State Aid Policy in the context of the financial crisis

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Introduction

The recent financial crisis, and the wider recession in the real economy, has fundamentally challenged current models of regulation and oversight in the financial sector, and raised questions about the role of the state in economic life. This article outlines the Commission’s response to the crisis, in implementing State aid policy, over the past year.

In times of severe economic crisis, there is always a risk that competition policy will not come top of the political agenda. In the context of this crisis, Governments’ immediate focus was on measures to keep banks afloat or maintain employment, and they sometimes believed that these measures could be divorced from competition policy. However, the past year has shown that the EU competition and state aid rules are a crucial component to any recovery plan. In the short term they have maintained a level playing field and preserved the achievements of the Single Market, while in the longer term they are also helping pave the way for economic restructuring and recovery.

What have we done to assist Member States in their efforts to resolve the crisis? The Commission’s initial objectives – in line with those of the Member States – were to preserve financial stability, deal with the risk of bank insolvencies and restore lending, in particular in order to avoid unnecessary bankruptcies and redundancies in the wider economy.

Since the situation became critical in September 2008, we have assessed over 100 national schemes or measures to support financial institutions, under the State aid rules. In doing so, we have taken account of the need to:

- ensure fair competition between Member States: measures taken by one Member State with respect to its own banks should not give them an undue competitive advantage compared to banks in other Member States;

- ensure fair competition between banks: measures must differentiate between beneficiary banks according to their risk profiles, to avoid giving an undue advantage to distressed or less-performing banks;

- ensure a return to normal market functioning: measures must address how to return the financial sector to long-term viability, where banks operate without state support.

In December 2008, the Commission adopted the Temporary Framework for State aid. The idea behind this scheme is to allow Member States – on a temporary basis until the end of 2010 – to grant certain types of aid to the “real economy” in order to reduce the negative effects of the crisis. Specifically governments needed to be able to facilitate companies’ access to finance. Sufficient and affordable access to finance is a pre-condition for investment, growth and job creation by the private sector. In the short term the economic crisis affects the viability of European companies – and in the long term it could delay investments in sustainable growth and other Lisbon Strategy (EU 2020) objectives. To date over 70 aid schemes have been approved under the Temporary Framework (2).

Background to the crisis

Traditionally, banks were institutions that took deposits and loaned money to finance business ventures, obeying strict ratios between the amount of deposits they held and the amount of money they could lend out. But in recent years, banks have hugely diversified their activities. They sell insurance, consumer finance products and mortgages to individuals. They started to lend more aggressively and trade in complex products such as derivatives, swaps and other risk management products.

In simple terms that means that banks grew their businesses partly by grouping loans and selling packages of loans (securitised products) to third parties – often other banks – who then received the income relating to those loans. This gave the lending banks more leeway because the loans were taken off their balance sheets, so that the deposit to lending ratios laid down by regulators were satisfied.

In parallel, the trend in recent years has been for banks to relax their lending criteria.

(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the author.

(2) We publish an overview of national measures adopted as a response to the financial/economic crisis, which is regularly updated. It can be found on the Rapid press releases database.
of credit influenced property prices, which seemed to be on an unstoppable rise in many advanced economies. Problems started to surface when – particularly in the US – overstretched borrowers started to default on their loans, triggering the so-called US sub-prime crisis. As a result, the prices of asset-backed securities plummeted and banks who had invested directly in asset-backed securities or whose commercial strategies were reliant on aggressive growth in sales started to encounter difficulties in accessing sufficient liquidity to meet their commitments.

In 2007 a first wave of measures were brought to our attention under the State aid rules. They involved two German Landesbanken: Sachsen LB (1) and IKB (2), who had both invested in US sub-prime securities. In the UK, Northern Rock (3), a bank and mortgage lender that had a growth rate of five times industry average, hit problems. For the first time in years, depositors queued outside a UK bank to attempt to recover their deposits because they feared the bank was about to fail. The UK government had no choice but to guarantee deposits and, ultimately, put Northern Rock under government control.

We assessed the state support these banks received under Article 87(3)(c) – as aid to companies in difficulty – in conjunction with the Guidelines on rescue and restructuring aid. An important issue we identified was that bailing out banks which are facing difficulties as a result of their own decisions could increase “moral hazard” – i.e. it may have the effect of encouraging risk-taking. It was also immediately apparent that, when markets are hit by a widespread crisis of confidence, a bank in difficulty is unlike any other business in difficulty – if one financial institution fails, confidence in the whole system is shaken. A bank can be “too big to fail”, because the impact of its failure, on consumer confidence and on the viability of other banks would just be too great, so that a government could not risk allowing it to fail.

