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Is the European Commission's recent interpretation of Article 107 (3)(b) a departure from established State aid policy on the financial sector?

Eoin Pentony

School of Social Science and Law

Name: Eoin Pentony BA, PGDip.

Student No: D05105088

Title "Is the European Commission's recent interpretation of Article 107 (3)(b) a departure from established State aid policy on the financial sector?"

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Declaration

I, the undersigned, declare that this dissertation which I now submit for the examination for the award of M.A in Law is entirely my own work and has not been taken from the work of others save and to the extent that such work has been fully cited and acknowledged within the text of my own work.

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Signed:

Eoin Pentony

Dated:

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Eoin Pentony

Title	"Is the European Commission's recent interpretation of Article 107 (3)(b) a departure from established State aid policy on the financial sector?"
Objectives:	To briefly review State aid jurisprudence and analyse if the Commission is liberally applying State aid to the financial sector. Attempt to measure the effectiveness of the tools used by the Commission to limit the aid's negative externalities.
Research Methods:	A mixed methodology research approach, utilising both the inductive and deductive methods for a broader, in depth investigation of State aid through both quantitative and qualitative research methods.

Abstract:
Chapter 3.5 The Credit Lyonnais Application

To limit the economic damage of State aid the Commission stated that the *"aid should be proportional to the objectives in question and the amount of aid should be limited to the strict minimum needed for restructuring so that the recipient company itself makes a maximum contribution to the recovery plan"*[1] This complies with the 1994 R&R Report. The Commission decided in *"examining a measure to assist the restructuring of a firm in difficulty, its overall assessment* (was) *to consider whether the common interest is served by the maintenance of the firm in business, given the competition that exists in the industry and the way competition will be affected by the aid."*[2] This *"common interest"* is the social objective by which the Commission currently justifies the use of State aid under Article 107 (3)(b). The Commission concluded "*CL has received State aid equal to at least twice and possibly even three times its current own funds, which amounted to FRF 44 billion in 1997."*[3] This had the result of enabling CL to not only avoid liquidation but to maintain a strong presence in the market.

The Commission ensured proportionality via a "quid pro quo" approach. This reduced the State aid's competitive effects. CL would be eligible for the aid however the firm must give something in return. The Commission minimised distortions to the Common Market by reducing the market share of CL by selling off assets and therefore *"serving to offset as far as possible the distortion of competition caused by the aid."* [4] The "quid pro quo" has the dual effect of raising funds for the beneficiary, through the selling of assets which were then used to finance the restructuring effort. The use of quid pro quo is significant. The Commission in this decision appears to have confused proportionality with quid pro quo. The proportionality test ensures aid is minimal, proportional and necessary. Quid pro quo is a concept outside the test of proportionality. It perpetuates a sense of equivalency, where proportionality imbues a sense of equilibrium.

[1] Commission, *Guidelines on State aid for rescuing and restructuring firms in difficulty* OJC368 23/12/1994 at 2.1
[2] Ibid at 10.5.
[3] Ibid.
[4] Ibid

# Chapter One		Literature Review

The subject of this thesis is a highly focused, contemporary legal issue. The nature of European State aid is such that some economic analysis is necessary to measure the impact of State Aid Policy and case law. The literature pertinent to this topic is wide-ranging, covering the broad disciplines of economics, political theory and law. Therefore it has been necessary to survey a representative sample of the work on all of the issues relevant to this thesis. This thesis seeks to link various key topics and issues which have not thus far been examined together, and so the scope of the review is broad rather than deep. This review will summarise the leading cases, policies and academic works relevant and where necessary, a greater elaboration will be given within the thesis.

This researcher contends that the European Commission's recent interpretation of Article 107 (3)(b) is a departure from established State aid policy on the financial sector.

1.1 What is State Aid?

The most fundamental question in this thesis is: what is state aid? This concept can be understood through an examination of EU law, Commission decisions, Commission reports, case law and relevant academic literature.

Article 107 (1) Treaty Functioning European Union 2008 (TFEU) (ex Article 87 (1)) states:

"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."

Article 107(1) provides that State aid is in principle incompatible with the Common Market. Article 107 does not expressly define the term "State aid".

However the European Court of Justice (ECJ) held in *Italy v Commission*[5] that:

"The aim of Article (87) is to prevent trade between Member State from being affected by benefits granted by the public authorities which, in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of goods. Accordingly, Article (87) does not distinguish between the measures of state intervention concerned by reference to their causes or aims but defines them in relation to their effect."

This seminal decision requires that the Commission examines "*the effect of the measure* (rather) *than its form or the intention of those who grant or receive the aid in question."*[6] This allows the Commission to apply a "before and after test" to the market, "*by carrying out critical analysis of the relevant market both prior to, and following the grant of aid."*[7] This interpretative 'we'll know it when we see it approach' gives the Commission greater independence and greater freedom in identifying State aid. Therefore State aid is not expressly defined, but its effects can be economically assessed.

1.2 The Vademecum Report

The Commission's Vademecum 2008 Report outlines four criteria in categorising State aid.[8] These criteria were developed inline with the *Italy v Commission*[9] decision.

1.2.1 Transfer of state resources

State aid provisions cover measures involving a transfer of state resources- national, regional, local authority, public banks and foundations. This also includes private and public intermediate bodies appointed by a State. Financial transfers include grants, interest rate rebates, loan guarantees, accelerated depreciation allowances, capital injection and tax exemptions. This list is not exhaustive. This was outlined in the broad definition of *France v Commission*, where the European Court of Justice (ECJ) held that *"advantages to be capable*

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[5] *Italy v Commission*, Case 173/73, [1974] ECR 709 para. 13.

[6] Flynn L, *Permissible Public Intervention in Markets and Substantive EC Law on State Aid ITLR Vol 20 No 6 at 87* (2002).

[7] O'Connor H A, *The Rights and Wrongs of State Aids* 15ILT 29 (1997).

[8] European Commission, *Vademecum, Community law on State aid*, Brussels, 2008, <http://ec.europa.eu/competition/state_aid/studies_reports/vademecum_on_rules_09_2008_en.pdf> at 19/2/10.

[9] *Italy v Commission*, Case 173/73, [1974] ECR 709 para. 13.

of being categorised as aid within the meaning of Article 87 (1)EC, they must first be granted directly or indirectly through State resources...and, second, be imputable to the State."[10] The imputability test of State aid is a new high standard at which the Commission applied to source the origins of State aid. Flynn[11] highlights the test used by the ECJ in the *Commission v France (1985)*[12] case. It was held "*Article (87) covers aid which.....was decided and financed by a public body and the implementation of which is subject to the approval of* (a) *public"* body. Further to this in the case *Pearle & Others*[13], the ECJ held that the requirement for State aid origins has just two elements *"direct and indirect use of State resources and the aid is imputable to the State."*[14] The broad standards used by the Commission allows it a wide discretion in identifying State aid.

1.2.2 Economic advantage

The aid should constitute an economic advantage if it is received outside the normal course of business. In the *Welsh Public Sector Network Scheme*[15] case the ECJ defined the concept of economic advantage in *"which the recipient undertaking would not have received under normal market conditions."* This criterion is akin to the traditionally applied Market Economy Investors Principle (MEIP).

The purpose of the MEIP was expressed in the *Siciliana Acque Minerali Srl*[16] case as *"to ensure respect for the principle of neutrality the aid must be assessed as the difference between the terms on which funds were made available by the State to the public enterprise and the terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market economy conditions"* Craig & DeBurca[17] define the MEIP standard as "*whether the undertaking could have obtained the amounts in question on the capital market."*[18] Jacques Bourgeois[19] argues

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[10] *France v Commission*, C-482/00, [2002] ECR I-4397 para 24.
[11] L Flynn, "*Permissible Public Intervention in Markets and Substantive EC Law on State Aid*" [2002] 20 ILT 87
[12] *Commission v France*, Case 290/83 (1985) ECR 439.
[13] *Pearle & Others C-345/02* ECR 1-7139 20.
[14] Steiner,Woods & Twigg-Flesner, *EU Law* (9th Ed., Oxford, 2006) at 654.
[15] Commission Decision No 6/2007, Welsh Public Sector Network Scheme-UK.
[16] Commission Decision No 2000/648/EC Siciliana Acque Minerali Srl at 16
[17] Craig & DeBurca, *EU Law Texts, Cases and Material*" (3rd Ed. Oxford, 2003) at 1141
[18] *Re Tubemeuse: Belgium v Commission,* C-142/87 [1990] ECR I-959 at 25

that the MEIP is too simplistic. The very use of state resources should disqualify State aid under the MEIP. Ignoring this, Bourgeois argues that a "benefit" must be felt by the member state to qualify the aid under MEIP: *"..only advantages which are granted directly or indirectly through state resources are to be regarded as state aid within the meaning of Article 87 (1)."*[20] This is a low standard because by its very nature, State aid should bestow a benefit on the recipient. Bourgeois highlights in the *Credit Lyonnais*[21] case, the Commission considered further factors outside the MEIP, such as the duration of the aid, degree of risk and rate of return to analyse the market conditions of the recapitalisation.

The economic advantage criterion encompasses all areas of MEIP in addition to an analysis of normal market conditions. The use of the economic advantage criteria negates the public funding versus private funding debate and focuses on the economic market conditions. This brings State aid analysis in line with the Competition Rules of Article 101 TFEU (ex Article 81) and Article 102 TFEU (ex Article 82).

State aid under Article 107 (3)(b) will always fail the MEIP, national banking guarantees and state recapitalisations are by their very nature outside the MEIP. The Commission has had to develop further tests to analyse State aid. If an undertaking fails the MEIP, the Commission will apply a selectivity test, failing this the Commission will apply a proportionality test and or the newest IAC Test (see all tests below). Although the MEIP is it still used it has little application for State aid of this nature.

1.2.3 Selectivity

State aid is deemed to exist if it is selective in nature. Selectivity exists if authorities administering the scheme have discretion over any preferential treatment. The issue of selectivity is the "preferential" or "unequal treatment" between competitive organisations.

Aid applied generally is not categorised as State aid. However the distinction between the two types of aid is difficult to determine in practice. Services of general economic interest (SGEI)[22]

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[19] Bourgeois J, *EU Rules on State Aids and the WTO Provision on Subsidies Compared European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,* (1st Ed., Oxford 1999)

[20] *Firma Sloman Neptune Schiffahrts AG v Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schhiffahrts Ag* C-72/91 and C-73/91 (1993)

[21] Commission Decision No 95/547/EEC (1996) (Credit Lyonnais)

[22] Also known as Universal Service Obligations.

such as bus services or telecommunications services are a good example of this difficulty. SGEIs serve a *"fundamental function in all Member States"*[23] but they are selective by definition, one service favoured over another. There was much debate on SGEIs until the seminal decision in the *Almark Trans*[24] case, where it was held that services of general economic interest (SGEI) would not be considered State aid where:

1. The recipient undertaking must actually have public service obligation to discharge.
2. The compensation should not exceed costs plus reasonable profit.
3. The parameters for compensation are objective, transparent, and are established in advance.
4. The tendering process is public. [25]

State aid to the financial sector falls outside the remit of the SGEI because it is beyond the parameters set out in *Almark Trans.*

The test for selectivity expressed in the *Adria-Wien*[26] case states: *"as to favour certain undertakings or the production of certain goods within the meaning of Article 87 (1) of the Treaty in comparison with other undertaking which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question."*

The *Adria-Wein* definition highlights the need for comparability not only within the same economic sector but between undertakings pursuing the same objective across the European Union.

1.2.4 **Effect on Competition & Trade**

Aid must have a potential effect on competition and trade between member states. This criterion is a combination of the traditionally used "*distort, or threaten to distort competition*" and "*effect on inter-state trade.*"

[23] European Commission, *Services of general economic interest and state aid*, Brussels 2002 at <http://ec.europa.eu/competition/state_aid/reform/archive_docs/1759_sieg_en.pdf> at 20/03/10.
[24] *Altmark Trans Gmbh, v Nahverkehrsgellschaft*, [2003] ECR I-1774.
[25] *Altmark Trans Gmbh, v Nahverkehrsgellschaft*, [2003] ECR I-1774.
[26] *Adria-Wien Pipeline and others v Finanzlandesdirektion fur Karnten* C-143/99 [2001] ECR I-8365, para. 41.

1. Distort/threaten to distort competition

In the case of *Phillip Morris,*[27] the ECJ held that to distort competition means *"that the aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade."* Craig & DeBurca state the requirement that State aid should "*distort or threaten to distort competition"* is unproblematic.[28] The use of State aid will by its very nature, place the beneficiary in an advantageous position. The Court will consider whether the beneficiary of the aid is in a stronger position post State aid injection.

2. Effect on inter-state trade.

There should be an effect on inter-state trade. The Commission must prove that trade *"may"* be affected. It does not have to prove that trade *"was"* affected. Further to this, the size of the aid or the size of the beneficiary does not exclude the possibility that trade may be affected.

State aid should have an "e*ffect on inter-state trade"* the Commission focuses on the potential effect, rather than an actual effect. It is therefore not necessary for the beneficiary to actually be involved in inter-state trade. The motivation behind this is *"the aid might make it harder for a competitor in another Member State to break into the national market."*[29] These criteria are so closely related that the Commission has recently combined them in the Vademecum Report; "*the beneficiary must engage in an economic activity and it must operate in a market in which there is trade between Member States.*"[30] This definition is so broad it is difficult to imagine an undertaking outside its scope.

1.3 State Aid and the Common Market

The *"integration and the maintenance of a fair competitive market form two central themes of the Community."*[31] The Commission uses State aid regulation as an economic tool to ensure the integration and maintenance of a fair competitive market. State aid regulation is therefore intrinsically linked to the Common Market.

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[27] *Phillip Morris Holland v Commission* Case 730/79 (1980) ECR 2671.

[28] Craig & DeBurca, *EU Law* (3rd Ed., Oxford 2003) at 1148

[29] Steiner,Woods & Twigg-Flesner, *EU Law* (9th Ed., Oxford, 2006) at 655

[30] European Commissions, *The application of State aid rules to measure taken in relation to financial institution in the context of the current global financial crisis,* (2008, Brussels).
<http://ec.europa.eu/competition/state_aid/legislation/banking_crisis_paper.pdf > at 19/02/10

[31] O Connor H, *The rights and wrongs of state aid* (1997) 15ILT 29.

Politically, State aid regulation is necessary to prevent the member states from "*subsidising or… supporting domestic actors*" which *"might be viewed by other member states as beggaring thy Community neighbor."*[32] Therefore State aid regulation encourages not only economic integration but it preserves political integration by limiting the use of unfair domestic economic policy. This integration is paramount for an economic union as it serves to promote economic and political stability.

In economic terms the use of State aid is justified to correct a market failure. Gual distinguishes two categories to justify the use of State aid: [33]

1. Programmes of efficiency: a programme designed to address market failure through "efficiency objectives" such as Research & Development (R&D) or capital market imperfections in relation to Small to Medium Enterprises (SMEs).
2. Programmes of equity: a programme designed to pursue "equitable objectives" such as protecting jobs or income levels.

This distinction is significant: State aid programmes of efficiency result in an increase of output and therefore a lowering of costs to enterprises and to consumers. In contrast equitable State aid programmes alter market structures resulting in higher prices and lower competition. Essentially programmes of equity distort the market, whilst programmes of efficiency streamline the market. This distinction has guided the Commission to discourage the use of equitable State aid programmes and encourage the development of efficiency programmes.[34] Buigues[35] argues that it is impossible to strictly categorise the two types of aid in economic terms. There will always be positive and negative externalities[36] when using equity or efficiency aid programmes. Buigues

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[32] Doleys T.J, *Fifty Years of Molding Article 87:The European Commission and the Development of EU State Aid Policy* 2009,< http://www.unc.edu/euce/eusa2009/papers/doleys_10H.pdf > at 19/02/2010

[33] Gual J, *Aggregate Targets for State Aid Reduction in the European Union, European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,* (1st Ed., 1999, Oxford).

[34] The Commission has encouraged the use of "cross industry" or "horizontal rules" such as Research, Innovation & Development, Small to Medium Enterprises, Services of General Economic Interest, Environmental Aid, Training Aid, Aid to Female Entrepreneurship, Aid for Disabled Workers and Rescue & Restructuring Aid as part of a trend towards efficient aid.

[35]Buigues P, *State Aid and Market Failure: The Quantification Issue, European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,* (1st Ed., 1999, Oxford).

