in the EU banking sector by outlining various methods to deal with impaired assets, notably through asset purchase (including bad bank scenarios) or asset insurance schemes (5).

In conclusion, in recent months the Commission has tried to react as swiftly as possible to the unprecedented developments in the financial sector. It has provided Member States with a framework that coordinates national measures to combat the crisis and aims to avoid harmful spill-overs. By means of the guidance it has given and by its decisions in individual cases, the Commission has ensured that the schemes introduced by individual Member States will not unduly favour the beneficiaries to the detriment of their competitors or aggravate the liquidity problems of financial institutions located in other Member States. The standards and safeguards on which the guidance is based are briefly discussed below.

2.2.1 Standards and safeguards for State guarantees

The Commission Communication of October 2008 develops a number of standards and safeguards for a variety of measures, which have to be complied with by governments. The following overview lists the key standards and safeguards with respect to the most important measure covered by the communication, i.e. State guarantees:

- Eligibility for a guarantee scheme. The criteria for eligibility must be objective and non-discriminatory.
- Types of liabilities covered. As regards guarantees going beyond retail deposits, the selection of the types of liabilities covered should be target-

(3) OJ C 244, 1.10.2004, p. 2.
2.2.2 Standards and safeguards for the recapitalisation of financial institutions

In relation to recapitalisation measures the Commission Communication of December 2008 identifies a set of standards and safeguards. These standards and safeguards include the following:

- Pricing of recapitalisation. Closeness of pricing to market prices is the best guarantee to limit competition distortions.
- Incentives for State capital redemption. Recapitalisation measures need to contain appropriate incentives for State capital to be redeemed when the market so allows.
- Prevention of undue distortions of competition. Safeguards may be needed in order to prevent aggressive commercial expansion financed by State aid.
- Distinction between fundamentally sound and distressed banks. A distinction should be made between fundamentally sound banks whose difficulties stem only from the current general market conditions and distressed banks facing a risk of insolvency as a result of their particular business model or investment strategy.

2.2.3 Principles for the treatment of impaired assets

With regard to the treatment of impaired assets the Commission Communication of February 2009 is based on a number of principles, such as:

- Full transparency and disclosure of impairments, which has to be done prior to government intervention.
- Coordinated approach to the valuation and identification of assets eligible for asset relief measures.
- Adequate burden-sharing of the costs related to impaired assets between shareholders, creditors and the State.
- Adequate remuneration for the State, at least equivalent to the remuneration of State capital.
- Coverage of the losses incurred from the valuation of the assets at real economic value by the bank benefiting from the scheme.
- Appropriate restructuring, including measures to remedy competition distortion, following a case-by-case assessment and taking into account the total aid received through recapitalisation, guarantees or asset relief, with a view to the long-term viability and normal functioning of the European banking industry.

3. Merger review in the financial sector

In the context of the financial crisis, rescue mergers between banks as well as nationalisations of banks by Member States have given rise to new challenges for the application of EU merger control, in terms of jurisdictional, procedural and substantive issues. The Commission’s analysis has however shown, and experience has confirmed, that, in any event, these challenges are an insufficient ground to relax or temporarily set aside the rules in place on merger control. On the contrary, the EC Merger Regulation constitutes an appropriate and sufficiently flexible tool for merger control enforcement also in times of crisis. The overall objective is the application of merger control in a manner that takes into account the requirements of financial stability for the banking system whilst preventing the creation of anti-competitive market structures.

3.1 Nationalisation and related jurisdictional issues

From a jurisdictional perspective, nationalisations of financial institutions by Member States are a new development. As such, the Commission treats nationalisations in a similar way to acquisitions of com-
panies by private parties. This follows directly from Article 295 of the EC Treaty, which provides that the rules in Member States governing the system of property ownership must in no way be prejudiced by the EC Treaty.

It has to be emphasised, however, that the design or implementation of a nationalisation measure must respect all Treaty obligations, including those relating to competition.