Essentially, this is where the much-discussed “systemic” effects of the banking crisis come into play. First, banks are to a significant extent interdependent because they trade with each other and lend to each other. When Lehman Brothers failed in September 2008, banks around the world scrambled to assess the extent of their exposure. Secondly, the banking system is based on confidence. If there are fears that a bank may collapse other banks will be reluctant to lend to it, and depositors may be afraid to entrust it with their savings, which means that in turn it will not be in a position to access sufficient liquidity to lend to businesses and consumers.

Stabilising the banking sector to tackle recessions

In autumn 2008 a series of summits between European leaders took place. The first national bank support schemes were devised, mostly providing state-backed guarantees to the financial sector. (4) A number of banks that were relatively unaffected by the crisis opted not to benefit from these schemes – including the Santander group, Barclays and Deutsche Bank.

In order to assist Member States to take urgent and effective measures to preserve financial stability and to provide legal certainty, the Commission adopted four Communications between October 2008 and July 2009, setting out how we would apply State aid rules to government measures to support the banking sector in the context of the economic crisis.

On 13 October 2008 the Commission adopted its first guidance paper – the Banking Communication (5). Essentially the conditions we insisted on are:

- Non-discriminatory access to the schemes in order to protect the functioning of the Single Market by making sure that eligibility for a support scheme is not based on nationality;
- State commitments to be limited in time – and reviewed at least every six months – so that support can be provided as long as necessary to cope with the current turmoil in financial markets but that it will be reviewed and adjusted or terminated as soon as improved market conditions permit;
- State support to be clearly defined and limited in scope to what is necessary to address the acute crisis in financial markets while excluding unjustified benefits for shareholders of financial institutions at the taxpayer’s expense;
- An appropriate contribution by the private sector by way of an adequate remuneration for the introduction of general support schemes (such as a guarantee scheme) and the coverage by the private sector of at least a significant part

(1) Restructuring aid to Sachsen LB, Case C9/2008.
(2) Restructuring aid to IKB, Case C10/2008.
(3) Northern Rock, Case NN70/2007; Restructuring aid to Northern Rock, Case C14/2008.
of the cost of assistance granted, so as to ensure that there are incentives to return state money;

- **Sufficient behavioural rules for beneficiaries** that prevent an abuse of state support, like for example expansion and aggressive market strategies on the back of a state guarantee;

- **An appropriate follow-up in the form of structural adjustment measures** for the financial sector as a whole and/or by restructuring individual financial institutions that benefited from state intervention.

These principles are based on our pre-existing guidelines on rescue and restructuring aid, although the decision was taken to approve measures on the basis of Article 87(3)(b) authorizing aid in order to "remedy a serious disturbance to the economy of a Member State" in view of the severity of the crisis.

In the mean time the solutions being devised by Member States evolved from largely guarantee-based schemes to other measures such as recapitalisation of banks. Following extensive discussions with the European Central Bank and Member States, the Commission adopted detailed guidance on how it would assess these bank recapitalisation measures — the Recapitalisation Communication (f) — on 5 December 2008.

From a competition perspective, in the absence of an appropriate risk-based justification, access by banks in one Member State to capital at considerably lower rates than that available to competitors from other Member States could have a significant impact on their competitive position in the Single Market. Excessive aid in one Member State could also provoke a subsidy race and create difficulties in Member States that had not introduced recapitalisation measures. And equally, recapitalisation schemes that were open to all banks without differentiation of their terms could distort competition and incentives, and weaken overall competitiveness of European banks. Finally, recapitalisation or other measures should not have the effect of putting banks that do not have recourse to public funding in a significantly less competitive position. A public scheme which crowds out market-based operations would frustrate the return to normal market functioning.

The Recapitalisation Communication distinguishes between banks that are fundamentally sound and receive temporary support to enhance the stability of financial markets and restore lending to businesses and consumers, and distressed banks whose business model has brought about a risk of insolvency and which pose a greater risk of distortions to competition.

In particular, the Communication established principles for pricing the injections of capital made by States into banks. For fundamentally sound banks, the price of capital injections should be linked to base rates set by central banks to which a risk premium is added to reflect the risk profile of the beneficiary bank, the type of capital used and the nature of the safeguards against abuse of public funding that accompany the recapitalisation measure. This pricing mechanism needs to carry sufficient incentives to keep the duration of state involvement to a minimum, for instance by having a rate of remuneration that increases over time.

Banks in distress which are at risk of insolvency should in principle be required to pay more for state support and be subject to stricter safeguards. Injections of state capital into these banks are acceptable only on condition that they are followed by far-reaching restructuring to restore long-term viability, which may include changes to management and corporate governance.