[36] An externality is an external effect, seen or unseen. The best example is atmospheric pollution.

therefore recommends the use of a proportionality test. State aid should only be granted if the positive externalities outweigh the negative externalities. Verouden argues that the equity/efficiency distinction is not always mutually exclusive.[37] Even within an efficiency programme the use of State aid by a member state always favours one region/undertaking at the expensive of another region/undertaking. This process can be seen in the *Credit Lyonnais* case[38] where a programme of equity was used for an overall efficiency objective. Verouden's argument culminates with the idea that if State aid is just used to alleviate a market failure, would it not be prudent for governments to use other more direct instruments such as tax, in such instances? The idea although interesting, would not be suitable as a remedy for the current economic crisis. The European Commission considers the recapitalisation of credit institutions as a necessary tool to fix the financial sector and the wider economy. "*The recapitalisation of vulnerable systemically relevant financial institutions was recognised....*(to encourage) *the stability of the* (economic) *system."*[39] State aid is an appropriate response for a market failure within the banking system because of the speed with which aid can be granted (compared to the effect of reducing taxes) and in the case of banking guarantees because of the authority and sovereignty that only a government can provide. Aid given from another source would not have the same meaning or impact. *"Among the best security which can be given to bank lenders or bond investors is the guarantee of the government of an OECD member.*"[40]

The distinction between types of State aid is important because it has allowed the Commission to develop better targeted State aid. However it must be recognised that recapitalisation programmes and banking guarantees are programmes of equity and not the traditional efficiency programmes encouraged by the Commission. NAMA is a programme of equity with the social objective of stabilising the financial sector (an efficiency aim). *"Officials expect Nama to*

[37]Verouden V, *EC State Aid Control:An Economics Perspective,* (1st Ed., Cambridge,2006).
[38] Commission Decision 95/547/EEC 1996 (Credit Lyonnais)
[39] European Commissions, *The application of State aid rules to measure taken in relation to financial institution in the context of the current global financial crisis,* (Brussels, 2008).
<http://ec.europa.eu/competition/state_aid/legislation/banking_crisis_paper.pdf > at 19/02/10
[40] Ehlermann & Everson, *Unapproved State Guarantee for Bank Loans and Other Borrowings :Legal and Policy Issues*" *European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,*(1st Ed., Oxford,1999,).

recover EUR 4 billion from selling properties and other assets"[41]per annum. Selling of these properties will increase the supply of property on the market and will therefore suppress the price of Irish property and the market's overall recovery. It is this type of market distortion that the Commission through Article 107 (3)(b) has traditionally endeavoured to avoid. This is evidence that the Commission has moved away from its traditional position on State aid policy.

1.4 Exemptions to State Aid

Where State aid is deemed to exist by the Commission or ECJ, member states may apply under the exemptions to Article 107 (1) via Article 107 (2) or Article 107 (3).

Article 107(1) provides that State aid is in principle incompatible with the Common Market. Article 107 (2) provides exemptions from Art 107(1) in the areas of socio-economic aid[42], environmental aid[43] and economic aid for German reunification[44]

*"*Article 107 (2)(1) states: *"The following shall be compatible with the internal market:*

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

(b) aid to make good damage caused by natural disaster or exceptional occurrences;

(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division."

Craig & DeBurca state the socio-economic aid exemption is limited for use where "*there is no discrimination, as to the good's origin.*"[45] Since most State aid is directed at a particular undertaking, the exemption will not apply.

The exemption under Article 107 (2)(b) covers State aid for environmental disasters. The ECJ laid down the test in *Olympiaki v Commission*[46] as *"only damage caused by natural disasters or*

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[41] Carswell S, *The anatomy of Nama*, The Irish Times 13/1/09 < www.irishtimes.com/focus/2009/nama-explained/index.pdf> 23/05/10

[42] Article 107 (2)(a).

[43] Article 107 (2)(b).

[44] Article 107 (2)(c).

[45] Craig & DeBurca, *EU Law Texts, Cases and Materials* (2003 3rd Ed. Oxford) at 1146.

exceptional occurrences may be compensated for under that provision." The recent volcano activity affecting the airline industries would be a good candidate under this type of aid. Finally Article 107 (2)(c) provides for the economic position of Germany, as a result of German Reunification. Craig & DeBurca state that it is a self-defined provision with limited application.[47]

Article 107(3) outlines broad areas for exemptions to Article 107(1).
Article 107(3)(a) states: *"aid to promote the economic development of areas where the standard of living is abnormally low or where there is a serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation."* [48] This Article provides for acceptable aid in areas of "*substandard living*" or "*serious underemployment*." This Article allows State aid or "*national regional aid*"[49] for socio economic disadvantaged areas of the European Union. The wording of the Article expresses the serious level at which the State aid be implemented where the "*living* (standard) *is abnormally low or where there is a serious under employment."*[50] State aid granted under this Article must be "*used sparingly, be proportional and concentrated on the most disadvantaged regions."*[51] Furthermore the economic advantages gained by the State aid must outweigh the distortions to competition. The Commission has published a formula[52] outlining the criteria for granting aid under this exception. The formula includes population density and unemployment levels between regions at both a national and Community level. The Article is interpreted at a pan European level rather

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[46] *Olympiaki Aeroporia Ypiesies AE v Commission*, [2008] Case T-268/06, 2008
[47] Craig & DeBurca, *EU Law Texts, Cases and Materials* (3rd Ed. Oxford, 2003) at 1147.
[48] Article 107 3 (d) and (e) do not have economic applications and are therefore outside the remit of this thesis.
[49] Craig & DeBurca, *EU Law Texts, Cases and Materials* (3rd Ed. Oxford, 2003) at 1147.
[50] Ibid at 1147.
[51] European Commission, *Guidelines on National Regional Aid*, Brussels, 1998 OJ C74/6.< http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:054:0013:0044:EN:PDF > at 19/02/2010.
[52] Ibid.

than a national level-*"the Commission looks not to national levels of employment and income but to the standard of the Community as a whole."*[53]

Article 107 (3)(b) contains two separate exemptions to State aid:

1. Aid "to *promote the execution of an important project of common European interest*"

This Project Exemption was outlined in the *Glaverbel v Commission*[54]case, here the ECJ held that a project may not be described as being a European Project unless *"it forms part of a transnational European programme supported jointly be a number of governments of the Member States…or to combat a common threat such as environmental pollution."* Therefore only coordination of aid between European governments would qualify aid under this provision.

2. Aid to "*remedy a serious disturbance in the economy of a Member State*".

The use of this Article has increased since the financial crisis began in September 2008. The Commission has *"recognised that the severity of the crisis justified the granting on the basis of"*[55] Article 107 (3)(b). This Article allows State aid for sectors experiencing a systemic failure or crisis.

Craig & DeBurca highlight the traditional rare utilisation of Article 107 (3)(b) since *"the economic problems must afflict the whole of the national economy."* [56] Steiner states the Commission's primary concern *"is to prevent the grant*(ing) *of State aid from exacerbating existing problems"* and "*from transferring them from one State to another."* [57] Steiner states that the Commission will "*not allow Member States to shore up obsolete structures"* or *"grant relief to rescue firms which are incapable of adjusting to conditions of competition*." [58] The Commission will allow aid from *"supporting bodies....to support financial agencies, through the maintenance and guarantee obligations, on a sectoral basis...to compensate for disadvantages*

[53]Steiner,Woods & Twigg-Flesner, *EU Law* (9th Ed., Oxford, 2006) at 657.
[54] *Executif Regional Wallon and SA Glaverbel v* Commission [1988] ECR 1573.
[55] European Commission, *State Aid Scoreboard,* COM (2009) Brussels 2009.
< http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0661:FIN:EN:PDF>
[56] Craig & De Burca *EU Law Texts, Cases and Materials* (3rd Ed. Oxford 2003) at 1149.
[57] Steiner,Woods & Twigg-Flesner "*EU Law*" (9th Ed., Oxford 2006) at 657.
[58] Ibid.

incurred by the agencies by virtue of the fulfilment of their public function."[59] This gives the Commission a wide discretion to grant State aid to bodies with a public function.

The Commission has published a series of Reports[60] (the Crisis Framework (below at 1.5))[61] to *"set out a coherent framework"* to ensure *"a level playing field between"*[62] member states. Steiner highlights that aid will only be permitted to "*sound economic structures, to enable an industry to become competitive, to resolve underlying problems* (and) *not to postpone or shift the solution."*[63] This is reinforced in the Commission's Recap Report *"it would not be justified to keep a firm artificially alive in a sector with long term structural overcapacity or when it can only survive as a result of repeated State intervention.*"[64]
Craig & DeBurca stress that the aid may be given to a particular region or industry and the need for the aid may be at a *"national and not just a Community dimension."*[65] This provision is unique, as all other exemptions are judged at a pan European level.

1.5 The Crisis Framework

The Commission has published a "Crisis Framework." This guides the member states in a uniform response to the financial crisis in the area of State aid. "*The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis"*[66] (the Banking Communication) was the first report published since the beginning of the current economic crisis. The Banking Communication provides a framework for recapitalisation, banking guarantee schemes and ad hoc measures compatible with State aid.

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[59] Koenig C, *State Guarantees for the German Landesbanken and the EC State aid regime,* European Business Law Review VOL 9 no 11-12 at 381-388 (1998).
[60] The Reports are soft law instruments and are used to guide a Member State on state aid limitations.
[61]The Banking Report, the IAC Report, the R&R Report, the Recap Report and the Viability Report. Detailed where relevant to this dissertation.
[62] European Commission, S*tate Aid Scoreboard,* COM (2009) Brussels 2009 , 661 at 8
[63] Steiner,Woods & Twigg-Flesner, *EU Law* (9th Ed., Oxford,2006) at 658
[64] European Commission, *Community Guidelines on State aid for Rescuing and Restructuring firms in difficulty,* (2004 Brussels.)< http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:244:0002:0017:EN:PDF> 19/02/10
[65] Craig & De Burca "*EU Law Texts, Cases and Materials*" (3rd Ed. Oxford 2003) at 1151
[66] European 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/C 270/02 Brussels, 2008.

Gibson-Bolton[67] states the Banking Communication was published in direct response to the collapse of Lehman Brothers. Before the publication of the Banking Communication the *"banks became even more reluctant to lend to one another."*[68] The Banking Communication resulted in an *"almost unprecedented basis for approvals"*[69] authorised by the Commission under Article 107(3)(b). The Banking Communication emphasizes the difficulties faced not only by ailing banks, but also by banks that are fundamentally sound and are facing a crisis stemming from the collapse of the inter-bank credit market. This distinction has major consequences for Irish banks involved with the National Assets Management Agency (NAMA). It indicates that a bank's survival is not guaranteed under NAMA.

The Commission is not obliged to grant State aid to every bank. Petersen states that the Commission has historically allowed banks to collapse. *"It has demonstrated its conviction that state aid can be avoided in most cases through the swift and resolute intervention of the....Central Bank."*[70] This is evidenced by the collapse of Barings and BCCI.

The Banking Communication quickly differentiates between State aid applications for *"individual undertakings or a group of undertakings or an ailing sector"* under Article 107 (3)(c) and aid under Article 107 (3)(b); "*aid undertaken to address this systemic crisis."*[71] This reinforces the distinct application of the Articles 107 (3)(b) and Article 107 (3)(c). The Commission utilised a three pronged proportionality test to investigate Ireland's application for a Banking Guarantee under Article 107 (3)(b).[72] The test consisted of:

- Appropriateness: the aid is targeted to remedy a serious disturbance in the entire economy.
- Necessity: the aid is the minimum amount necessary to achieve its objective
- Proportionality: the negative externalities to competition are balanced against the positive effects of the measure.

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[67] Gibson Bolton E, *Bank bailout, state aid and the financial crisis* 4 CRI 162 (2009).
[68] Ibid.
[69] Gibson Bolton E, *Bank bailout, state aid and the financial crisis* 4 CRI 162 (2009).
[70] Petersen A, *European Competition Law Annual 1999, Selected Issues in the field of State Aids* (Oxford 1st Ed., 2001).
[71] [71] European Commissions, *The application of State aid rules to measure taken in relation to financial institution in the context of the current global financial crisis,* (2008,Brussels). < http://ec.europa.eu/competition/state_aid/legislation/banking_crisis_paper.pdf > at 19/02/10
[72] Commission Decision No NN048/08 *Ireland, Guarantee scheme for banks in Ireland,* Brussels, 2008.

The Commission did not raise an objection under Ireland's application for State aid. The three pronged test reiterates the proportionality test favoured by Craig & DeBurca and Buiges.
Barrett highlights the importance of the temporary nature[73] of any State aid. The Irish Banking Guarantee Scheme will run until 29th September 2010.[74] Barrett argues that another scheme will be needed to replace the current Guarantee, but the range and depth would not be as drastic *"it seems unlikely that such a scheme would necessitate the same comprehensive re-shaping of Ireland's existing legal framework"*[75] (see further information in 5.2).

The *"Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis"* (Recap Report)[76] reinforces the idea that recapitalisation of the banks are central to the recovery of the financial sector. Any financial interventions have to be decided at a national level but within a *"coordinated* (European) *framework."*[77] However the Commission expresses caution on the assumption that fully recapitalised banks automatically start lending into the real economy. The Commission states any intervention should be *"well targeted to guarantee that banks resume their normal lending activities."*[78] The Recap Report culminates by stating the two central objectives of any state intervention. Firstly, to *"unblock bank lending to companies and thereby guarantee continuity in their access to finance"*[79] and secondly, to *"to encourage companies to continue investing in...sustainable growth."*[80]

The Commission's *Community Guidelines on State aid for Rescuing and Restructuring firms in difficulty* (R&R Report) [81] is a useful comparison to the Crisis Framework because it has been

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[73] Barrett M, *The Irish State Guarantee Scheme and the Irish Deposit Protection Scheme (2008) 15(11)CPL 255*
[74] Credit Institution Financial Support Act (2008) S1.
[75] Commission Decision No NN048/08 *Ireland, Guarantee scheme for banks in Ireland,* Brussels, 2008.
[76] Commission, *Temporary framework for State aid measure to support access to finance in the current financial and economic crisis* (2009/C 83/01) Brussels (2009).
[77] European Commissions, "*The application of State aid rules to measure taken in relation to financial institution in the context of the current global financial crisis"*, Brussels (2008) <http://ec.europa.eu/competition/state_aid/legislation/banking_crisis_paper.pdf > at 19/02/10
[78] Barrett M, *The Irish State Guarantee Scheme and the Irish Deposit Protection Scheme* (2008) 15(11)CPL 255
[79] Ibid
[80] Ibid
[81] European Commission, *Community Guidelines on State aid for Rescuing & Restructuring Firms in difficulty,* C244/02, Brussels 5/12/08,

developed under Article 107 (3)(c) applications since 1994. This Report has been updated and extended since 1994 in response to the needs of *"firms in difficulty"*[82]in both periods of economic growth and contraction.[83] The proportionality test was codified in the 1994 R&R Report. However it's effect was limited to a one undertaking under Article 107 (3)(c). The use of the proportionality test at a systemic level is untested. In theory, there is no limit to the amount of State aid that could be granted under Article 107 (3)(b) (see discussion in section 4.1). The R&R Report is also significant because the newer guidelines listed under Article 107 (3)(b)[84] are converging with the older guidelines listed under the R&R Report (under Article 107 (3)(c)). This hybridisation of the guidelines is further evidence of a dilution of the traditional position of the European Commission regarding Article 107 (3)(b).

The Commission's Report on the *"Treatment of Impaired Assets in the Community Banking Sector"* (IAC)[85] was published in response to the *"popularity..of governments reducing banks' exposure to so-called toxic assets by purchasing"*[86] the assets and isolating them.
The IAC highlights the need for a "*common and co-ordinated Community approach"*[87] through boosting market confidence, limiting negative spillovers among member states, protecting the single financial market and ensuring compliance with State aid regulations. Barrett highlights *"the Directive 2009/14/EC requires that the minimum coverage under deposit-guarantee schemes should be €50,000 per depositor*"[88] and "*Ireland has elected at this time to prescribe a minimum amount of deposit guarantee protection (€100,000)."*[89] This spillover effect is prohibited under IAC.[90] Ireland was allowed a greater level because of the advent of financial crisis under Article 107 (3)(b).The Commission is currently examining the €50,000 limit

< http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:244:0002:0017:EN:PDF> at 19/02/10
82 Above n 75
83 This is contrasted to Article 107 3(b) which is traditionally used in periods of economic crisis
84 The guidelines include: *The application of state aid rules to measure taken in relation to financial institutions in the context of the global financial crisis 2008, the recapitalisation of financial institutions in the current financial crisis 2008, the Commissions communication on the return to viability and the assessment of restructuring measure in the financial sector 2009* and *the Treatment of Impaired Assets in the Community Banking Sector 2009*
85 European Commission *Treatment of Impaired Assets in the Community Banking Sector,* Brussels, 25/02/09.
86 Gibson Bolton E, *Bank bailout, state aid and the financial crisis* (2009) 4 CRI 162
87 Above n 79
88 Commission Decision No NN048/08 *Ireland, Guarantee scheme for banks in Ireland,*. Brussels, 2008
89 Ibid
90 Above n 79

provided under Directive 2009/14/EC. This European limit is expected to be increased to match the Irish limit.

This is to be decided by December 31st 2010.[91] If the Commission does not increase the level, Ireland will have to decrease the Banking Guarantee level inline with the Directive 2009/14/EC, thereby nullifying any economic spillover. This will effect any extension to the Irish Guarantee Scheme under the CIFS (see discussion in 5.2)

The IAC also calls on banks to be wound up if there is a situation of *"technical insolvency without State intervention."*[92] This will have a huge impact on the beneficiaries of NAMA.

There is evidence that three of the six institutions are insolvent (see 4.1). The Commission by granting aid to insolvent firms will have departed from its newly created Crisis Framework. The IAC also reiterates the proportionality test laid out by the R&R Report. Therefore the Commission advocates the express use of the proportionality test under Article 107 (3)(b). However as evidenced below, there is an issue in the appropriate use of the proportionality test under Article 107 (3)(b) (see discussion in 4.1 & 4.7).

