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State aid policy in the financial crisis

The financial crisis has led the European Commission to use state aid rules in an unprecedented way to respond to the most abnormal economic conditions seen since 1929. In this context the application of state aid policy is changing rapidly from its traditional role of preventing governments from aiding their own 'national champions', but is it also departing from the basic principles of state aid? Dorothy Livingston of Herbert Smith LLP provides a guide to recent developments

The last three months of 2008 saw the most abnormal economic conditions since 1929. For well over a year financial institutions had been losing confidence in their dealings with each other and their customers, leading to an unwillingness to lend, first drying up the interbank market and then affecting the wider economy. The shock of the failure of Lehman and the need for support and/or forced mergers of many leading US banks and investment firms, as well as the difficulties faced by many European financial institutions, precipitated a situation so serious that it has forced the European Commission to use the state aid rules as part of the programme to tackle the crisis. The Commission has extended its measures as the effects are felt beyond the financial sector.

This is in contrast with the role of state aid law and policy, almost from the start of the Community in the 1960s, as a limit on competitive distortions within the single market created by Member States aiding their own 'national champions' and propping up industries in terminal decline so as to avoid tough decisions on employment. This historical role appears to have taken something of a back seat, although a large number of routine decisions exemplifying this approach continue to come through the pipeline. The two key crisis frameworks for aid to financial institutions[1] and to tackle the effects of credit squeeze on the real economy[2] include the application of familiar principles for the avoidance of distortion and the limitation of measures to the minimum necessary.

This article discusses these crisis frameworks and their application, with particular reference to measures enabling banks and businesses to raise finance.

Significance of state aid rules to funding of banks and businesses

Even in normal conditions, the state aid rules are among the most important aspects of competition law for financial institutions. If such institutions are lending to a borrower that has the benefit of a government guarantee, are themselves borrowing from government or having their commercial borrowings guaranteed by government, state aid rules will usually, although not invariably, be engaged. If a financial institution has serious liquidity or solvency problems and a Member State proposes to inject funds or nationalise, state aid rules will again be engaged. The 'state' for this purpose includes local authorities and certain publicly owned bodies, such as the Bank of England.

When the financial crisis spreads beyond the banking sector into the 'real economy', state aid rules assume significance for all types of business (including those that would not normally be regarded as eligible for significant aid), as do the wider economic plans of the EU to tackle the crisis. After years of urging Member States to reduce their aid levels, the Commission has adopted a pragmatic response to the current situation, working overtime to provide guidance on the granting of aid and to process individual decisions in a matter of days, rather than the months usually allowed for consideration of aid applications.

That said, the Commission has well-established powers to recover aid granted in breach of Articles 87 and 88 EC Treaty. By way of example, in October 2004 the Commission ordered the repayment by WestLB and six other public banks of €3 billion plus interest in respect of a non-notified state aid measure.[3]

This article is based on the state aid sections of Livingston, D. (2008), 'The European Union—Law, Financial Institutions and the Banking Crisis', published in the December edition of the *Capital Markets Law Journal*, Oxford University Press.

In such cases it is always the recipient of the aid that stands to lose out financially. A financial institution which may be the beneficiary of a state subsidy, or which is lending to a business which may be the beneficiary of a state subsidy, should therefore aim to ascertain at an early stage whether the proposed subsidy requires notification and, if so, ensure that the Member State authorities go through the correct procedures prior to any grants being made. It has been suggested that in some cases a lender may also be a beneficiary of the aid—eg, if it does business that it would not otherwise have done: this is a grey area for state aid policy.

The financial institutions framework

The Commission Communication of October 2008 marked the recognition by the Commission that the financial turmoil had reached unprecedented levels in the history of the Community. The Communication confirms that aid to financial institutions which are fundamentally sound but for the crisis may be treated as discretionary aid under Article 87(3)(b)—namely aid 'to remedy a serious disturbance in the economy of a Member State', as long as the crisis situation justifies this.

Normally this provision will apply for general schemes available to all or several financial institutions where a Member State has declared that there is a risk of such a serious disturbance. The Commission does not rule out that ad hoc interventions may fall under this provision, but the normal rules on rescue and restructuring aid are more likely to apply in such cases. In any event, the general principles on rescue and restructuring aid continue to apply, but it is recognised that interventions lasting beyond the six months normally allowed for rescue aid will be needed. The duty to produce plans (in the nature of restructuring plans) for beneficiary undertakings within six months remains, and Member States are required to report to the Commission every six months.

An important consideration is the separate treatment of illiquid but otherwise sound financial institutions and those that are suffering from inefficiencies, poor asset management or risky strategies. The latter would fit within the normal framework for rescue aid, whereas fundamentally sound institutions benefit from the rules established in the Commission Communication, as the Commission considers aid within these rules likely to have limited effects on competition. As with all aid, measures must be demonstrated to be:

- well targeted to achieve the objective of remedying a serious disturbance in the economy;
- proportionate to the challenge faced—ie, not going beyond what is required to attain this effect;
- designed to minimise negative spillover effects on competitors, other sectors and other Member States.