By way of these two Communications, we made sector-specific adjustments and introduced some necessary flexibility into our handling of national financial sector rescue schemes and individual financial institution rescue measures, without losing sight of key state aid principles. By giving Member States clear guidelines on what would or would not be acceptable we also helped achieve a degree of consistency in Member State responses across Europe.

Flexibility in process has of course been very important. Support measures such as guarantees or re-capitalisation schemes and individual financial institution rescue measures have been cleared by the Commission very quickly, where the schemes fulfil the conditions discussed above, which guarantee that they are well-targeted and proportionate and contain safeguards against unnecessary negative effects on competition.

**The banking sector: restoring confidence and returning to viability?**

While it seems clear that the financial sector rescue packages adopted by Member States since October 2008 averted the risk of financial meltdown, in early 2009 it became apparent that further measures were needed in order to restore trust and to return the financial sector to normal functioning.

One reason why credit remained squeezed seemed to be uncertainty about the value and location of impaired assets held by banks. On 25 February 2009, after detailed discussions with the Member States, the Commission adopted the Impaired Assets

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Communication (9). This Communication discusses the budgetary and regulatory implications of asset relief measures that could be adopted by Member States to remove impaired or toxic assets – that is to say assets that now have much-reduced or no value, ranging from US sub-prime mortgage backed securities to loans to previously healthy businesses that have gone under as a result of the economic crisis – from the balance sheets of banks, and provides guidance on the application of the State aid rules to such measures.

The Impaired Assets Communication stipulates that:

- Member States must make asset relief measures conditional on full transparency and disclosure of impaired assets and must ensure that the costs of the impaired assets are shared between the Member States, shareholders and creditors of the financial institutions.

- Member States should take a coordinated approach to identifying assets eligible for asset relief measures and to valuing assets. The primary task of carrying out asset valuation is at the national level, and validated by the appropriate supervisory authority. However, each individual case is checked by the Commission with the help of external experts.

- Finally, restructuring measures should follow, so as to ensure the return to viability of the banks in question, and the return to normal market conditions.

The measures in question could involve asset purchases (including “bad” bank scenarios), asset swaps, state guarantees, or hybrid systems – that is of course up to the Member States who are responsible for the methods and design of asset relief measures.

Finally, on 22 July 2009 the Commission published guidelines setting out its approach to assessing restructuring aid given by Member States to banks (10) (the Restructuring Communication). Essentially, those banks that have received large amounts of aid and that have unsustainable business models will have to restructure in order to return to long term viability without relying on State support.

The Restructuring Communication stipulates that banks in need of restructuring have to demonstrate strategies to achieve long term viability under adverse economic conditions: they involve rigorous stress testing of the businesses. In some cases, divestments will not be needed but in many cases they will be essential, either to ensure viability of core businesses or to reflect the negative competitive impact of aid on key market segments.

However, we need to be realistic about divestments, for example with respect to the likelihood of finding buyers and the time period for divestiture.

Additionally, banks that have received large amounts of aid and that have unsustainable business models, and their capital holders, should contribute to the cost of restructuring as much as possible with their own resources. This creates appropriate incentives for future behaviour. An appropriate price for State support ensures that the aid cannot be used to finance activities such as acquisitions which are not linked to the restructuring process. Similarly, aid should not be used to pay interest to holders of hybrid capital instruments when a bank in receipt of aid is making losses, unless this remuneration is essential to attract new capital.

A certain number of bank restructuring plans have already been adopted. For instance, on 18 November 2009 the Commission approved restructuring plans for the KBC group, ING, and Lloyds Banking Group (12).

The “real” economy

Before the end of 2008, the effects of the crisis were being felt in the “real” economy, and Member States began to consider what measures they could take to tackle the knock-on effects of the financial crisis.

In recent years, in line with the State Aid Action Plan, EU State aid rules have been simplified and improved so that it is now easier for Member States to give the type of aid most likely to improve Europe’s prosperity and competitiveness (e.g. research, development and innovation, risk capital, training, environmental aid, aid for SMEs), and so that the Commission can concentrate its scrutiny where there is most risk of distortions of competition. For example, the General Block Exemption Regulation adopted in July 2008 implemented a simplified procedure for the approval of aid (13). Similarly, the De

(9) Communication from the Commission on the Treatment of impaired assets in the Community banking sector, OJEC [2009] C 72/1 (the Impaired Assets Communication).

(10) Communication from the Commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid OJEC [2009] C 195/9 (the “Restructuring Communication”).