In conclusion a review of the pertinent official documentation and academic literature in this area expresses that the Commission uses State aid as an economic tool rather than an outright prohibited act. Extensive economics analysis has guided the Commission to encourage better methods of State aid which will benefit rather than hinder the Common Market. The Commission's Vademecum Report outlines the current criteria for State aid. The criteria compress thirty years of State aid into four factors. The Commission has advocated the use of up to date economic tools such as the proportionality test and the MEIP all within a recently published Crisis Framework.

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[91]Commission Decision No NN048/08 *Ireland, Guarantee scheme for banks in Ireland,* Brussels, 2008

[92] Above n 79

Chapter Two The Economics of State aid

EU State aid control is an essential part of competition policy and ensures uniform regulation of the Single European Market. Article 107 of the Treaty of the Functioning of the European Union (TFEU) provides a framework for the use of State aid by member states. The use of State aid by a member state would firstly give an unfair competitive advantage to that member state and by doing so would threaten the Single European Market. "*State aid rules, first and utmost, ensure a level playing field for European companies*."[93] Secondly, strict regulation of State aid prevents the use of protectionist policies and averts the creation of a subsidy race amongst member states. The Commission encourages member states "*to solve structural problems rather than merely masking them.*"[94] The member states must focus on adapting internal demand, division of labour and/or increase the efficiency of production through research and development. Thirdly the Commission recognises State aid as an effective tool that can be used to prioritise regional development and more recently combat distressed sectoral development. These tools include the development of the State Aid Action Plan[95], the use of block exemptions[96] and the *de minis* doctrine.[97]

The resulting levels of pan European State aid have fallen by around 2% of GDP per annum for the last ten years and were at 0.5% in 2007.[98] The unemployment rate fell over the same period at was 7% EU-wide in 2008. Budget deficits decreased and EU-wide GDP has grown by

[93] European Commission *Vademecum, Community law on State aid*, Brussels, (2008).
[94] European Commission *Fifth Report on Competition Policy*, Brussels, (1976).
[95] The State Aid Action Plan is guide to the future developments in State aid.
[96] The Commission is codifying State aid exemptions which promote programmes of efficiency such as R&D.
[97] This doctrine is a minimum standard below which funding is not considered State aid. Its economic effect is deemed minimal.
[98] European Commission, *Autumn 2009 Report*, Brussels COM (2009) 661 at 3

1.5% per annum in the same period.[99] The steady decrease of the overall levels of State aid since 1997[100] is a result of:

- Economic growth had impacted in less rescue and restructuring State aid for ailing firms.
- Coal Sector State aid had continued to decrease in Poland, France, Germany and Spain
- Successful pre-accession and post-accession commitments by members states that joined in or after 2004.

Ultimately the reasons for the decrease have been from the Commission's tough stance on State aid on the industrial sectors and the restructuring of State aid by the accession states as a term of membership of the EU.

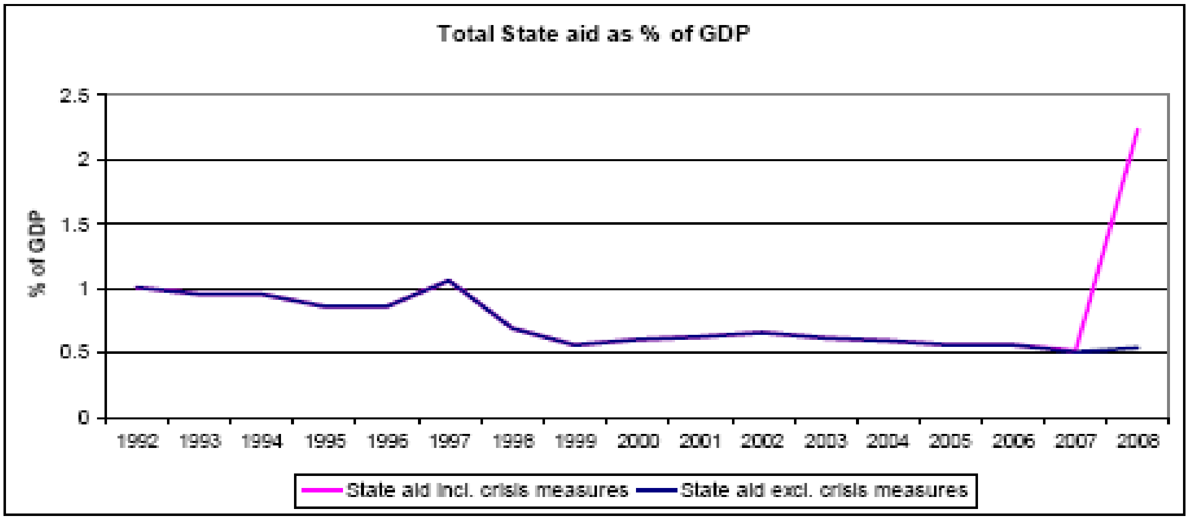
2.1 The Financial Crisis and State Aid

The financial crisis in September 2008 caused an abrupt end to this decade of prosperity. Unemployment rose to 9% by July 2009, the EU-wide GDP has fallen by approximately 4% in 2009.[101] The use of State aid has increased as member states injected aid to stabilise their economies. The EU-27 injected EUR 212.2 billion or 1.7% GDP in State aid in 2008.[102]

[99] European Commission, *Autumn 2009 Report*, Brussels COM (2009) 661 at 3
[100] European Commission ,*Autumn 2009 Report*, Brussels COM (2009) 661 at 7
[101] European Commission, *State Aid Scoreboard 2009*, Brussels SEC (2009) 1638
[102] European Commission, *Fact & figures on State aid in the EU Member States* Brussels SEC (2009) 1638

It is worth noting that although overall levels of State aid have increased (pink line), the levels of pre crisis aid have continued to decrease (purple line). The increase in State aid is due to member states' crisis measures and in particular State aid measures within domestic financial sectors.

Fig 1 Total aid as % of GDP EU-27[103]



2.2 The Financial Sector

The Commission views a stable banking system as "*key to provide the economy with liquidity… in the form of credit*."[104] The member states have injected vast amounts of aid to shore up their financial sectors. Ireland has contributed EUR 376 billion into the Banking Guarantee and the total EU-27 contributions was approximately EUR 3044.6 billion[105] from 2008 to 2009.

The speed and uncertainty of the financial crisis has left the Commission struggling to process Article 107 exemption applications. "*These… exceptional times are making new demands on the state aid system and… we have room to manoeuvre as we figure our way through this crisis.*"[106]

[103] European Commission, *Vademecum, Community law on State aid*, Brussels, 2008, <http://ec.europa.eu/competition/state_aid/studies_reports/vademecum_on_rules_09_2008_en.pdf> at 19/2/10
[104] European Commission, *Autumn 2009 Report*, Brussels COM (2009) 661
[105] This includes guarantee schemes, recapitalisation schemes, liquidity interventions and asset relief interventions.
[106] Kroes N, EU Competition Commissioner, Brussels 28/11/08

Several member states have described State aid policy as a barrier to recovery. Swedish Minister of Finance Anders Borg said *"we have to call off these legions of state aid bureaucrats*."[107]

There is a balance between a member state's request for State aid and the Commission's power to authorise that aid. If the Commission rejects or is to slow to authorise State aid, the member states might:

1. Rebel from the Commission's authority and implement the aid.
2. Await a long term answer and the beneficiary of the State aid might fail.

The first scenario would undermine the position of the Commission and would cause both political and legal EU wide damage. The second scenario would cause political and economic damage at a domestic level and undermine the 'l'esprit de l'Union europeenne'. Further to both of these scenarios, the 'realpolitik' might obligate a member State to grant State aid regardless. The financial crisis has acutely highlighted this balance and the Commission has reacted with the publication of the Crisis Framework outlining State aid policy in particular sectors (discussed at 4.1).

[107] EUBusiness, *EU competition watchdog defends tough state aid rules* http://www.eubusiness.com/news-eu/1228475823.02/ 22/06/10

Chapter Three The development of Article 107 (3)(b) 1971-2007

The parameters for State aid have developed incrementally through a combination of case law, the Commission's decisions and the Commission's frameworks. The development of State aid has been tied closely to the economic growth of the European Community. This chapter analyzes banking guarantees, credit facilities and "ring fencing" models utilised by the member states since 1971.[108] In addition other State aid trends have been included where relevant to this dissertation.

From 1971 to 1994 the Commission gradually extended State aid policy to accommodate the deteriorating economic circumstances of the member states. The Commission limited the State aid applications within programmes of efficiency. This limit was passed only on two extraordinary occasions, the 1975 Energy Crisis and the 1978 Belgian Economic Crisis, on both occasions the Commission tempered the effects of the State aid. In 1994 the Commission abandoned the equity/efficiency in favour of a proportionality test applied in the *Credit Lyonnais* case. This marked a new direction in State aid regulation. However the appropriateness of the proportionality test on the services sector is at question (see below).

Despite the distinct functions of Articles 107 (3)(b) and (3)(c), there is an overlap in the development of these Articles. Whilst Article 107 (3)(b) is concerned with remedying *"a serious disturbance in the economy of a Member State"* Article 107 (3)(c)'s remit 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."* Therefore Article 107 (3)(b) applies at a national level, whereas Article 107 (3)(c) applies on a sectoral level. There is evidence of a convergence of the criteria used to assess these Articles. Article 107(3)(c) has been used by the member states with greater frequency and therefore it has been developed further. In contrast Article 107(3)(b) is rarely used and is it not as evolved. This convergence will be further discussed below. For this reason both Articles have been included in this analysis.

[108] 1971 was the year when the Commission started compiling State Aid Annual Records

The majority of the earliest cases were investigated by the Commission under Article 108 TFEU (ex Article 93 2) *"The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid…the Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.*"

The considerable use of Article 108 (ex Article 93 (2)) resulted from the Commission's initial political struggle to regulate State aid. This struggle dominated the Commission's early rulings up until the *Belgium v Commission*[109] in 1986 (discussed below). This ruling confirmed the Commission's position as State aid regulator by the European Court of Justice.

3.1 1970-1979

One of the earliest State aid cases involved Belgium in 1971.[110] In this case, it was initially agreed that State aid would be given from "*Societe Nationale de Credit a l'Industrie*" of up to BF 800 million to "*enterprises in difficulty.*" When the fund ran out, the Government granted credits to enterprises in difficulties directly from the Ministry of Economic Affairs' budget. The Commission decided that aid was incompatible with the Common Market where:

1. *"as with all aid to enterprises in difficulty, it effected competition and trade by preventing the consequences of normal play of the market through artificially keeping enterprises alive which could encumber that structure of sectors facing adaptation difficulties and which, in order to stay on the market, might act in such manner as seriously to disturb the market."*

2. *"it fell within the framework of general aid systems and was, therefore, likely to help all enterprises, regardless of sector or geographical location. It was therefore impossible for the Commission to assess its effect."*

3. *"its aim was essentially conservatory in that the purpose was to prevent the closing down of enterprises, and leading to unemployment. No definite undertaking was required from*

[109] *Belgium v Commission* C-234/84 [1986] ECR 2263
[110] OJ No. L 10 of 13 January 1972 p. 22.

the recipients of the credits as regards an effort at adaptation that would enable the enterprises to resume a position which would be competitive.” [111]

State aid in this case was found to be incompatible with the Common Market. The decision shows that State aid:

- must not artificially keep an enterprise alive
- must be sector specific and measurable within that sector
- the beneficiary must undertake action in order to resume a normal unaided trading position.

The Commission justified the aid to prevent the economic problems in Belgium spreading to Europe. Today this justification is known as the “social objective” and it is the deciding factor in State aid. This decision is the starting point from which this researcher will compare all subsequent decisions.

In 1972 the Commission considered an Article 107 (3)(b) application (ex Art 92 (3)(b)) of the Italian Law No 184. The Italian Law No 184 of 22 March 1971 provided for Government intervention *“to encourage the restructuring and the conversion of certain industrial undertakings”*[112] through the creation of two enterprises:

1. *The Instituto Mobiliare Italiano (IMI) which facilitated restructuring programmes to modernize or merge undertakings. The IMI controlled a Lit 40,000 million fund provided by the central government.*

2. *The Gestione e Participazioni Industriali (GEPI) set up several semi state companies designed to reorganise and advise firms in difficulty. The GEPI controlled a Lit 111,000 million fund. The GEPI was able to acquire temporary holdings in enterprises in difficulty and provide preferential credit treatment.*[113]

[111] Commission Decision No 72/34/EEC (1971).
[112] Commission, *IInd Report on Competition Policy 1972,* Brussels, April 1973.
[113] Commission, *IInd Report on Competition Policy 1972* Brussels, April 1973.

The Commission's primary concern was the general application of preferential credit through the GEPI. *"Such credit was of general scope and could be granted to encourage investment by firms completely irrespective of their location or of the industry to which they belong."*[114] However despite this concern, the Commission granted the application on the basis that *"the firms concerned might have been forced to….close down altogether; this would have been bound to worsen further an economic and social climate which is already unfavourable"* and that *"the aim is to cope with essentially transitional difficulties which should disappear once the economic recovery expected is under way"*[115] In this case, the Commission interpreted 107 (3)(b) generously fearing a worsening of the economic climate. Significantly the aid was temporary in nature (a duration of a year) and the actions were designed to remedy a serious economic difficulty.

GEPI and IMI's temporarily acquired several private enterprises. The Commission allowed this where:

1. *the central authority confines itself to the acquisition of certain firms with specified terms, duration and purpose.*
2. *the acquisitions are not general but confined to particular industries.*[116]

Even from this early point, the Commission allowed the ring fencing of bad assets within a well defined central authority confined within a clear remit.

3.1.1 Transparency of GEPI and IMI

The Commission implemented for the first time the requirement of a regular reporting system from a member state. There are also early signs of the conception of the transparent aid principle, which appears in the form of *"the manner in which IMI and GEPI acquisitions were…liquidated and the development of the financial situations of the firms concerned…and any other advantage the firms may have gained elsewhere."*[117]

[114] Commission, *IInd Report on Competition Policy 1972,* Brussels, (1973) at 107.
[115] Ibid.
[116] Commission, *IInd Report on Competition Policy 1972,* Brussels (1973) at 122.
[117] Ibid.

The principle of transparency requires that impact of the aid must measurable. *"Thus the intensity and duration of the aid…must be commensurate with the degree of importance of the aid."*[118] The principle of transparency shows early indications that the Commission was attempting to balance State aid invested vis-a-vis the impact on the market. This is used today as part of the test of proportionality. The use of a regular transparent reporting system will enable the Commission through *"post facto knowledge"*[119] to determine the effects of State aid. The Commission's ability to judge the effects of aid using only *"post facto knowledge"* highlights the limited use of economic forecasting by the Commission in 1972.

3.1.2 State Aid and banking guarantees

The use of a banking guarantee by the Netherlands tested State aid regulation in 1973. The Netherlands guaranteed financial transactions through Nationale Investeringsbank (NIB). State guarantees may be given if they are in the interests of the national economy as a whole. Despite existing as a general application of State aid, they are not directly incompatible with State aid policy. In this case, the State Guarantee was deemed to be within the remit of State aid where the result *"grants a form of official aid to those undertakings receiving support."*[120] Further to this the Commission stated that despite the *"benefit represented by the guarantee is of a qualitative nature and cannot be quantified,"*[121] it is not a barrier for an Article 107 (3)(c) application. The impact of a guarantee is unquantifiable and it is a general application of State aid. Banking guarantees are therefore an exception under State aid regulation. However the ability of a guarantee to stabilize an economy is unparalleled. The cental issue surrounding banking guarantees is when they are used in conjunction with other types of State aid most commonly in rescue and recapitalisation State aid. Historically banking guarantees have obligated the member states to recapitalise any and all firms in difficulty (as discussed in the *Credit Lyonnais* case at 3.5 and Anglo Irish decision at 4.6, 4.7 & 4.8).

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[118] D'Sa R, *European Community Law on State aid* (1st Ed., London 1998).
[119] Commission, *IInd Report on Competition Policy 1972,* Brussels 1973 at 109
[120] Commission, *IIIrd Report on Competition Policy 1973,* Brussels 1974 at 97
[121] Ibid at 97

It is significant to note that the Commission examined the NIB State Guarantee under Article 107 (3)(c) rather than Art 107 (3)(b), as the guarantee was deemed *"within the framework either of sectoral or regional programmes or in respect of specific programmes concerning a specific undertaking."*[122] Therefore its remit was limited. The Commission will therefore consider the economic circumstances surrounding a member state before granting aid under 107 (3)(c) rather then at a Community level.

3.2 The Energy Crisis of 1975

The economic difficulties of 1975 heralded a new determination by the Commission in State aid regulation. The Commission introduced a *"new coordinated machinery ….of differentiated ceilings of aid intensity, transparency, regional specificity, the sectoral repercussions of regional aid and a system of supervision"*[123] The European Council agreed Economic Policy Guidelines where *"Member States which have a balance of payments surplus must implement an economic policy of stimulating a domestic demand and maintaining a high level of employment, without creating new inflationary conditions."*[124] This is consistent with Article 108 (2) (ex Article 93 (2)) "*on application by a Member State, the Council may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the internal market."* However this is subject to Article 108 (3) (ex Article 93 (3)) *"if* (the Commission) *considers that any such plan is not compatible with the internal market having regard to Article 107, it shall without delay",* abolish or alter such aid. The Commission recognised the need for Article 107 (3)(b) intervention was *"justified in boosting investment by granting firms financial benefits in the form of tax deductions or low-interest loans on an automatic or quasi general basis for a limited period."*[125]

[122] Commission *IIIrd Report on Competition Policy 1973,* Brussels 1974 at 118.
[123] Commission 5*th* *Report on Competition Policy 1975,* Brussels 1976 at 68.
[124] Ibid at 95.
[125] Commission *5th Competition Report 1975,* Brussels 1976 at 133.