The Communication envisages the following types of aid.

- **Guarantees covering liabilities of financial institutions**. Covering either retail deposits or types of debt which are the subject of serious market difficulties: the example given for other debts that could be guaranteed is interbank lending, where the market has dried up. This is in line with action being taken in the UK and some other Member States. The Directive on depositor guarantee schemes does, of course, allow for indefinite schemes for retail depositors,[4] but durations of up to two years are suggested as likely to be acceptable for other justified interventions, but with six-monthly reviews of whether they remain necessary, with some possibility of covering debts for their contractual term, even where this would expire outside the two-year window.

- **Guarantees covering liabilities of a single institution**. Aid of this type for a single institution will be more harshly judged because of its greater ability to distort competition. The Commission could be expected to focus on whether the recipient of the guarantee was indeed a fundamentally sound institution.

- **Recapitalisation of financial institutions**. The general points applicable to guarantee schemes carry across, but there is an emphasis on the need for objective criteria for participation, and for beneficiaries to contribute as much as they can themselves—eg, by raising money through rights issues, as is a feature of the UK recapitalisation scheme. In addition, there is a requirement that the state receives value through the investment that it makes: preferred shares with adequate remuneration are cited as a prime example of how this may be achieved. Substantial additional guidance on recapitalisation was given in a further Commission Communication of December 2008.[5] This deals with the following.

  - **Pricing of recapitalisations for fundamentally sound banks**. This draws on work by the ECB published on November 20th 2008,[6] and indicates an 'entry price' within a 'price corridor' having as its lower bound the required rate of return for subordinated debt, and as its upper bound the required rate of return for ordinary shares.

  - **Incentives for state capital redemption as soon as the market allows**. This justifies an add-on to the entry price described above, or by call options or other redemption clauses, increases in cost if the capital is maintained in place, or dividend restrictions while the capital remains in place.

  - **Prevention of undue distortions in competition**. For example, by measures to restrict aggressive commercial expansion on the back of the aid, to be tailored to the risk profile of the specific bank, as assessed in accordance with Annex 1 to the December 2008 Communication.

- **Buying of assets by a Member State**. This should be done according to a valuation that reflects underlying risk, with no undue discrimination between sellers of troubled assets.

- **Other forms of liquidity assistance**. The October 2008 Communication states that these may be justified if they are of wide application and fall within the state aid rules. The Commission recognises that many general measures are an aspect of monetary policy and outside the state aid rules.

- **Controlled winding-up**. In addition, the October Communication deals with the aid measures in the context of the controlled winding-up of financial institutions. This may follow on from rescue aid or take place in a single action. Where parts of a business are sold, the following conditions apply:

  - the sales process should be open and non-discriminatory;
  - the sale should take place on market terms;
  - the sales price should be maximised;
  - if aid is to be given to the business being sold, this must meet normal rescue and restructuring aid guidelines.

There are other specific concerns:

- where any category of creditors is to be reimbursed through aid measures, the same criteria should apply as for a guarantee scheme;
- the liquidation period should be as short as possible to minimise distortion of competition;
- moral hazard (eg, arising from the exclusion of shareholders and some creditors from aid altogether) should be minimised.

The two Commission Communications represent a useful contribution to understanding the Commission's approach in current circumstances to assisting the resolution of the crisis. The Communication on recapitalisation contains a review of the perceived competition risks of aid being given and remaining in place over a significant period of time. Both Communications emphasise the importance of six-monthly reports to the Commission on the operation of national aid schemes for financial institutions and the establishment of a clear path towards exit from state aid. The Commission will assess behavioural safeguards in the context of its review of these reports. The whole approach is designed to bring in the same rigour as has been applied to state aid surveillance in the past to the proliferating number of aid schemes for financial institutions.[7]

A large number of individual aid packages have also been approved, including Dexia (which is being funded by the Belgian, French and Luxembourg governments), Fortis (the same three countries), Roskilde's managed liquidation (Denmark), and IKB in Germany (to name but a few), again with more still under consideration. The Commission periodically publishes a list of approved and pending applications involving financial institutions.[8]

Temporary framework to address the credit squeeze in the real economy

On November 26th 2008 the European Commission adopted its European Economic Recovery Plan, giving a broad view of economic stimuli that may be applied to European economies under a variety of Community rules.[9] On December 17th the Commission announced a temporary framework under EC Treaty state aid rules providing Member States with additional opportunities to deploy state aid to tackle the effects of the credit squeeze on the real economy.[10] The framework forms part of the economic recovery measures and was approved in record time following consultation with Member States. It reflects the impact of a shortage of interbank lending on the availability of lending to manufacturing and service businesses throughout the EU.