Minimis Regulation approved in 2006 allowed Member States to award support of under EUR 200 000 per company without the need to notify (13).

However, in the context of the crisis there was a need for additional measures targeted to the exceptional difficulties in obtaining finance.

The measures contained in the Temporary Framework are—like the crisis measures adopted in the banking sector—based on Article 87 (3) (b) of the Treaty. This is why the new measures are limited in time, until the end of 2010.

On the basis of the Temporary framework Member States may:

• Give EUR 500 000 per undertaking to cover investments and/or working capital over a period of two years.
• Offer State guarantees for loans at a reduced premium. The guarantee may relate to both investment and working capital loans and it may cover up to 90 percent of the loan.
• Offer aid in the form of subsidized interest rate applicable to all type of loans. This reduced interest rate can be applied for interest payments until the end of 2012.
• Offer subsidized loans for the production of green products involving the early adaptation to or going beyond future Community product standards.

The Commission considers that environmental goals should remain a priority despite the crisis—and, for this reason, it sought to give support to companies investing in environmental projects.

Furthermore, the Temporary Framework also allows for:

• A temporary derogation from the Community guidelines on Risk Capital guidelines in order to allow EUR 2.5 million of risk capital injection in SMEs per year (instead of EUR 1.5 million) and a reduction of the minimum level of private participation (from 50 percent to 30 percent).
• A simplification of the Communication on short-term export credit insurance. This makes it easier for Member States to demonstrate that certain risks are temporarily non-marketable and can thus be covered by the State.

Member States do need to notify all the measures contained in the Temporary Framework—but special procedures have been put in place to ensure that the Commission is in a position to very quickly adopt decisions allowing State aid under the Temporary Framework.

To give some examples of decisions under the Temporary Framework: on 30 December 2008 the European Commission approved two German measures to support the real economy, the first under the Temporary Framework. The first measure was intended to provide liquidity for companies affected by the credit squeeze, and allows interest rate reductions on loans to finance investments and working capital of up to EUR 50 million to be granted to companies with a turnover of less than EUR 500 million. The second measure is a framework scheme which allows federal, regional and local bodies to provide aid of up to EUR 50 000 000 to firms in need. It only applies to companies that were not in financial difficulties on 1 July 2008 (14).

On 12 June 2009 the European Commission authorised a Finnish guarantee scheme aimed at providing relief to companies encountering financing difficulties as a result of the credit squeeze. The scheme allows authorities to grant aid in the form of subsidised guarantees for investment and working capital loans concluded by 31 December 2010. The scheme meets the conditions laid down in the Temporary Framework because it is limited in time, respects the relevant thresholds and applies only to companies that were not in difficulty on 1 July 2008. (15)

In adopting the Temporary Framework, the Commission sought to react in a pragmatic and responsible way to the evolving market circumstances, so as to enable Member States to react to market circumstances, but without compromising the State aid rules and the EU Single Market.

The Commission is also thinking ahead and preparing for the review process—to this end we are closely monitoring the aid schemes put in place by Member States under the Temporary Framework.

As with financial sector measures, the Commission’s aim has been to be flexible on process—by facilitating national umbrella schemes—but firm on the underlying principles. It is important the Commission responds to market conditions while at the same time resisting pressures to allow Member States to adopt protectionist measures and provide long term support to ailing national companies, contrary to the principles of fair competition among EU companies. EU State aid policy provides a framework for ensuring that restructuring is based on a feasible, coherent and far-reaching plan to restore long term


(14) Case number N 661/2008 and N 668/2008 (the latter was amended on 5 June 2009 and 16 July 2009).
(15) Case number N82h/2009.
viability of companies, which also helps safeguard employment.

**Conclusion**

After its critical phase, and largely due to public intervention, the financial sector has stabilised. We are now focussing more and more on how to achieve the long-term viability of financial institutions without state support, and how to prepare phasing out of the public support which the financial sector has received.

Going forward, banks must operate on the basis of sound business models in a regulatory framework in which they can compete on the merits with balanced incentives and without State aid. They must be able to exit the market or restructure when they are no longer competitive, without triggering the systemic consequences that have characterised the current crisis.

EU State aid policy can help achieve this goal, but we will of course need to work extremely closely with colleagues in other parts of the Commission, with the European Central Bank, national central banks and national ministries and financial sector regulators, as well as the banks themselves, in order to find constructive solutions.

Ultimately we believe that the way out of this crisis – for the financial sector and the wider economy – lies with competitive markets, not markets where inefficient and ailing companies are propped up by state support, illegal cartels or abuses of market power, nor with markets where consumers pay to support structures which are not sustainable.