The Commission granted the member states' schemes with the general requirements that the aid:

- does not artificially extend the life of an ailing firm.
- the beneficiary does not expand production capacity.
- the problems are not shifted to another member state or industry.
- the aid is accompanied by the implementation of restructuring operations.
- it fulfils genuine and important requirements with regard to employment.

The overall social objective was to stabilise the member states economies and prevent further stagnation.

France commenced an aggressive State aid scheme which involved:

- A subsidy of 10% of the value of the firm orders for capital goods or tools for agricultural, commercial, craft businesses or industrial undertakings.
- Long term financing assistance to help firms carry out investment programmes- to increase capacity, create new jobs or conserve energy. The fund is FF5500 million and long term loans can be granted for up to 15 years.

The Commission found the economic measures utilized by the French Government were in line with the European Council's "*adjustments to the economic policy guidelines for 1975.*"[126] The Commission required prior notification to be given for cases "*where long-term subsidized interest loans were granted.*"[127] The 15 year duration of the loans are significant in the development of State aid. The Commission until then required any State aid schemes be temporary in nature, of less than two years. This tempered the uncompetitive effects of State aid. The unusual presence of the European Council underlines the Commission's motivation to grant this extraordinary duration. It should also be noted that the French scheme was a programme of economic efficiency, encouraging the use of R&D, modernisation of machinery and energy conservation. Therefore the State aid granted was consistent with the Commission's Economy Policy on State Aid.

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[126] Commission, *5th Competition Report 1975,* Brussels 1976 at 96.
[127] Ibid at 96.

From 1976 there is a shift away from general applications of State aid, towards a more specified, "aid to employment" or "aid to exports." The Commission discouraged the use of general State aid applications where:

1. There is no specific relationship to the beneficiary industries or beneficiary regions.
2. The Commission cannot assess or measure general applications of State aid.
3. General aid programmes can infringe on specified aid programmes.

In 1979 this trend towards specified aid was criticised by the Commission on the grounds that it was still too general.[128] State aid is incompatible with the Common Market, where it is being used to keep the status quo, such as maintaining employment levels. Further to this, aid for employment is not an economic activity itself and therefore would not fall under the economic exemptions of Article 107.

In 1978 the Commission challenged Belgium under *"firms in difficulty"* through Article 107 (3)(b) on the Clause 75 of the Belgian Act on economic and budgetary reform. The Belgian Clause provides credit for viable "*firms in difficulty in the form of repayable advances, ordinary loans and convertible loans."*[129] The Commission agreed to grant the aid to cases not involving a restructuring plan where:

1. *"if the closure of the firm would cause particularly acute social or industrial problems.*
2. *to the extent necessary to maintain the day to day operation of the firm concerned.*
3. *for a period not exceeding, in principle, six months, the period only to be exceeded in exceptional cases with prior Commission agreement.*
4. *in the forms of loans at market rates of interest."*[130]

This is marked departure from State aid policy. The exemptions granted by the Commission are very broad and would be common in any recession. However the State aid was tempered by a six month limit. The use of *"loans at market rates of interest"* is an early form of the Market

[128] Commission, *9th Competition Report 1979*, Brussels (1980).
[129] Commission, *8th Competition Report 1978* Brussels (1979) at 229.
[130] Ibid at 230.

Economy Investors Principle (MEIP). The MEIP is commonly used today to assess State aid applications.

From 1971 to 1979 the Commission was willing to depart from precedent in two circumstances, firstly, in 1975 when the European Council intervened in extraordinary economic circumstances and secondly, in the 1978 Belgium Application however this was limited by a six month duration.

3.3 Further economic difficulties of 1980-1990

In 1980, the seminal *Philip Morris BV v Commission*[131] case challenged the ability of the Commission to regulate State aid. The ECJ held *"it should be borne in mind that the Commission has a discretion the exercise of which involves economic and social assessments which must be made in Community context."*[132] This ruling places the economic and social assessment of State aid firmly within the Commission's remit.

The Commission also introduced the controversial Transparency Directive.[133] *"The Commission sought to require governments to make available upon request, information on financial transactions concerning the nature and effect of their links with public undertakings."*[134] Several member states challenged this directive and the Commission's legislative ability.[135] The ECJ held that under Article 189 *"the Commission, just as the Council, has the power to issue directives in accordance with the provisions of the Treaty."*[136] This decision and the decision in *Belgium v Commission* [1986] (below) crystallised the Commission's role as regulator and enforcer of State aid. Post *Belgium v Commission* [1986], there is a reduction in Article 108 Commission investigations.

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131 *Philip Morris BV v Commission* 730/79[1980] E.C.R 2671.
132 Ibid at 14.
133 Commission Directive No 80/723/EEC (1980).
134 Above n 27.
135 *France, Italy & UK v Commission* Jointed Cases 188 to 190/80 ECR [1982]
136 Ibid at 6

In 1981 the Commission expanded the criteria of State aid to include:

1. *"the use of State aid by a Member State must not lead to the transfer of industrial difficulties and unemployment from that Member State to the rest of the Community.*
2. *where aid is given, it must bring about the restoration of the health of the recipient undertaking so that it can within a reasonable period of time, be expected to operate viably without further aid.*
3. *any aid permitted should be so structured* (so) *that* (its effects) *are transparent."*[137]

The first criteria, reinforces the *Philip Morris BV*[138] judgement, the consideration of State aid as a Community issue not a national one. The second criterion summaries what the Commission has and is currently trying to achieve; a return to viability within a reasonable period of time. The third criterion emphasizes the 1975 Commission's idea of transparency.

The Commission also in 1981 began the use of the MEIP to analyse whether an "economic advantage" was bestowed on the beneficiary. *"The test is whether or not the State is supplying the recipient undertaking with an economic advantage that it could not have obtained under normal market conditions.*"[139] This was first expressed in the Shipbuilding Directive[140] as aid *"which they directly or indirectly control and which do not count as the provision of risk capital according to standard company practice in a market economy"* and was later applied to all areas of State aid. The MEIP was accepted by the ECJ in the seminal case of *Belgium v Commission* [1986], the ECJ held that the MEIP is *"an appropriate way to determine the existence of aid."*[141]

In 1985 the Commission introduced several mechanisms to simplify and streamline applications for State aid. The Commission firstly introduced the Research & Development Framework (R&D). R&D State aid was then "*one of the largest...form(s) of intervention by government(*s*) in support of industry."*[142] The introduction of the R&D Framework was the beginning of a trend of codification of the exemptions to Article 107 (ex Article 92). However the Commission added

[137] European Commission ,*Annual Competition Report 1981* Brussels 1982 at 180
[138] *Philip Morris BV v Commission 730/79[1980] E.C.R 2671*
[139] Jones & Surfin *Competition Law* (2nd Ed., Oxford 2004) at 28
[140] Commission Directive No 81/363/EEC 1981 OJ l137/39
[141] *Belgium v Commission* C-234/84 [1986] ECR 2263 at 2263
[142] Commission, *Competition Review 1985* Brussels 1986

the caveat that *"state aids to R&D, as is the case with any form of State aids are notifiable under Article 93(3)."*[143] The R&D Framework gave the member states greater independence in utilising State aid but it maintained the Commission's position as state aid regulator. The Framework encouraged programmes of efficiency, and therefore promoted the Commission's State aid Economic Policy.

The Commission also introduced the *de minimis* doctrine through the Transparency Directive, Directive 85/413.[144] This doctrine exempted public undertakings with an annual turnover of less that 40 million ECU's from State aid regulation. This further exemplifies the Commission's trend towards increasing access to State aid through the codification of State aid exceptions.

In 1987 the Greek financial crisis prompted the Commission to allow an application under Article 107 (3)(b) (ex Article 92 (3)(b)) to *"remedy a serious disturbance of the economy of a Member State."* The Greek Economy had been contracting since 1985.[145] Two years later, the Business Reconstruction Organisation (BRO) was charged to *"provide State aid for companies subject to such interventions* (to convert) *outstanding debts into equity* (relieving) *them of a high levels of interest payment and by cleaning up balance sheets."*[146] This intervention was only applicable to *"the import and application of foreign technology and the development of Greek-based technology."*[147] Therefore any intervention in the economy was strictly limited to technology companies. This complements the Commission's Economic Policy of State aid through the use of programmes of efficiency.

The BRO intervened in companies under the following conditions:[148]

- the beneficiary company has suspended or ceased trading for financial reasons
- the beneficiary company has stopped making payments.
- the beneficiary company has been placed in receivership or is under temporary administration or any form of liquidation.

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143 Commission, *Competition Review 1985* Brussels (1986) at 218
144 Commission Directive 85/413 OJ L 229, (1985)
145 Commission Decision No 88/167/EEC (1987) at para 5
146 Commission Decision No 88/167/EEC (1987)
147 Commission Decision No 88/167/EEC (1987) at para 2
148 Commission Decision No 88/167/EEC (1987)

- the beneficiary company has debt five times the sum of its company capital and visible reserves and is manifestly unable to meet its obligation.
- the beneficiary company is of interest to national defence or of vital importance in the exploitation of sources of national wealth.

The organisational structure of the BRO is vague. It is described as being held by the *"Greek State or by the State and the local government bodies, employees bodies, state-controlled banks and public sector undertakings."*[149] This is a marked departure from the decision regarding the Italian Law No 184 of 22 March 1971, where the Commission stated *"the central authority confines itself to the acquisition of certain firms with specified terms, duration and purpose."*
The Commission quickly emphasises the use of a Greek Economic Stabilization and Recovery Programme in conjunction with the BRO Programme. The Commission justified the use of State aid through the BRO as *"20% of the industrial employment of Greece and a considerably larger percentage of its industrial output and international trade"* would be affected.[150] This quantifies the "systemic" element of Article 107(3)(b). Finally the Commission states that *"the aid must not promote the expansion of the production capacity* (and must not) *merely shift the problem without finding a genuine solution to the social and industrial problems facing the Community."*[151] This reinforces the idea of State aid at a Community level and not a national level and it also prevents member states from using State aid as a facade for national subsidies.

The economic conditions improved in Europe in the 1990's and there was an overall decrease in the levels of rescue and recapitalisation aid under Article 107 (3)(b) and (c). The Commission expanded the use of horizontal aid programs including aid for environmental protection and energy conservation, SMEs, privatization and investment aid in 1992 and rescue and recapitalisation aid in 1994.

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[149] Commission Decision No 88/167/EEC (1987).
[150] Commission Decision No 88/167/EEC (1987).
[151] Ibid.

3.4 The R&R Framework

In 1994 the Commission expanded its horizontal aid programme by launching a Framework for Rescue and Recapitalisation (R&R).[152] Although both rescue and recapitalisation were considered in the same Report, they were two distinct mechanisms, never to be combined. This policy was changed in the 2004 Report on Rescue and Recapitalisation. Rescue aid was deemed to be temporary in nature: *"rescue aid provides a brief respite, generally for not more than six months."*[153] In contrast, recapitalisation aid is long term and is incorporated with a *"feasible, coherent and far-reaching plan to restore a firm's long-term viability."*[154] Therefore a member state should never grant the aid to a failing undertaking. The purpose of rescue and recapitalisation aid was to maintain *"a competitive market structure when the disappearance of firms could lead to a monopoly...and by the special needs and wider economic benefits of SME sector."*[155] This market driven purpose was greatly expanded to include any and all sectors (discussed below at 4.5). It is significant to note that the purpose of the rescue and recapitalisation aid is not only to return a firm to viability but also to prevent a monopoly from forming in the market.

3.4.1 The proportionality test on the primary sector

The Commission introduced the proportionality test under R&R Report. The test consisted of proportionality of aid, minimal impact on the market and necessity of the State aid.

Proportionality was applied in two circumstances, firstly, where there is an over capacity in the manufacturing sector, *"the restructuring plan must make a contribution, proportionate to the amount of aid received"*[156] and secondly, and more significantly, where an over capacity was not at issue "*the aid will be used only for the purpose of restoring the firm's viability"* and *the amount…of the aid must be limited to the strict minimum needed to enable restructuring to be undertaken and must be related to the benefits anticipated from the Community point of view."*[157] The wording of the proportionality test suggests the Commission only considered applying the

[152] Commission, *Community guidelines on State aid for rescuing and restructuring firms in difficulty,* OJ C 368, 23.12.1994 p 12
[153] Commission, Guidelines on State aid for rescuing and restructuring firms in difficulty OJC368 23/12/1994 at 2.1
[154] Ibid.
[155] Ibid at 1.2.
[156] Ibid at 3.2.2 (ii).
[157] Ibid at 3.2.2 (iii).

test on the manufacturing sectors, SMEs or agricultural sectors (primary sectors). The Report also constantly refers to the "production capacity" as a measurement for the State aid investment. This has major implications when the proportionality test is applied to the services sector.

The concept of production capacity is not innate to the services sectors. Programmes of efficiency are inherently easier to implement in the manufacturing or agricultural sectors. These sectors can be modernised or computerised. The services sector in contrast is not as susceptible to programmes of efficiency such as modernisation, training or computerisation. Therefore the Commission's only tool to ensure proportionality is to restructure the beneficiary. However restructuring a beneficiary does not guarantee increasing the efficiency of the firm and it does not guarantee a return to viability (discussed at 4.5). The Commission ensures the minimal impact on the Common Market by requiring the beneficiary to make significant contributions towards any restructuring plan *"from its own resources or from external commercial financing."*[158] The R&R Report focuses on the minimal, necessary and proportional impact on the Common Market rather then the domestic market. The R&R Report was quickly tested with the advent of the Credit Lyonnais Application.

3.5 The Credit Lyonnais Application

In 1994 the Commission was faced with the rescue and recapitalisation of Credit Lyonnais (CL) in the French banking sector. It was then the single largest amount of State aid for an undertaking in the history of Community. CL had been experiencing financial difficulties since 1992, after a period of expanded growth. This lead the French Government to create a "hive off vehicle" Omnium Immobilier de Gestion (OIG) which absorbed property assets of FRF 40 billion (€6 billion). In 1995, a further FRF 190 billion (€28.6 billion) of assets were transferred to two new hive off vehicles CDR and SPBI of which, the losses were covered under a state guarantee to prevent the insolvency of CL. CDR absorbed OIG. The net value of the two hive off vehicles was about FRF 135 billion (€20 billion). Both CDR and SPBI's banking arms had a life span of five years. CDR was also financed by a private firm EPFR of up to FRF145 billion (€22 billion) to be paid off by 2014. The state guarantee of CL resulted in the French Government being liable for any losses. The French State Guarantee complicated the rescue and recapitalisation State aid

[158] Above n 146

because ultimately the French taxpayer was liable. Therefore CL could not fail for fear of the liability.

In 1996 the French Government recapitalised CL with a further FRF 4 billion. In 1996 the Commission approved the emergency aid and initiated Article 108 (2) (ex article 93 (2)) procedure, investigating restructuring measures obligated by recapitalisation conditions. The Commission decided that the aid was *"compatible with the common market under Article 92 (3)(c)…and with the Community guidelines on State aid for rescuing and restructuring firms in difficulty*[159]*"* despite the fact that over 50% of CL's business existed outside of France. The Commission used Article 107 (3)(c) because the economic problems were limited to a particular sector within a single beneficiary despite the wider economic implications.

The Commission used the following restrictions to reduce the adverse trading conditions and ensure compliance of State aid:

(1) a restructuring plan based on realistic assumptions which enables a minimum return on the invested capital to be generated within a reasonable time-span and the firm's long-term viability to be guaranteed;
(2) the provision of sufficient quid pro quos to offset the distorting effect of aid on competition so that the aid can be regarded as not contrary to the common interest;
(3) aid should be proportional to the objectives in question and the amount of aid should be limited to the strict minimum needed for restructuring so that the recipient company itself makes a maximum contribution to the recovery plan;
(4) the full implementation of the restructuring plan and observance of any other obligation laid down by the Commission's final decision;
(5) setting-up of a monitoring system for the previous condition.[160]

[159] Commission Decision No 98/490/EC at 2.4 (Credit Lyonnais)
[160] Ibid

The Commission implemented the proportionality test under the 1994 R&R Report. However the Report was not designed to be used on the services sector and particularly on a financial institution on this scale. The scope of the Report and the amounts of money involved were outside anything that the Commission was prepared for.

The difficulty in providing State aid for a bank is the aid preserves an inefficient entity for the overall health of the economy. This is a programme of equity, used to maintain the status quo. Restructuring the beneficiary bank goes some way in reducing the equitable issues, however the impact on preserving an inefficient bank on the domestic market and Common Market is massive and restructuring does not guarantee a return to viability. State aid by its very nature is an interference or manipulation of the market. The motivation behind State aid regulation is to protect the Common Market from inefficient interference or manipulation. Therefore in this case how does the Commission justify using a programme of equity to recapitalise an ailing company? The aid was used to preserve an inefficient undertaking because of the economic vacuum that would be left in its absence. Public money was being used because the social objective benefits (of preventing a wider banking crisis) exceeded the costs of recapitalisation. This is contrary to Commission's Economic Policy. Previous programmes such as the Greek BRO Programme were limited to R&D or training initiatives.