Similar to acquisitions of control by private entities, acquisitions by public entities may therefore also be subject to mandatory notification to the Commission under the Merger Regulation. Whether an obligation to notify exists will in practice depend on the factual circumstances of the case at issue. The general rule is that no prior notification is required as long as the financial institutions are held by the State after the operation as economic units with independent decision-making power.

In particular for cases where Member States hold controlling interests in more than one financial institution, it has to be ascertained, in order to rule out an obligation to notify, that there is no room for coordination between different State-controlled banks. Finally, the acquired banks must be in a position to formulate their business strategy and carry out their day-to-day business on an autonomous basis. Nationalisations which fulfil the above criteria should not constitute notifiable transactions.

3.2 Procedural issues

One of the specific challenges the Commission faces in its review of mergers in times of crisis is of a procedural character. Timing of the review process and the possibilities to consummate a merger are normally of the essence for the merging parties and may be an even more pressing issue in rescue mergers.

The review periods provided for by the Merger Regulation are short and follow a well-defined time frame, the purpose being to ensure that the Commission has sufficient time for a thorough examination of the concentration while still allowing for a swift and foreseeable review process for the parties.

As a rule, the Merger Regulation provides for a standstill obligation pending the Commission’s review, i.e. transactions notifiable under the EC Merger Regulation cannot be implemented before being cleared by the Commission. However, rescue mergers may require rapid and flexible reaction by the Commission in order to enable at least partly the immediate implementation of transactions. If required by the financial situation of the parties involved, the Commission can accommodate the necessity to implement immediately by granting derogations from the standstill obligation, taking into account the effects of such a measure on the parties directly involved in the transaction and on third parties and the possible effects on the market as such.

3.3 Substantive issues: the failing firm defence

As a practical matter, there has hitherto been no case brought before the Commission where the merging parties have raised a failing firm defence as a result of the financial crisis, be it in the financial sector or in the sectors of the “real economy”. This is largely due to the fact that, with few exceptions, Member States have not as of yet “allowed” banks to fail and have been in a position to take various policy measures to this end including full nationalisation, recapitalisations and various types of guarantees.

Nevertheless, it cannot be ruled out at this stage that a failing firm scenario could arise should such measures not be sufficient or not have the intended effects with regard to any particular market or firm. In this respect, when assessing the competition impact of a merger, the Merger Regulation allows the Commission to take into account rapidly evolving market conditions and, where applicable, the failing firm defence.

In order for a failing firm defence to be accepted, three cumulative criteria are especially relevant as set out by the Commission’s horizontal merger guidelines: (i) the allegedly failing firm would, in the near future, be forced out of the market because of financial difficulties if not taken over by another undertaking; (ii) there is no less anti-competitive alternative purchase than the notified merger; and (iii) in the absence of a merger, the assets of the failing firm would inevitably exit the market.

It must be noted that even if it cannot be shown that each of the three indicative criteria are met, an analysis of what would be the development of the market absent the merger could still lead to the conclusion that lessening of competition in the market is not an effect of the merger. The Commission will thus undertake a thorough prospective analysis of the market conditions and compare scenarios, with and without the proposed transaction and, where necessary, take into account remedies.

4. Conclusion

As set out in this paper the Commission’s competition policy has been adequately equipped to deal with the challenges of the crisis in the financial sector. The fundamental principles of State aid and merger policy have provided a sound basis for dealing with the problems that the markets have been facing in these times of turmoil. In the field of State aid the Commission’s policy has been focussed on
maintaining a level playing field and fighting “beggar thy neighbour” policies. It has done so on the basis of its existing set of rules on rescue and restructuring aid as recently supplemented by specific rules on State guarantees, recapitalisation schemes for financial institutions and the treatment of impaired assets. With regard to mergers there has been no case for setting aside existing policy either. The rules in place allow for an appropriate response to a wide range of issues.