The new framework therefore introduces a number of temporary measures to allow Member States to address the exceptional difficulties experienced by companies in obtaining finance. In particular, Member States will be able to grant, without notification of individual cases, subsidised loans, loan guarantees at a reduced premium, risk capital for small and medium-sized enterprises and direct aids of up to €500,000 within the context of aid schemes and for firms not in difficulty as at July 1st 2008.[11] All measures are limited until the end of 2010 and subject to conditions. Based on Member States' reports, the Commission will evaluate whether the measures should be maintained beyond 2010, depending on whether the crisis continues.

More than in the case of financial institutions, the Commission Communication on the framework indicates adaptations of existing guidance and block exemptions to allow additional aid without the need to notify, and with

an emphasis on assisting small and medium-sized enterprises.

Large-scale aid in the manufacturing or service sectors, whether to a whole industry or an individual business, would still be likely to require specific approval. It remains to be seen how larger-scale aid in the real economy will be approached by the Commission, whose mission for so many years has been to stamp out such aid. It seems probable that some sectoral schemes can be justified, despite the risk that they distort competition between manufacturers from different Member States, but that aid to individual recipients will continue to be closely scrutinised.

The Commission has recently approved the first measures under the temporary framework to tackle the effects of the credit crisis on the real economy.[12] The first measure is a €15 billion loan programme in Germany to provide liquidity for undertakings affected by the credit squeeze. The second, also in Germany, allows federal, regional, or even local authorities to provide aid of up to €500,000 for firms in need. Both are judged compatible with Article 87(3)(b) of the EC Treaty as aid to remedy a serious disturbance in the economy of a Member State. Maintaining reasonable limits on aid that distorts competition in this context will be a tough challenge for the Commission as industry sectors hard hit by the crisis seek further assistance. They approach the task with a real awareness of the issues facing them in what is still a fast-moving situation. For example, within hours of the Commission approving a package for Ireland to recapitalise Anglo Irish Bank with an injection of capital giving it 75% of the bank's capital, the Irish government announced that it would need to move to full nationalisation.[13] There are also indications that the UK and other major Community financial sectors may require further measures to enable them to put their troubles behind them and provide lending to the real economy where this is needed.

Dorothy Livingston

[1] European Commission (2008), 'Communication from the Commission: The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis', 2008 OJ C 270/02, October 13th; European Commission (2008), 'Communication from the Commission: The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition', 2009 OJ C 10/03, January 15th.
[2] See European Commission (2008), 'State Aid: Commission Adopts Temporary Framework for Member States to Tackle Effects of Credit Squeeze on Real Economy', press release IP/08/1993, December 17th.
[3] European Commission (2004), 'Commission Orders Germany to Recover more than €3 bln, Plus Interest, from WestLB and Six other Public Banks', press release IP/04/1261, October 20th. Decisions were reported in OJ L 307, November 7th 2004.
[4] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes as amended by Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees.
[5] European Commission (2008), 'Communication from the Commission: The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition', 2009 OJ C 10/03, January 15th.
[6] European Central Bank (2008), 'Recommendations of the Governing Council of the European Central Bank on the Pricing of Recapitalisations', November 20th.
[7] As at December 5th the Commission had approved full aid schemes for financial institutions in the UK (modifications approved December 23rd), Germany (modifications approved December 12th), the Netherlands, France, Ireland, Portugal and Greece. The Austrian scheme was approved on December 10th, and schemes for Italy, Spain and Latvia were approved on December 23rd. Other applications for approval are in the pipeline and it is probable that the majority of Member States are now contemplating recapitalisation schemes, even if original measures taken did not include recapitalisation—eg, pure guarantee schemes. The Finnish scheme was approved under EEA rules.
[8] Most recently updated on January 12th 2009, in European Commission (2009), 'State Aid: Overview of National Rescue Measures and Guarantee Schemes', press release MEMO/09/5.
[9] European Commission (2008), 'The Commission Launches a Major Recovery Plan for Growth and Jobs, to Boost Demand and Restore Confidence in the European Economy', press release IP/08/1771, November 26th.
[10] See European Commission (2008), 'State Aid: Commission Adopts Temporary Framework for Member States to Tackle Effects of Credit Squeeze on Real Economy', press release IP/08/1993, December 17th.
[11] The fisheries sector is excluded from these measures.
[12] European Commission (2008), 'State Aid: Commission Approves First Real Economy Crisis Measures', press release IP/08/2063, December 30th.
[13] European Commission press release IP09/50, January 14th 2009, and Irish Ministerial Statement of January 15th 2009, 'The funding position of the bank has weakened and unacceptable practices that took place within it have caused serious reputational damage to the bank at a time when overall market sentiment towards it was negative. Accordingly the Government believes that the recapitalisation is not now the appropriate and effective means to secure its continued viability. Therefore the Government must move to the final and decisive step of public ownership.'

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