3.5.1 Proportionality and Credit Lyonnais

To limit the economic damage of State aid the Commission stressed that the *"aid should be proportional to the objectives in question and the amount of aid should be limited to the strict minimum needed for restructuring so that the recipient company itself makes a maximum contribution to the recovery plan."*[161] This complies with the 1994 R&R Report. The Commission decided in *"examining a measure to assist the restructuring of a firm in difficulty, its overall assessment* (was) *to consider whether the common interest is served by the maintenance of the firm in business, given the competition that exists in the industry and the way competition will be affected by the aid."*[162] This *"common interest"* is the social objective by which the Commission currently justifies the use of State aid under Article 107 (3)(b). The

[161] Above n 152
[162] Above n 152 at 10.5.

Commission concluded "*CL has received State aid equal to at least twice and possibly even three times its current own funds, which amounted to FRF 44 billion in 1997.*"[163] This had the result of enabling CL to not only avoid liquidation but to maintain a strong presence in the market.

The Commission ensured proportionality via a "quid pro quo" approach. This reduced the State aid's competitive effects. The Commission minimised distortions to the Common Market by reducing the market share of CL by selling off assets and therefore *"serving to offset as far as possible the distortion of competition caused by the aid."*[164] The "quid pro quo" has the dual effect of raising funds for the beneficiary, through the selling of assets which were then in turn are used to finance the restructuring effort. The use of quid pro quo is significant. The Commission in this decision appears to have confused proportionality with quid pro quo. The proportionality test ensures aid is minimal, proportional and necessary. Quid pro quo is a concept outside the test of proportionality. It perpetuates a sense of equivalency, where proportionality imbues a sense of equilibrium. Subiotto highlights that under quid pro quo the *"beneficiaries* (might) *have been required to take additional compensatory steps."*[165] Similarly how would the Commission use quid pro quo against an unviable undertaking? (see 4.1). The Commission instructed CL to reduce its commercial presence outside France by selling assets worth FRF 556 billion and internally selling assets of FRF 64 billion. This reflected the high levels of disruption felt by CL's competitors.

It is important to reiterate that CL's State aid was subject to Article 107 (3)(c). The CL decision is a significant departure from precedent. The Commission was unprepared for a challenge from the services sector especially on such a massive scale. The Commission responded by expanding the scope of the 1994 R&R Framework to include the services sector. However the aid was not applied through any programmes of efficiency. The Commission implemented a proportionality test (via restructuring) to achieve a balance against the French State aid. The Commission was attempting to ensure the return to viability of Credit Lyonnais. The Commission embraced an

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[163] Above n 152 at 10.5.
[164] Above n 152 at 10.5
[165] Subiotto R, *European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,* (1st Ed., 1999, Oxford) at 422.

equitable programme to correct a market failure and to achieve financial stability It was an inappropriate limitation of State aid when combined with the social objective of financial stability. The social objective will always negate the equity/efficiency distinction.

CL is an excellent example of an ailing firm in need of several State aid injections within a limited time frame. CL had experienced difficulty for several years and the Commission was familiar with its financial viability. However in a situation where an undertaking needs several State aid injections within the six month timeframe, the Commission would have to grant the aid without examining the restructuring/viability plan. The Commission will not know if the firm is viable until the plan is submitted. The Commission is financially blind (see 4.8).

There are mechanisms for repatriating State aid however in the case of CL, the French Government would never allow the State aid to be repatriated. This is the underlines the realpolitik surrounding State aid.

Post Credit Lyonnais, the Commission continues to justify the use of State aid through the public interest objective. *"So even if the member state does not choose the most efficient undertaking, the decision cannot be overturned where reasonable objective justification is given for the choice."* [166] However the use of a public interest objective is a dangerously vague concept. It is difficult to contemplate a limit on any public interest objective where a financial institution (or any services sector undertaking) is in danger of collapse. This has huge implications for every member state.

3.6 Conclusion

The use of Article 107 (3)(b) and (3)(c) has incrementally grown from a strict position allowing aid under the criteria in the 1971 Belgium Decision case[167] through the 1975 Energy Crisis to the 1987 Greek BRO Programme. The Commission kept the aid within the criteria of temporary, for restructuring purposes, and confined within programmes of efficiency. The *Credit Lyonnais* case marked a major departure from these policies. The services sector is not as susceptible to the normal modes of State aid. The Commission utilised the proportionality test to qualify the needs of the beneficiary against the needs of the common and domestic markets with the goal of

[166] Petersen *State aid and Banking European Competition Law Annual 1999: Selected Issues in the Fields of State Aid,* (1st Ed., 1999, Oxford).
[167] *Belgium v Commission,* C-234/84 [1986] ECR 2263

maintaining the social objective of financial stability. This justified the abandoning of the Commission’s Economic and Legal Policy. However the CL case was limited to the remit of Article 107 (3)(c) at an undertaking or/and sectoral level. To apply the proportionality test to the services sector under Article 107 (3)(b) is a dangerous combination. A member state experiencing an economic crisis could in theory justify large amounts of State aid to ailing or even failing firms. This could negate the effects of the proportionality test.

Chapter Four Post Credit Lyonnais

The post *Credit Lyonnais* era was a period of economic stability in Europe. The Commission continued to apply the proportionality test to State aid applications. The overall levels of State aid fell (see section 2.2). However with a contraction in the European Economy and the advent of the financial crisis in September 2008, systemic economic problems emerged and the proportionality test under Article 107(3)(b) was applied to bring economic balance.

The Commission published five significant reports as part of a 'Crisis Framework' in State aid in response to the economic difficulties applicable to Article 107 (3)(b) TFEU and Article 107 (3)(c) TFEU. The Crisis Framework consists of:

1. "*Community Guidelines on State aid for Rescuing and Restructuring firms in difficulty",* October 2004 (the R&R Report) (discussed under Article 107(c)).[168]
2. *"The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*", October 2008 (the Banking Communication).[169]
3. *"The recapitalisation of financial institutions in the current financial crisis"* in December 2008 (the Recap Report).[170]
4. *"Commission communication on the return to viability and the assessment of restructuring measure in the financial sector in the current crisis under the State aid rules",* (2009) (the Viability Report).[171]
5. *"The Treatment of Impaired Assets in the Community Banking* Sector", 2009 (IAC). [172]

R&R Report is pre-financial crisis and is directly related to Article 107 (3)(c) and indirectly to Article 107 (3)(b). The next two reports were published in reaction to the financial crisis and

[168] Commission, *Community Guidelines on State aid for Rescuing and Restructuring firms in difficulty,* 2004/C 244/02 (hereinafter the R&R Report)
[169] 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/C 270/02 (hereinafter Banking Communication)
[170] Commission, *The recapitalisation of financial institutions in the current financial crisis* 2009/C 83/01(hereinafter the Recap Report)
[171] Commission, *Commission communication on the return to viability and the assessment of restructuring measure in the financial sector in the current crisis under the State aid rules* 2009/C 195/04 (hereinafter the Viability Report)
[172] Commission Notice, *on the Treatment of Impaired Assets in the Community Banking Sector*, 25th February 2009 (hereinafter IAC)

apply to Article 107 (3)(b). The Viability Report is applied at a post recapitalisation stage, to ensure stability in the Common Market and will therefore be examined in the chapter five. The IAC Report is instrumental in advising the member states regarding asset management schemes such as NAMA (also see 4.5). The Commission assessed NAMA under Article 107 (3)(b) TFEU. This is subject to the Commission's Banking Communication. The Banking Communication is of direct relevance so is examined below in detail.

4.1 The Banking Communication

Bolton states the Banking Communication was published in response to the repercussions to the collapse of Lehman Brothers in September 2008.[173] The collapse of Lehman Brothers heralded the disruption of the inter-bank lending market. Banks struggled to access credit and laboured to apply for quick State aid under the old rescue and restructuring guidelines. [174] The timeframe for granting aid and the amounts of aid given were inadequate.[175] The Commission published the Banking Communication in October 2008 to provide a specific, uniform approach to financial sector State aid. The Banking Communication provides a framework for recapitalisation schemes, banking guarantee schemes and ad hoc measures.

The Banking Communication distinguishes between the difficulties faced not only by ailing banks, but also for banks that are fundamentally sound but are facing crises stemming from the collapse of the inter-bank lending market. The Banking Communication quickly differentiates between State aid applications for individual undertakings under Article 107 (3)(c) and *"aid undertaken to address this systemic crisis*"[176] in a group of undertakings or an ailing sector under Article 107 (3)(b). Further to this, the Commission will continue to interpret Article 107 (3)(b) restrictively in line with the *Freistaat Sachsen* case.[177]

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[173] Gibson-Bolton E ,*Bank bailouts, state aid and the financial crisis* 4 CRI 162 (2009) at para 2.
[174] Gibson-Bolton E ,*Bank bailouts, state aid and the financial crisis* 4 CRI 162 (2009) at para 2.
[175] Ibid.
[176] Banking Communication, C 270/02 (2008) at paragraph 9.
[177] *Freistaat Sachsen and Volkswagen AG v Commission,* Joined Cases T-132/96 (1999) ECR II-3663.

This Report reiterates the proportionality test codified in the R&R Report.[178] This test consists of:

1. Appropriateness; the aid is well targeted to its objective, to remedy a serious disturbance in the entire economy.
2. Necessity: the aid measure must in its amount and form be necessary to achieve the objective. The aid must be the minimum amount necessary to reach the objective.
3. Proportionality: the distortions of competition must be properly balanced against the positive effects of the measure.

The proportionality test was applied to all economic exemption State aid applications. The difficulty in applying the test under 107 (3)(b), is that in theory no application would fail it because of the exceptional nature of Article 107(3)(b). By applying the proportionality test under Nicolaides' criteria,[179] it emphasises the inapplicability of Article 107 (3)(b):

1. Appropriateness: rescue aid is appropriate by its very nature. It is targeted to remedy a serious systemic problem.
2. Necessity: *"in the absence of state aid, undertakings could not do on their own what the aid scheme seeks to induce them to do."* The purpose of the 107 (3)(b) aid is rescue. A firm under 107 (3)(b) could not use its own resources because of the extent of its financial problems.
3. Proportionality: This is more difficult to quantify. Nicolaides suggests measuring the use of State aid through an aid ceiling.[180] Aid ceiling are applied in other forms of aid such as regional aid. However this is not applicable, to 107 (3)(b) because it does not have a codified aid ceiling. The concept of an aid ceiling for rescue aid could undermine the rescue. Maes states that State aid ceiling are insufficient, *"the need to grant aid may differ across MS. But the aid needs to be proportional and limited to the minimum necessary."* [181] Several member states have introduced domestic caps to State aid. Spain has capped State aid in direct

[178] R&R Report, C 244/02 (2004).
[179] Nicolaides *State Aid Policy in the European Community* The Hague, Kluwer Law International 2005 at 38.
[180] Ibid
[181] Maes S, Annex 3

proportion to the beneficiary's market share,[182] whilst Austria has created a State aid ceiling.[183] Both mechanisms are consistent with State aid requirements. However both mechanisms limit the State aid contributions by the member states to potential beneficiaries.

4. Nicolaides also suggests cumulation of aid; *"no aid from two or more sources may be received."*[184] Again this is not relevant to Article 107 (3)(b), because the aid comes from one government source as seen with NAMA. This stresses how the proportionality test was not designed and is not suitable to be applied under Article 107 (3)(b).

The proportionality test further functions to protect the member state. State aid given via rescue and recapitalisation aid must be repaid by the beneficiary.[185] Where amounts of State aid are given from small member states such as Ireland, the repayment of the State aid in the long term ensures the member state will not go into debt. However, where the State aid is given to a ailing firm there is no assurance that the State aid will be repaid. This results in the transfer of the financial difficulties from the beneficiary to the member state. Kelly estimates that the Government has committed up to €70 billion into NAMA and recapitalisation of the banks, of which up to 50% could be lost.[186] This highlights the disproportionate effect of State aid on an ailing company. This is a major State aid issue, any attempt to wind down these beneficiaries will therefore disrupt the proportionality of that aid.

The *Credit Lyonnais* case suggests the Commission can gain proportionality by reducing the international and domestic branches of an undertaking. This is however an ineffective method of ensuring proportionality, to a small group of banks with limited foreign assets, based mostly within one member state. How does the Commission therefore ensure State aid proportionality?

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[182] Commission Decision, State aid NN54/B/2008 (Guarantee scheme for credit institutions in Spain)
[183] Commission Decision, NN557/2008(MaBnahmen nach dem Finanzmarktstabilitais)
[184] Nicolaides *State Aid Policy in the European Community* The Hague, Kluwer Law International at 39.
[185] Banking Communication, 2008/C 270/02
[186] Kelly M, *Burden of Irish debt could yet eclipse that of Greece,* Irish Times 23/05/10
<http://www.irishtimes.com/newspaper/opinion/2010/0522/1224270888132.html> 24/05/10

4.1.1 Solvency Ratio and proportionality

The Commission has successfully applied a solvency ratio to airline companies, ensuring the beneficiary is not overcapitalised as a result of the aid. The Commission found that State aid did not lead to overcapitalisation in the following cases with following debt/equity ratios 1.25 for Sabena in 1991, 0.75 for Aer lingus in 1995 and again in 1996 at 0.41 and 0.78 for Olympic Airways in 1994.[187] Schiitterle states that the Commission could use the solvency ratio to ensure proportionality. [188] This was applied in *GAN* case[189] where the Commission noted *"following the state aid operation, the level of capitalisation of the group is barely above the regulatory limit and is therefore not liable to strengthen GAN beyond that which is strictly necessary for its restructuring."*[190] The Commission applied this test in *Credit Lyonnais* stating *"a capital injection of FRF 1 billion, or any measure whose effect is equivalent, allows a bank to increase the weighted assets in its balance sheet above what is required by the compulsory solvency ratio of 4 % to 8 %, and thus to expand its activities."*[191] The Commission measured proportionally of State aid through an examination of the balance sheet of the beneficiary vis-à-vis the state aid injection. Credit Lyonnais (CL) received an injection of three times its balance sheet.[192] The Commission applied the solvency ratio test and CL was deemed over recapitalised. CL's assets were reduced as a result (see 3.5). Under the application of the solvency ratio, in theory all the NAMA beneficiaries would be deemed proportional vis-à-vis the State aid injection if they return to the nominal liquidity ratio (see Anglo in Section 4.1.1). However this alone could not act as the standard for State aid. A viability test would be needed to ensure further recapitalisation injections would not be needed.

4.2 The Systemic nature of Article 107 (3)(b)

Article 107(3)(b) is reserved for State aid to remedy a 'systemic crisis'. This is the defining quality of Article 107 (3)(b). It is however a nebulous concept. The 1975 Energy Crisis was

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[187] Schiitterle P, *European Competition Law Annual 1999 Selective Issues in the Field of State* Aid (1st Ed., Oxford 1999).
[188] Ibid at 420.
[189] Commission Decision, 98/204/EC (1998) (GAN)
[190] Ibid at 420.
191 Commission Decision, OJ L 221 , 08/08/1998 98/490/EC: (Credit Lyonnais) P**.** 0028 – 0080.
[192] Commission Decision, OJ L 221 , 08/08/1998 98/490/EC: (Credit Lyonnais) P**.** 0028 – 0080. at 54

deemed an economic crisis at a systemic level. Similarly the Greek financial crisis in 1987 the Commission equated a systemic problem as *"20% of the industrial employment of Greece."*[193] The uncertainty that surrounds the systemic quality exists within Irish financial sector.

Bank	Total assets 2008 EUR bn	% of total	balance sheet % GDP approx
Bank of Ireland	194.1	26.5	100%
Allied Irish Bank	179.5	24.5	90%
Anglo Irish Bank	88.5	12.1	50%
EBS	21.4	2.9	12.50%
INBS	14.4	2	7%

Fig 1.0[194]

From Fig 1.0, BOI, AIB and Anglo are obviously of systemic importance to the Irish Economy. However EBS and INBS have significantly smaller balance sheet as a % GDP. The Commission applied the broad social objectivity standard to all State aid applications and although a small credit institution would not have systemic presence within the Irish Economy, its failure would *"undermine confidence in the Irish financial sector as a whole, thus entailing a serious risk of a systemic crisis."*[195] This stresses the difficulty in applying the broad social objective standard; every financial institute is eligible not because they are of systemic importance in the economy but because their failure would expose the remaining financial sector. This is the lowest possible standard for a State aid test. It also results in an increase in the amounts of State aid needed, further marginalising the proportionality test.

4.3 The Irish Guarantee Scheme

The Irish Government attempted to stabilise the Irish financial sector through the use of a Banking guarantee scheme on 30th September 2008 under the Credit Institutions Financial Support Act 2008 (CIFS). The scope of the Guarantee covered *"all deposits, covered bonds, senior debt and dated subordinated debt with the following banks: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society"*[196] until 28th September 2010. The value of the Guarantee is

[193] Above n 139.
[194] Data calculated from Commission Reports N149/2009, N241/2009 and N725/2009
[195] Commission Decision, No 9/2009 *Recapitalisation of the Anglo-Irish Bank,* Brussels, (2009) at 50.
[196] Commission Decision, NN 48/2008 *Ireland Guarantee scheme for banks in Ireland,* Brussels (2008) at 5

estimated at €65billion.[197] The scope of the debts covered is massive. It includes every type of deposit and debt held by a bank. Initially the Guarantee was only available to domestic banks but this was extended by request from the Commission to any subsidy of a bank operating in Ireland of "*systemic significance…with a significant main street retail presence.*"[198] This is now the current test for banking guarantees ensuring minimal discrimination of non-domestic European banks. The Guarantee contains a "claw back clause" allowing any costs to be recouped by the State. This functions to protect the taxpayer from liability. This was codified in the Forms Guarantee Report as *"such risk-carrying by the State should normally be remunerated by an appropriate premium."*[199] The Guarantee contains a transparency and enforcement clause that allows the Minister of Finance to *"increase the charge, impose additional conditions or revoke the guarantee"*[200] to ensure maximum protection for the taxpayer. The protection of the taxpayer is of up most importance to the Commission and this protection was codified in the Banking Communication.[201] The Commission's Forms of Guarantee Report contains one criterion on the eligibility of a beneficiary, namely *"the borrower is not in financial difficulty."*[202] This must be combined with a high level of transparency to ensure that the beneficiaries are not in financial difficulty. The Commission relies on financial reports from the Central Bank, Irish Financial Regulator and the Irish Government to assess the financial situation of an undertaking. It is in the banks interest to receive the State aid and it is in the Governments interests to ensure the viability of the financial sector. Therefore there are strong motivations to misrepresent a potential beneficiary's financial status.

In addition the Forms of Guarantee Report obligates any guarantee beneficiary to be contractually linked to specific conditions which may go as far as the compulsory declaration of bankruptcy for an undertaking.[203] This gives the member states an exit strategy in the event a guarantee becomes unfeasible. It has become clear that three of the six beneficiaries were in

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[197] Commission Decision, State aid N9/2009 *Recapitalisation of the Anglo Irish Bank by the Irish State*
[198] Ibid at 16
[199] Commission Notice, *On the application of Art 87 & 88 to State aid in the form of guarantees* (2008/C 155/02) Brussels at 2.1
[200]Commission Decision, NN 48/2008 *Ireland Guarantee scheme for bank in Ireland,* Brussels, (2008) at 31.
[201] Banking Communication, C 270/02 (2008) at 1
[202] Commission Notice *On the application of Art 87 & 88 to State aid in the form of guarantees* C 155/02) Brussels (2008) at 3.2
[203] Ibid at 5.3

financial difficulty at the creation of the Banking Guarantee, namely Anglo Irish Bank[204], Irish Nationwide[205] and Educational Building Society.[206] This calls into question the transparency and disclosure measures of these undertakings and the ability of Government, Central Bank and Financial Regulators to audit and regulate the financial sector. It is also in violation of the only criterion of the Commission's Forms of Guarantee Report namely *"the borrower is not in financial difficulty."* The Irish Government under the terms of Guarantee can expel these beneficiaries. It is unlikely to do so as the Guarantee is to expire as of September 2010 and to expel these beneficiaries would destabilise the banking sector and therefore undermine the social objective of the Irish Guarantee. The Commission could launch an investigation under Article 108 and impose fines. It is unlikely to do this as the fines would ultimately be paid by the taxpayer, the very group the Commission is trying to protect from exposure.

In assessing the Irish Banking Guarantee the Commission applied the MEIP under Article 107 (1). It found that the Guarantee went beyond the MEIP where:

1. The very large scope of the guarantee was beyond anything a private operator would engage.
2. Guarantees don't exist in the normal market.
3. No private investor could have granted such a significant guarantee on such a large scale.
4. The guarantee imposed allows the banks to obtain liquidity at an advantageous condition
5. The guarantee is successful because it is backed by a sovereign government. [207]

The factors applied by the Commission are so general they will ensure every guarantee applied under the MEIP will fail. The Commission found the guarantee provided a selective advantage to the beneficiaries and therefore created a distortion on the competition and trade between the

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[204] The Anglo Ireland Bank Interim Report registered a balance sheet total of €88.5 billion and a loss of 3782 million. The Bank lent approximately 82% of its total assets.

[205] Irish Nationwide has a balance sheet worth €12.5billion and is transferring €2.7 billion to NAMA and might be recapitalised a further €2 billion < http://www.independent.ie/business/irish/let-irish-nationwide-fail-as-a-test-2124714.html >

[206] EBS will transfer €1 billion to NAMA and is expected to be recapitalised by a further €100 million. <http://www.irishtimes.com/newspaper/ireland/2010/0331/1224267400546.html>

[207] Commission Decision NN 48/2008 *Ireland Guarantee scheme for banks in Ireland*, Brussels, (2008) at 60-67

member states. This is consistent with the Banking Communication. Therefore the Commission found the Guarantee constitutes State aid within the meaning of 107 (1) TFEU.

The Commission assessed the scheme under Article 107 (3)(b). This complies with the Banking Communication, it allows the use of Article 107 (3)(b) *"in light of the level of seriousness that the current crisis in the financial markets has reached and of its possible impact on the overall economy of Member States."*[208] The Commission applied the proportionality test outlined in the Banking Communication to the Irish Guarantee Scheme and found that as regards:

1. Appropriateness: the Guarantee will stabilise the banks by reviving depositors trust in the banking system and thereby avoiding bank runs.
2. (a) Minimum scope necessary: the guarantee includes everything, this has the effect of reassuring depositors and therefore the scope is deemed appropriate.

   (b) Minimum time necessary: the Commission distinguishes between individual undertakings with a minimum of six months necessary and a group of undertaking with a minimum of two years necessary to regain stability. The scope of two years is also linked to the "*resumption of inter-bank lending*" in the global market. This is a nebulous concept with no guarantee of the resumption of inter-bank lending at any level.
3. Minimising distortions to the competition. The Commission highlights the use of the fee element of the Guarantee, which will "*compensate the State for the additional funding costs it bears as a consequence of the guarantee"* and in particular the related risk profiling. This shields the taxpayer from loss. The contribution by the banks minimises the distortion caused by the Guarantee.

Finally the Commission reacted favourably with the oversight function of the Regulatory Authority (RA). The RA will *"monitor and review the expansion of the activities of covered institution benefiting from the guarantee."*[209] This ensures that the beneficiaries will not gain a competitive advantage through the Guarantee. This exists independently to the Commission's monitoring and regulatory function.

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[208] Banking Communication, C 270/02 (2008) at para 9

[209] Commission Decision NN 48/2008 *Ireland Guarantee scheme for banks in Ireland*, Brussels, (2008) at 71

Eight days after the Guarantee was launched, the RA fined Irish Nationwide Building Society after Mr Michael Fingleton Jnr used the Guarantee as a marketing ploy to encourage investment with the Building Society. The RA fined the Irish Nationwide Building Society €50,000 and the matter was deemed closed.[210] Despite the low amount of the fine, this is a good example of a domestic body enforcing a State aid issue and how a company could violate the Guarantee Agreement and act aggressively upon receiving State aid. The Commission strongly criticised Irish Nationwide's action but did not investigate or fine the company. This is probably because the RA had already investigated and fined the Building Society.

Historically banking guarantees have always existed as an exception to the rules on State aid as evidenced in Section 3.1.2 by the Netherlands Nationale Investeringsbank (NIB). The application of the proportionality test to the Irish Banking Guarantee highlights a convergence of the criteria for the banking guarantee with other forms of State aid assessment. The utilisation of the MEIP to a banking guarantee ensures that the guarantee will always be deemed as State aid.

4.4 The European Guarantee Scheme

Directive 2009/14/EC guarantees up to €50,000 per deposit.[211] This is expected to be increased to €100,000 on 31st December 2010.[212] The purpose of which is to *"maintain depositors confidence and attain greater stability on the financial market."*[213]

By implementing a pan European Guarantee Scheme covering up to €100,000 it will reduce the need of the member states to introduce domestic guarantee schemes. As evidenced with the *Credit Lyonnais* case and evidenced below, the interaction between a guarantee scheme and further State aid mechanism results in:

1. members states being obligated to give aid.
2. the Commission granting state aid because the member state is liable.

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[210] Financial Regulator, *Settlement Agreement between the Financial Regulator and Irish Nationwide Building Society*, Dublin (2008) <http://www.financialregulator.ie/publications/Documents/Irish%20Nationwide%20Settlement%20Agreement%20%20-%207%20October%2008.pdf>

[211] Commission Directive, No 2009/14/EC *On the deposit-guarantee schemes as regards the coverage level and the payout delay* Brussels (2009) < http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:068:0003:0007:EN:PDF.

[212] Ibid at 3.

[213] Ibid at 3.

The proposed European guarantee scheme should replace the need for a domestic guarantee scheme. Therefore the new European guarantee will ensure that State aid applications will be considered in isolation of any domestic recapitalisation schemes, which will hugely simplify State aid regulation. Any domestic recapitalisation schemes can therefore be considered without the obligation that a banking guarantee creates.

4.5 NAMA and Anglo

There were several State aid mechanisms implemented to further stabilise individual banks. In examining NAMA, it is necessary to examine these and their incremental effects. The Commission is not examining NAMA in its entirety but it is examining the individual bank transfers on a case by case basis as per the Irish Governments request.[214] In examining NAMA, this researcher will take the example of Anglo Irish Bank and its State aid mechanisms. Anglo Irish Bank is suitable because it is one of the most controversial of all the financial institutions involved in NAMA and because Anglo's total assets as % GDP is the average of the financial institutions in Ireland. (See fig 1.0)

4.6 The first recapitalisation application of Anglo Irish Bank

On the 21st December 2008, three months after the Banking Guarantee was launched, the Irish Government announced it would recapitalise Anglo by €1.5billion. Anglo had a balance sheet of over €100 billion (50% of Irish GDP).[215] The Bank lent 70% of its total assets (just less then €100 billion) of which 57% was in Ireland, 29% in the UK and 13% in the US.[216] The Irish Government proposed to inject the €1.5 billion to *"avoid further deterioration in the financial situation of the Bank which would represent a threat to the stability of both the financial system in the State and the wider economy."*[217] A restructuring plan had to be submitted within six months as per the Banking Communication. The six month period is problematic as an ailing firm might require further aid within that time frame. The Commission is financially blind for six months and therefore this process could be subject to abuse. This happened with Anglo's

[214] Commission Decision No 725/2009 *Ireland establishing of a NAMA: Asset relief scheme for banks in Ireland* Brussels (2010).
[215] Commission Decision No 9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State*, Brussels (2009).
[216] Ibid
[217] Ibid at 3.15

recapitalisation. The Commission granted two State aid applications before a restructuring plan was received. The restructuring plan was deemed insufficient and an investigation has commenced (see below).

The Commission stated *"the R&R guidelines are of general application, while foreseeing certain specific criteria for the financial sector."*[218] The R&R Guidelines were created for Article 107 (3)(c). This is further evidence of the convergence in assessing undertakings via Article 107 (3)(b) and Article 107 (3)(c). The Irish Government received a 75% voting right in the company for the capital injection with a five year buy back clause from Anglo. The Commission did not view the transfer of ownership as an issue and the five year buy back clause will act as an incentive for Anglo to repurchase the shares.

The Commission granted the recapitalisation under Article 107 (3)(b) because the combination of the Banking Guarantee and new recapitalisation (particularly the restructuring aspect) will *"secure the proportionality of the aid and* (will serve) *to limit possible distortions of competition*"[219] Regarding Anglo's financial position the Commission stated it *"does not share the view of the Irish authorities that the bank remains fundamentally sound."*[220] Ultimately the Commission granted the aid because it was consistent with the Recap Report. The Commission granted State aid to a firm that is not viable. This is contrary to the current Crisis Framework. The Commission appears to be influenced by the "small" amount of aid requested. This highlights the issue of the uniform application of State aid to member states. Ireland's tax income for 2008 was approximately 49 billion.[221] In contrast, German revenue for the same period was €1050.7 billion.[222] One billion euro is a substantial amount for any small member state. An unviable firm should not receive aid just because the application is inline with the overall Crisis Framework. Furthermore to attain proportionality from a State aid injection, the firm must return to viability. Proportionality cannot be achieved from a liquated firm. In contrast to this State aid cannot be used to artificially maintain an ailing firm. Therefore State aid should be granted only to viable firms.

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[218] Ibid at 6

[219] Commission Decision, N9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State* Brussels, (2009) at 70.

[220] Ibid at 66.

[221]Department of Finance, <http://www.budget.gov.ie/Budgets/2008/Documents/BudgetTables.pdf > 10/05/10

[222] German Federal Statistical Office, <http://www.destatis.de/jetspeed/portal/cms/Sites/destatis/Internet/EN/Navigation/Statistics/FinanzenSteuern/OeffentlicheHaushalte/OeffentlicheFinanzen.psml> 10/05/10.

As in the *Credit Lyonnais* case, the use of a bank guarantee has lead to a situation that the State aid had to be given. If Anglo had gone into liquidation in December 2008, the tax payer would have been liable. The €1 billion recapitalisation was never given to Anglo. The economic situation deteriorated and State aid on a larger scale was deemed necessary as is outlined below.

4.7 The Nationalisation of Anglo Irish Bank

On the 4th February 2009, the Government notified the Commission of the nationalisation of Anglo *"for as long as this required to safeguard its financial stability."*[223] The nationalisation was necessary because of the *"corporate governance developments at the Bank had caused serious reputational damage to it."*[224] The Commission perceives the nationalisation of Anglo as a *"mere change in ownership"*[225]and this does not constitute State aid under Article 107 (1) of the TFEU. The Commission viewed the Banking Guarantee in combination with the nationalisation of Anglo as not creating an extra burden on the State. However this presumption is flawed. The Guarantee is temporary in nature and a burden would be created if any future liabilities arose. Therefore nationalisation is not a mere change in ownership it is a promise to cover any future liabilities. This promise has huge implications particularly where an undertaking is in difficulty and it is applying for aid under Article 107 (3) (b) or (c). Anglo had already been granted aid for recapitalisation under Article 107 (3)(b) and given the contraction in the economy and the firms financially difficulty there was a high probability that future State aid would be needed. The Commission, in granting the nationalisation effectively ensured the Irish State would be liable for all future debts. This however, would be subject to further Commission approval.

This demonstrates that the Commission considers Anglo (and other beneficiaries) as quasi-nationalised under the Banking Guarantee. The Guarantee would and must cover any future liabilities. Therefore any banking applications of State aid would be granted for the duration of the Banking Guarantee. This unlimited access to State aid could be problematic where a credit institution cannot raise capital on the markets. The Government is therefore the only source of

[223] Commission Decision, No 9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State,* Brussels (2009) at 19.
[224] Commission Decision, No 356/2009-*Recapitalisation of Anglo Irish Bank by the Irish State,* Brussels (2009) at 17.
[225] Commission Decision No 9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State*, Brussels (2009).

capital. It is possible that the cost of State aid will be greater then the cost of not granting State aid. This issue is more likely to arise under Article 107 (3)(b) where there is a systemic economic problem, than any other Article 107 exemptions. State aid applications under 107(3)(b) by their nature are more costly. This has a greater impact on smaller member states such as Ireland.

The Commission's decision may have been different if the Banking Guarantee did not exist, in this situation the transfer of Anglo's liabilities on to the State would have probably been deemed State aid under Article 107 (1) and therefore by subject to Article 107 (3)(b).

4.8 The Second Recapitalisation Application of Anglo Irish Bank

On the 29th May 2009, the Irish Government applied for a €4 billion capital injection of State aid to Anglo Irish Bank. This recapitalisation is significant because it is four times that of the January Recapitalisation Application which the Commission deemed not a significant size.[226] Furthermore the Commission stated that Anglo is not viable.[227] The €4 billion recapitalisation was deemed necessary because of a combination of the financial crisis, the Banking Guarantee and pre-nationalisation reputational damage of Anglo. The purpose of the measure is *"to preserve the stability of Anglo, to safeguard the Irish financial system and to remedy a serious disturbance in the Irish economy caused."*[228] Critically the liquidity ratio had fallen below the minimum regulatory standards of the Financial Regulator. The Financial Regulator granted a temporary derogation in respect of this liquidity shortfall. However under paragraph 28 and 30,[229] Anglo *"will have to draw up a restructuring plan within six months...where* (the) *covered institutions' solvency ratio falls below the minimum regulatory standard."* The second recapitalisation application was still within the six month restructuring plan limit of the first recapitalisation application. Stan Maes, head of the Chief Economist Team, European Commission stated in the questionnaire that the *"bank restructuring (monitoring)"*[230] is one of the biggest issues concerning State aid. If the restructuring/viability plan is deemed insufficient, the Commission could repatriate the State aid.[231] The Commission is unlikely repatriate the State

[226] Commission Decision, No 9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State,* Brussels (2009) at 66
[227] Ibid at 66.
[228] Ibid at 22.
[229] Commission Decision No NN048-08 *Guarantee scheme for banks in Ireland,* Brussels (2008)
[230] See annex 1.
[231] Article 108 (2) TFEU.

aid, because the realpolitik of the situation could and would not allow it. Withdrawing the State aid from Anglo would result in its collapse. The recapitalisation application states the initial deleveraging (reduction of financial instruments) will offset against NAMA proposal "*if possible.*"[232] This is a serious State aid issue. A member state cannot rely on one State aid mechanism to offset another, particularly where NAMA was still (at the time) under the Commission's consideration. Anglo also proposed to use €1 billion of the €4 billion to purchase old subordinated loans and thus reduce Anglo's overall debt via a "Liability Management Exercise".

In assessing the aid under Art 107 (1), the Commission found Anglo was open to *"intense international competition"*[233] and the aid was imputable to the Irish State and therefore "*state resources are involved.*"[234] The imputability test was first implied in the *France v Commission* where the ECJ held that the *"advantages to be capable of being categorised as aid within the meaning of Article 87 (1)EC, they must first be granted directly or indirectly through State resources...and, second, be imputable to the State."*[235] The use of this new test represents a high standard in State aid assessment. The Commission applied the MEIP to the application. The Commission distinguished between firms in difficulty and normal firms. The MEIP appears to be inapplicable where the purpose is to *"avoid a further deterioration in Anglo's financial position."*[236] This is a major progression in the development of the MEIP. Every firm in difficulty would fail the MEIP. State aid under rescue and recapitalisation by its very nature exists outside the MEIP. The Commission applied the test of selectivity where the MEIP was inapplicable. The Commission decided *"the advantage is selective since it only benefits the Bank."*[237]The Commission examined the application under 107 (3)(b) and applied the proportionality test laid out in Banking Communication.

[232] Commission Decision, N9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State* at 42.
[233] Ibid at 45.
[234] Ibid at 46.
[235] *France v Commission,* C-482/00, [2002] ECR I-4397 para 24.
[236] Commission Decision, N9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State* Brussels (2009) at 48.
[237] Commission Decision, N9/2009 *Recapitalisation of Anglo Irish Bank by the Irish State* Brussels (2009) at 48.

The Commission found the aid was appropriate where:

1. There was a severe deterioration of the capital of Anglo as huge impairment provisions are required to cover the losses on its loan books. The Commission considers that the Bank is distressed and in serious difficulties failing to meet requirements by the Financial Regulator.[238]
2. Anglo is of systemic importance to the Irish economy and the *"intention of the Irish Authorities is that, following the capital injection, there will be a transfer of land and ...loans and connected exposures to NAMA*"[239]
3. The Commission views the lack of remuneration from the capital injection as *"indicative of the high level of distress of Anglo Irish"*[240]

The Commission did not view the Liability Management Exercise as a State aid issue as it will be subject to the market value. The second factor above indicates that the recapitalisation was a bridging mechanism to NAMA. This goes against the Commission's primary "first time, last time" rule as set out in the R&R Report.[241] State aid has never been used to fill a gap until further State aid mechanisms can be implemented. State aid mechanisms have always been self contained, minimal and necessary. This is stated under the current Crisis Framework and ensured through the use the proportionality test, the MEIP and the latest test under the IAC Report (discussed below). Historically there have been times where multiple State aid applications were granted to the beneficiary as seen in *Credit Lyonnais* but the applications were always considered independently and in their entirety. The Commission granted four billion euro to Anglo, a firm it considers not viable, without reviewing a restructuring plan (this had not been submitted yet) to ensure its survival until the next State aid mechanism (which had not been granted) could be implemented. This is a reckless use of State aid by the Commission.

The third factor goes against the "quid pro qua" perception that the Commission has set as standard. It appears that the Commission views the lack of quid pro qua as indicative of distress but not a reason to withhold State aid. Overall there is a strong indication by the Commission

[238] Ibid at 53.
[239] Ibid at 55.
[240] Ibid at 65.
[241] R&R Report, C244/02 (2004) at 5.

that restructuring Anglo will remedy many of the issues discussed above. The Commission notes that Anglo is subject to the terms of the CIFS. It is unclear if the Commission views this positively because Anglo is contractually obligated under the terms of the CIFS or negatively because the Irish State is liable and therefore obligated to give the aid. The Commission ultimately granted the State aid under Article 107 (3)(b)

4.9 The National Assets Management Agency

NAMA is an Assets Removal Scheme (ARS). ARSs are traditionally used when there is a higher *"probability that the pace of deterioration of assets value and credit quality, and associated bank assets impairment and capital erosion, could accentuate in the foreseeable future*."[242] ARS's also allow a "clean break" for the banks allowing them to recover faster then if an Assets Insurance Scheme (AIS) is used. An AIS is used *"where the assets remain on the banks' balance sheet"*[243] but the assets are insured by the State.

The purpose of NAMA is to *"restore stability to the Irish banking system"* [244] by "*acquiring such eligible bank assets from participating institutions.*"[245] The table below shows the total assets of the financial institutions based in Ireland.

Bank	Total assets 2008 EUR bn	% of total
Bank of Ireland	194.1	26.5%
Allied Irish Bank	179.5	24.5%
Anglo Irish Bank	88.5	12.1%
Permanent TSB	74.3	10.1%
Bank of Scotland (Ireland) (Lloyds)	54.1	7.4%
Ulster bank (RBS)	48.7	6.6%
National Irish Bank (Danske)	28.2	3.8%
EBS	21.4	2.9%
KBC Ireland (KBC)	21.1	2.9%
INBS	14.4	2.0%
ACCBank (Rabobank)	8.4	1.2%

fig 2.0[246]

[242] European Central Bank *Guiding Principles for bank asset support schemes* Brussels (2008) pg 5 http://www.nama.ie/Publications/2009/GuidingPrinciplesBankAssetSupportSchemes25FEB09.pdf 24/05/10.
[243] Ibid at 2.
[244] Commission Press Release, IP/10/198 26/02/2010.
[245] Commission Decision, N725/2009 *Ireland establishment of NAMA: Asset relief scheme for banks in Ireland,* Brussels (2009) (hereinafter Est of NAMA).

Of the institutions listed above only Bank of Ireland (BOI), Allied Irish Bank (AIB), Anglo Irish Bank (Anglo), Educational Building Society (EBS) and Irish National Building Society (INBS) have opted to participate in NAMA.

4.10 The NAMA Process

NAMA will purchase €82.5 billion worth of assets, [247] €10 billion of which is rolled up interest. The State will therefore purchase the €72.5 billion of assets with at "hair cut" price of €54 billion. NAMA will receive €12 billion in interest payments from good developers which owe €62 billion of the €72.5 billion. The State will have to pay €16 billion in Irish bond interest payments. NAMA will recover €4 billion per annum from selling properties and other assets. The interest from the good loans will cover the shortfall from the bad loans. This shortfall is predicted to reduce as the assets are sold off and as the loans mature in the eleven year life cycle of NAMA. NAMA is predicted to make €5 billion in profit.[248]

The transferring process from credit institutions to NAMA is expected to be 7 months in duration from May 2010 to November 2010, as shown in Figure 2.

Period	Projected number of exposures (cumulative)	Projected book value of loans transferred (cumulative) , in EUR billion	Projected amount of issued securities, in EUR billion
Month 1	10	16	11.2
Month 2	35	24	16.8
Month 3	100	38	26.6
Month 4	300	50	35.0
Month 5	750	60	42.0
Month 6	1,200	70	49.0
Month 7	1,500-2,000	77	54.0

Figure 2[249]

[246] European Commission, *Vademecum, Community law on State aid*, Brussels, 2008, <http://ec.europa.eu/competition/state_aid/studies_reports/vademecum_on_rules_09_2008_en.pdf> at 19/2/10.

[247] €82.5 billion as stated in State aid N725/2009 Ireland establishment of NAMA Asset relief scheme for banks in Ireland.

[248] Carswell, *The anatomy of Nama,* The Irish Times 13/11/09 <http://irelandafternama.files.wordpress.com/2009/11/the-anatomy-of-nama1.png> Figures updated from State aid N725/2009 Report.

[249] Carswell, *The anatomy of Nama,* The Irish Times 13/11/09 <http://irelandafternama.files.wordpress.com/2009/11/the-anatomy-of-nama1.png> Figures updated from State aid N725/2009 Report.

NAMA's "*fundamental purpose* (is to) *acquir*(e) *assets in order to address a serious threat to the economy and to the systemic stability of credit institutions in the State*."[250]

NAMA will evaluate the property through four mechanisms by calculating:

1. The current market value of the property or *"the estimated amount that would be paid by a willing buyer to a willing seller in an arm's length transaction."*[251]
2. The long term economic value of the property.
3. The current market value of the transferred loan asset itself or *"the estimated amount that would be paid by a willing buyer to a willing seller in an arm's length transaction*"[252]
4. The long term economic value of the loan asset, *"the value determined by NAMA."*

The majority of the evaluation will be determined ahead of the transfer and will be valued by an independent professional real estate valuer in accordance with the provisions of the Appraisal and Valuation Manual of the UK Royal Institution of Chartered Surveyors. "*The asset valuer should be a member of a recognised professional body."*[253] Independent evaluation is in line with IAC *"when assessing the valuation methods put forward by the Member State for asset-relief measures...the Commission will consult panels of valuation experts."*[254] Independent evaluation of assets is one of the oldest requirements of the Commission. It predates the MEIP but it is still useful as it serves to complement the Principle by ensuring market value.

4.10.1 Risk sharing

Some of the assets cannot be valued ahead of the transfer and if their original price purchase price is above NAMA selling price, the financial institution will repay NAMA the difference.

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[250] Est of NAMA, N725/2009 (2009) at 44

[251] Ibid at 53.

[252] Ibid at 53

[253] D'Sa R, *European Community Law on State aid*, (1st Ed., London 1998).

[254] Commission Notice *on the Treatment of Impaired Assets in the Community Banking Sector* Brussels at 43 < http://ec.europa.eu/competition/state_aid/legislation/impaired_assets.pdf>

There are two further risk sharing mechanisms:

1. NAMA will pay 5% of the transfer price in the form of a subordinated debt security. If losses occur and the repayment of the subordinated security is compromised, up to 5% loss will be borne by the participating credit institution.
2. The Irish Government *"intend(s) to introduce a levy on the participating financial institutions if, on the winding up of NAMA, there were to be a deficit"*[255] This was not considered by the Commission as it is an intention.

The Government will submit or amend a restructuring plan for all the undertakings involved and will report to the Commission every six months on the *"functioning of the assets relief measure and on the development of the participating institutions' restructuring plans."*[256] The Commission examined NAMA under Article 107 (1) TFEU. The Commission applied the MEIP. The Commission found the purchase of assets with up to 95% State guaranteed bonds are clearly financed through State resources. The Commission then applied the selectivity test and found an economic advantage to exist where the Scheme strengthens the beneficiaries' position against their competitors in Ireland and in the EU. Finally the Commission applied the IAC Report and found State aid to exist where *"impaired assets are purchased at a value above the market price"*[257] This is a new standard applied by the Commission. The Commission also noted that NAMA's exemption from stamp duty is a direct form of State aid. Taxation as a form of State aid is a sensitive subject. Taxation does fall within the sovereignty of a member state and non discriminatory taxation does not generally constitute State aid.[258] However in the seminal case of *Italy v Commission* 1974,[259] the ECJ held that any measures "*intended to partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general system without there being any justification for this exemption on the basis of the nature….constituted State aid"*[260] Despite NAMA's unique function it does not justify the exemption from stamp duty because it was deemed a selective advantage of State aid.

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[255] Est of NAMA, N725/2009 (2009) at 70
[256] Ibid at 74 vi
[257] Above n 241
[258] D'Sa R, *European Community Law on State aid*, (1st Ed., London 1998).
[259] *Italy v Commission*, C-173/79 [1974] ECR709.
[260] Jones & Sufrin *EC Competition Law*, (3rdEd., Oxford 2007).

4.10.2 Transparency

The IAC requires State aid to *"be subject to full ex-ante transparency and the disclosure of impairments by eligible banks on the assets"*[261] covered by NAMA. The Commission also views positively the duty of the NAMA Officers *"to act in utmost good faith"*[262]and the notification in the form of a letter to each individual from the Financial Regulator identifying the valuation process and any losses incurred by the participating institutions. The "ex ante" transparency is the highest level of transparency ever required by the Commission. The contractual inclusion of the fiduciary duty of the NAMA Officers and the notification proceeds are unique and represent a major progression in the area of transparency. These measures result in ensuring the NAMA Officers are liable for any malfeasance. This could act as an exit strategy for Ireland in the event of transparency issues.

4.10.3 Burden Sharing

The IAC states as a general principle that *"banks ought to bear the losses associated with impaired assets to the maximum extent"*[263] and therefore *"the assets should be transferred at a price that…stays below the real economic value."*[264] The Commission views the burden sharing scheme as adequate because transfer price is below the real economic value[265] of the bank asset.

4.10.4 Eligibility of Assets

The Commission recognises the Irish Economy has been affected by the burst of a property bubble and as a consequence property loans are *"at the source of the principle uncertainty"*[266]
76% of the non-performing aggregate loans of the participating credit institution are in the form of loans backed by land and property development.[267] This estimate by HSBC highlights the large exposure of the financial institutions to the burst property bubble. The Commission found on this basis that the scope of assets within NAMA comply with the HSBC Report and are therefore eligible for transfer. The IAC expressly states the bursting of a property bubble as an

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[261] Above n 241 at 20.
[262] Est of NAMA, N725/2009 (2009) at 94.
[263] Above n 241 at 21.
[264] Est of NAMA, N725/2009 (2009) at 98.
[265] The value of the assets adjusted for inflation.
[266] Commission Decision N725/2009 *Est of NAMA: Asset relief scheme for banks in Ireland* at 111.
[267] Ibid at 111.

example of a group of eligible assets. Furthermore the IAC highlights the use of a proportionality test- "*the greater the proportion which the assets concerned represent in the portfolio of the bank, the more thorough the restructuring and the remedies to avoid undue distortions of competition.*"[268] In the case of NAMA, as stated above 76% of loans are a direct result of a property bubble. This reduces the need for restructuring measures and remedies for the beneficiary banks. The IAC limits the use of open ended State aid by considering only assets entered on to the balance sheet of the beneficiary banks by a specified cut off date. This is the reason for the seven month NAMA transfer limitation.

4.10.5 NAMA's Powers

The Commission in examining NAMA's legal powers, utilised the MEIP. This is unusual because the Commission usually considers the economic position of an undertaking in the market rather than its powers on the market. This is an extension to the MEIP.

NAMA's legal powers include:

1. The power to make an order vesting in NAMA the interest in land.
2. The power to compulsory acquire land.
3. The right to unilaterally amend contracts.[269]

All the powers were found to be distortive to the market as they were outside the norms of the market operators. This is problematic as the purpose of NAMA is to restore normal function by interfering with the market. Traditionally the Commission would remedy any distortions in the domestic market by:

1. restructuring the undertaking
2. fining the undertaking.

In both cases this would be unsuitable because NAMA cannot be restructured and fining NAMA would result in fining the Irish taxpayer. This is a situation the Commission has endeavoured to avoid. The Commission could attempt to limit the State Body's powers. However this would lead to a political confrontation between the Commission and the Oireachtas. Again this is something both parties would want to avoid. The Commission was appeased by NAMA consulting the

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[268] IAC, at para 36.
[269] Est of NAMA, N725/2009 (2009).

Commission on the use of its power. The Commission found NAMA compatible to Article 107 (3)(b). The Commission launched a formal investigation into Anglo Irish Bank[270] on the 31st March 2010 regarding the viability of the restructuring plans submitted by Anglo and the Irish Government.

4.11 Conclusion

The application of the proportionality test to a systemic problem under Article 107(3)(b) has allowed the Commission to justify the nationalisation and heavy recapitalisation of a firm it considers unviable because of an overall social objective; the stabilisation of the financial sector. This is dangerously low standard and as demonstrated above has lead to the abandonment of the strict policy regulation of State Aid in the financial sector. The Irish Banking Guarantee was implemented to restore confidence into the Irish Financial Market. Its purpose was never to actually restore any or all of the credit institutions. This is evidenced by the wide scope and the €376 billion value of the Guarantee. The combination of the Banking Guarantee and proportionality test has forced Ireland to recapitalise several ailing firms. This recapitalisation is outside the original purpose of the Banking Guarantee. The implementation of the pan European Guarantee Scheme will reduce the need for domestic guarantee schemes. This will ensure that any future domestic State aid applications will remain separate and distinct. A member state will no longer be able to justify aid through a broad social objective. The State aid will be considered in its entirety rather then its effect vis-à-vis a banking guarantee.

Overall there has been a movement away from the Commission's traditionally State aid policy on the financial sector. However this does not appear to be intentional. It has occurred because of the main tools applied by the Commission, the proportionality test and social objective are inappropriate mechanisms for use with the systemic problems under Article 107 (3)(b). The social objectivity of financial stability results in every State aid application being granted. The granting of two recapitalisations, one nationalisation and a further transfer of bad assets from Anglo is evidence of the inappropriateness of the social objective standard. By granting State aid to several ailing firms, this calls into question whether proportionality can be achieved. This limits Ireland's ability to recoup funds invested into the beneficiary banks. This could jeopardise

[270] and Irish Nationwide Building Society.

Ireland financial position. State aid has grown to a point where, the amounts of aid are so massive, the ability of member state to recoup the aid is vital to the member states' viability.[271]

The Commission has expressed the view that reckless corporate governance was central to the problems experienced by Credit Lyonnais, Anglo Irish Bank and Irish Nationwide Building Society. However the requirements of State aid applications do not remedy the initial cause for the need of State aid. The Commission must ensure the use of responsible corporate governance at a pre State aid level within a pan European Banking Regulatory Body. This will ensure that credit institutions are not as vulnerable to shocks to the market.

By regulating the cause, the Commission will reduce the number and scope of State aid applications. Maes states *"we may need to think about bank-specific guidelines, given the special nature of systemic crises in the financial sector.....will also depend on regulatory reforms."* [272]

The De Larosiere Report[273] recommends the creation of European Supervisory Authority (ESA). The ESA will monitor and regulate the banking industry.[274]

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[271] See discussion in Kelly M, *burden of Irish debt could yet eclipse that of Greece,* Irish Times 24/05/10 <http://www.irishtimes.com/newspaper/opinion/2010/0522/1224270888132.html> 26/05/10

[272] Maes S, Questionnaire, Annex 1

[273] De Larosiere J, *The high-level Group on Financial Supervision in the EU* IP08/1679 Brussels (2008).

[274] The ESA's are currently being drawn up so it is impossible to predict their powers and effects.

Chapter Five Exit Strategies

The single biggest difficulty in this area is the uncertainty surrounding the beneficiaries and the European Economy. It is therefore impossible to predict an accurate exit strategy for the State aid beneficiaries. The Commission views "*that although market conditions* (of the) *EU…financial markets have not yet fully normalised…access to funding is no longer a systematic and generalised problem.*"[275] Therefore the role of Article 107(3)(b) for the majority of the member states has come to an end. The current issue for the Commission is to ensure proportionality of State aid within the Common Market.

5.1 The Viability Report and Exit Strategies

Stan Maes, head of the Chief Economist Team, European Commission stated in the questionnaire that the *"exit debate (granting of debt guarantees in particular* (and) *also bank restructuring (monitoring)"*[276] are the biggest issues concerning State aid. The ultimate aim of State aid is to return the beneficiaries to viable enterprises. This is subject to the Viability Report.[277] Under the Banking Communication discussed in Section 4.1, the beneficiaries were obliged to draw up restructuring plans in which they identify problems and devise solutions for a return to sustainability. The Viability Report establishes the restructuring plan as the *"first step in the restoration of viability."* It is not possible to comment on individual restructuring plans as they are confidential. The Restructuring Plan must include alternative strategies such as mergers, break ups and even liquidations. This is a big progression in State aid Regulation. Traditionally State aid was used to return a firm to viability. The idea of liquidating a State aid beneficiary appears contrary to this idea. However considering the overall social objective of State aid; stabilising the financial sector it is not as alien as first perceived. Despite the proportionality issue, the slow controlled wind down of a financial institution would preserve banking stability within the financial sector and also rid the sector of an inefficient undertaking. This would return the sector to a competitive equilibrium.

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[275] Commission Notice, *The Application of state aid rules to government guarantee schemes covering bank debt to be issued after 30th June 2010,* Brussels (2010)
[276] See Annex 1
[277] Viability Report (2009/C 195/04) (2009).

As part of the exit strategy the Commission requires that the State aid *"is either redeemed over time…or remunerated according to normal market conditions."*[278] This will ensure proportionality. As stated above in 4.1.1, the ability of a member state to recoup the aid under Article 107(3)(b) is at question. Kelly predicts that Ireland could have a debt ratio of 115 % GDP by 2012[279], as a result of NAMA and banking recapitalisation State aid.

The Commission requires any restructuring plan to be implemented as soon as possible and to have a maximum life span of five years.[280] The danger in codifying the life span is it forces banks to sell off assets and this could create a banking assets fire sale. This would undermine the stability of the financial market and the ultimate goal of State aid. The Commission therefore must balance the stability of the beneficiaries' vis-à-vis the imposition of proportionality. The five year limit is therefore unrealistic. The Commission views it will achieve this balance through *"adequate remuneration of any state intervention.* (This) *is one of the most appropriate limitations of distortions of competition."*[281] This will be achieved through the divesting of subsidiaries or branches or customer and business portfolios.[282] This ability is also questionable as discussed in 4.1. Further to this the Commission requires regular reporting of every six months concerning restructuring efforts. This is an extension of traditional State aid reporting. The Viability Report also requires external consultancy[283] regarding any possible strategies. This is akin to the independent evaluation required under IAC Report.[284]

The biggest difficulty in implementing an exit strategy is that it assumes the economic crisis is over or ending. There is no guarantee in this. Article 107 (3)(b) is only used within systemic economic problems, such as a recession. However if the recession is to continue further State aid might be needed. This would infringe upon any restructuring plans and exit strategies. Furthermore any State aid mechanisms exited prematurely might undermine economic stability or recovery.

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278 Viability Report (2009/C 195/04) (2009) at 14

279 Kelly M, *Burden of Irish debt could yet eclipse that of Greece,* Irish Times 24/05/10 <http://www.irishtimes.com/newspaper/opinion/2010/0522/1224270888132.html> 25/05/10.

280 Ibid at 15

281 Ibid at 34

282 Ibid at 35

283 Viability Report (2009/C 195/04) (2009) at 9

284 IAC Report at 5.1

5.2 NAMA and the Irish Banking Guarantee Scheme

The Irish Banking Guarantee Scheme as expressed under the CIFS will expire on the 30th September 2010. The Irish Government has indicated a need to extend the Guarantee.[285] The Commission wants to implement "*a process of gradual disengagement from the use of government guarantee schemes.*"[286] Therefore whilst the scope of the Guarantee will be reduced, the membership fee for any guarantee scheme will be increased.[287] This acts as a disincentive for undertakings. The Commission has recommended the use of a banking guarantee cap on State aid. If a beneficiary exceeds the cap, it will automatically trigger the requirement of a viability review. This however, will have the same problems as the six month restructuring plan required under the Banking Communication. The Commission will be financially blind for duration it takes to complete the viability review. The ability of the Commission to repatriate the aid could also be diminished under Article 107 (3)(b) because of the 'realpolitik'. No member state would allow the withdrawal of State aid resulting in the collapse of an undertaking.

As stated above, the possible extension of the European Guarantee Scheme[288] from €50,000[289] to €100,000 will reduce the need and impact for a domestic guarantee scheme. This will greatly simplify State aid regulation. Member states will no longer be obliged under banking guarantees to grant State aid to ailing undertakings.

5.3 NAMA and an Exit Strategy

The NAMA transfers began on 3rd May 2010 and will continue for seven months.[290] It is believed that between 20%[291]-50%[292] of the assets transferred will go bad. The remaining 80%-50% of the assets are viable. NAMA is an unusual "bad bank" because it is transferring both good and bad loans. As a result, it has a higher chance of breaking even. Furthermore the burden

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[285] Irish Independent "Lenihan moves to extend guarantee" Dublin 13/06/2009 <http://www.independent.ie/business/irish/lenihan-moves-to-extend-bank-guarantee-deadline-1772602.html>

[286] Commission, *The application of state aid rules to government guarantee schemes covering bank debt to be issued after 30th June 2010,* Brussels (2010)

[287] Viability Report 2009/C 195/04 section 6

[288] Directive 2009/14/EC

[289] Commission Directive 20014/EC

[290] Commission "State aid N725/2009 Ireland est NAMA" 26.2.2010 Brussels at 46

[291] Carswell S, *"The anatomy of NAMA"* 13/11/09 http://irelandafternama.wordpress.com/2009/11/24/the-anatomy-of-nama-in-the-irish-times/

[292] Above n 279

sharing methods, particularly the claw back clause, allows the Irish Government to fine beneficiaries in the event of a short fall (as discussed in Section 4.10.3). NAMA has a predicted lifespan of eleven years. This is well beyond the codified five year plan under the Viability Report. Asset relief management/asset removal schemes are subject to the IAC Report. However although the Report outlines exit strategies for the beneficiaries, it is silent on the exit strategy of any asset removal schemes (ARS). Ireland was not alone in creating ring fencing mechanisms. Therefore the European Commission will have to create a further framework outlining the exit strategy for the ARSs.

5.4 Anglo Irish Bank and an Exit Strategy

The Commission has launched (as stated in chapter four) a formal investigation into the restructuring plan submitted by Anglo. The Competition Commissioner has stated "*Brussels will not rubber-stamp such schemes and may even let banks go bankrupt if those plans do not satisfy the Commission.*"[293] However Anglo is subject to the CIFS and therefore Ireland and the Irish taxpayer would be liable for an Anglo bankruptcy. The Commission will implement the proportionality test to ensure a balance of State aid vis-à-vis the Common Market. It is impossible for Anglo to reconstitute the State aid quid pro quo. The amounts of State aid exceed Anglo's balance sheet. This is similar to the *Credit Lyonnais* case, where CL's State aid exceeded its balance sheet in excess of three times (see Section 3.5). In the event that Anglo is wound down over a period of time[294] in applying the proportionality test it is difficult to imagine the recovery of any State aid. This is an example of the social objectivity over powering the proportionality test. The proportionality test ensures that State aid is minimal, well targeted and proportional.[295] Social objectivity justified the use of State aid. In applying both together, social objectivity negated the proportionality test. In this way the proportionality test and social objectivity only work in harmony where the beneficiary returns to a viable enterprise.

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[293] Taylor P <http://blogs.reuters.com/great-debate/2009/04/20/dont-bank-on-eus-tough-state-aid-talk/> 20/04/09
[294] See Article: http://www.independent.ie/business/irish/dukes-says-anglo-will-look-at-20year-winddown-plan-2172407.html 9th May 2010
[295] Banking Communication 2008/C 270/02

5.5 Conclusion

The uncertainty surrounding the financial sector and the economy make it difficult to predict any movement within the area of exit strategies. Currently there are no exit guidelines for ARSs. The Commission will have to establish a framework in this area. There are numerous paths open to Anglo, the worst case scenario in terms of State aid regulation is the liquidation of Anglo and the impact of the social objective of saving Anglo negating the proportionality test. Ireland would have to absorb any loss. This would therefore transfer the financial difficulties from the State aid beneficiary to the State. The Commission must endeavour to find a balance between the financial needs of the economy vis-à-vis State aid regulation.

Chapter Six Dissertation conclusion

Is the European Commission's recent interpretation of Article 107 (3)(b) a departure from traditional State aid policy on the financial sector?

The historical analysis of State aid mechanisms highlights that the parameters for State aid have developed incrementally. The efficiency/equity distinction guided the Commission from 1971 until the *Credit Lyonnais* case in 1994. The efficiency/equity distinction was inappropriate for the large scale recapitalisation of a financial sector where the stability of the economy was paramount. France had to implement a large scale programme of equity to stabilise the economy. The Commission justified the recapitalisation of CL using the social objectivity goal of financial stability. The Commission reduced the competitive impact of the State aid via the proportionality test. This was sufficient for the repeated rescue and recapitalisation of one large financial institution under Article 107 (3)(c). This case marked a departure from the tradition approach of State aid regulation.

The collapse of Lehman Brothers in September 2008 and the resulting collapse of the Celtic Tiger's property bubble heralded a systemic economic crisis in the Irish financial sector. NAMA and the Irish Banking Guarantee were implemented to combat this crisis subject to Article 107(3)(b). The proportionality test had never been applied under Article 107(3)(b). The use of the Irish Banking Guarantee in conjunction with the standard of financial stability obliged the Commission to grant every State aid application for rescue and recapitalisation.

The obligation caused by the Irish Banking Guarantee on State aid will end with the new European directive on guarantees in December 2010. Subject to the IAC, a member state will not be allowed to exceed the directive's amount. This will reduce the need for a domestic guarantee scheme, thereby simplifying State aid regulation.

The speed of the applications was such that the Commission was incapable of analysing if a viable restructuring plan had been submitted. This is evidenced by the Commission investigation into Anglo and Irish Nationwide Building Society. The Commission must ensure that any future State aid beneficiaries submit a restructuring/viability report before State aid is granted. Any delays preparing the restructuring/viability report can be negated if all firms are statutorily obliged to create a restructuring/viability report as standard (similar to a living will).

The use of proportionality test is unsuitable where the beneficiary is unviable. Where a beneficiary is wound down post State aid injection, the Commission cannot ensure proportionality of the State aid. The social objective negates the proportionality test. The Commission's ultimate goal of financial stability is not justified where the financial difficulty is transferred via Article 107(3)(b) from the beneficiary to the member state. It appears the Commission will grant any and all levels of State aid under the social objective standard under Article 107 (3)(b).The Commission has therefore moved away from its traditional restrictive approach to State aid in response to the needs of the members state's extraordinary economic circumstances.

Annex 1

Art 107 3 b *"to remedy a serious disturbance in the economy of a Member State"*?

1. What in your opinion is the biggest issue of State aid on the financial sector for the Member States and/or the European Commission?

2. The Commission has granted every Art 107 3 b application since 2008 to European Union Banks. Do you think the Commission fears fragmentation of the Community (political motivation) or a deepening of economic difficulties (economical motivation) or another factor if it denies a Member State's Article 107 3 b application of State Aid to a credit institution?

3. The Commission's economic policy on State aid promotes programmes of efficiency, for example the horizontal aid programmes (R&D Aid or Training Aid). Rescue and Restructuring Aid to banks are programmes of equity (protecting jobs levels, economies etc).

   Do you think State Aid Economic Policy needs to be revised?

4. Estimates of Anglo Irish bank indicate a balance sheet of EUR90 billion but the bank has been recapitalized of up to EUR10.4 billion[296] and Anglo will be transferring EUR22 billion of loans to the Irish National Assets Management Agency. This is 20% of Irish GDP.

   Should there be a cap on state aid per company?

5. Estimates of the Irish National Assets Management Agency could cost of up to EUR32billion. This is 20% of Irish GDP[297]. It is now possible to imagine a Member State getting into financial difficulty because of State aid obligation. Considering the current debt situation in Greece,

   Should the Commission consider the ability of the Member State to pay the State Aid when assessing State aid?
   Should there be a cap on state aid per Member State?

[296] Case N356/2009,N9/2009 and NN12/2010
[297] EU Observer http://euobserver.com/9/29800

Annex 2

Eoin

Apologies about the delay in replying.

I am not in a position to respond to your queries as they deal with issues which the Central Bank would not be in a position to comment.

I wish you all the best with it and with your continuing studies.

Regards

Neil

Neil Whoriskey
Head of General Secretariat
Central Bank

+353 1 224 6260 (d)
+ 353 87 221 9199 (m)
neil.whoriskey@centralbank.ie

Annex 3

Questionnaire of Stan Maes, PhD,European Commission DG Competition, Chief Economist Team

1. What in your opinion is the biggest issue of state aid on the financial sector for the Member States and/or the European Commission?

   Exit debate (granting of debt guarantees in particular). Also bank restructuring (monitoring).

2. The Commission has granted every Art 107 3 b application since 2008 to European Union Banks. Do you think the Commission fears fragmentation of the Community (political motivation) or a deepening of economic difficulties (economical motivation) or another factor if it denies a Member State's Article 107 3 b application of State Aid to a credit institution?

   Many of the crisis-related Communications (on bank recapitalization, impaired assets, etc.) have an end-2010 deadline, at which point in time we will need to decide whether a prolongation of the 107 3 b framework is still appropriate. The referral to 107 3 b is largely a legal issue, although it has some economic consequences (banks get more time to divest assets to avoid downward price spirals, etc.). Important is that the main "pillars" of the economic assessment do not change when comparing bank restructuring under 107 3 b with the application of the pre-crisis rescue and restructuring guidelines.

3 The Commission's Economic Policy on State aid encourages programmes of efficiency, for example the horizontal aid programmes (R&D Aid or Training Aid). Rescue and Restructuring Aid to banks are programmes of equity (protecting jobs levels, economies etc).

   Do you think State Aid Economic Policy needs to be revised?
   We may need to think about bank-specific guidelines, given the special nature of systemic crises in the financial sector. Not yet decided. Will also depend on regulatory reforms.

4. Estimates of Anglo Irish bank indicate a balance sheet of EUR90 billion but the bank has been recapitalized of up to EUR10.4 billion[298] and Anglo will be transferring EUR22 billion of loans to the Irish National Assets Management Agency. This is 20% of Irish GDP.

   Should there be a cap on state aid per company?
   The aid needs to be proportional and limited to the minimum necessary. In case it is not, it should be deemed incompatible and should be recouped.
   When a bank receives relatively large amounts of aid (as a percentage of risk weighted assets), the required restructuring (burden sharing, competition measures) will be deeper. That is how we try to achieve a level playing field across banks and Member States.

5. Estimates of the Irish National Assets Management Agency could cost of up to EUR32billion. This is 20% of Irish GDP[299]. It is now possible to imagine a Member State getting into financial difficulty because of State aid obligation. Considering the current debt situation in Greece,

   Should the Commission consider the ability of the Member State to pay the State Aid when assessing State aid?

   Actually we take the willingness and ability to grant aid into account by ensuring that the aid gets remunerated properly.
   Also, the final cost to the state cannot always be equated to the initial investment. It depends on the conditions and the viability of the bank post-restructuring.

   Should there be a cap on state aid per Member State?

   No. The need to grant aid may differ across MS. But the aid needs to be proportional and limited to the minimum necessary.

Disclaimer: the views expressed are those of the author and cannot be regarded as stating an official position of the European Commission.

[298] Case N356/2009,N9/2009 and NN12/2010
[299] EU Observer http://euobserver.com/9/29800

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