

Gray J, de Cecco F.

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Chapter 2. Competition, stability and moral hazard: the tension between financial regulation and State aid control

Joanna Gray and Francesco de Cecco

1. Introduction

The events of 2008 and their aftermath underscored how the priorities of financial regulation and those of State aid control can come into direct conflict, and the hard policy choices that must inevitably be made as a consequence. The aim of this chapter is to tease out this tension at a relatively general level – to set the scene conceptually before the more detailed chapters following explore its different aspects in more concrete scenarios. First, this chapter discusses regulatory intent and dominant policy concerns of both of these discrete legal regimes highlighting their difficult but necessary interdependence. It discusses how and whether the central concern of financial regulation, to minimize risk of bank failure thereby retaining systemic stability, might itself raise moral issues and harm competitiveness. Second, it conducts an assessment of the performance of the State aid regime during the financial crisis in order to gauge whether the systemic nature of the crisis had some bearing on the way in which the State aid rules were applied in times of extreme urgency, taking into account threats to both banking stability and member state stability. Third, the chapter traces the transition to Banking Union which, although still very much a work in progress, should ensure that during future crises in the European banking sector, it is not a combination of member state governments and the State aid legal regime that take command of crisis management.

a) *Context: regulatory fragmentation but interdependence*

Prior to the banking crisis of 2008, the focus of European policy in the financial sector was on developing a single market which would integrate banking and financial services. It was hoped that a single currency combined with the measures taken as a result of the 1999 Financial Services Action Plan would lead to greater competitiveness, growth, prosperity and sense of cohesion in Europe.¹ However, even the best laid, best intentioned and best executed plans can be thwarted by unexpected events. Events in global financial markets and the effect they have had on Europe's banks since 2008 have stymied the efforts of the 1999 Lisbon summit where the Financial Services Action Plan was drawn up. How different it all appears now as tighter degrees of banking and monetary union emerge within the Euro area as a response to crisis, while at the same time the member state that hosts the largest financial center in the EU looks for a new legal and political settlement with the rest of Europe.²

One lesson from the crisis that devastated the European banking sector in 2008 was that, in the absence of a genuinely supranational regime for regulation, it remained for the State aid regime alone to police the measures taken by member states to stabilize, rescue and resolve banks established within their territories. For in times of financial distress and systemic crisis, national governments look to protect first and foremost the deposits of their electorates, as well as the jobs they have within financial institutions established there. Supporting a border-free European single market in banking and financial services comes a distant second. As the experience of 2008 demonstrated, banks established in other member states can suddenly be faced with interventions and

¹ Communication from the Commission of 11 May 1999 Financial Services: Implementing the Framework for Financial Markets – Action Plan (COM(1999)232) (Financial Services Action Plan 1999), not yet published; Green Paper on Financial Services Policy (2005-10) [2006] OJ C65/134.

² Announcement of national referendum on a new status for the UK within the EU by British Prime Minister on 22 February 2016 <<https://www.gov.uk/government/speeches/pm-commons-statement-on-eu-reform-and-referendum-22-february-2016>> accessed 15 April 2016.

measures justified in terms of their contribution to “financial stability” despite their discriminatory, protectionist and anti-competitive effects. Given the enormous policy development and legislative effort that has gone into the European Banking Union in the post-crisis period (and which are considered in outline below and in detail elsewhere in this work), it is easy to forget the near absence of a “*communautaire*” response both during and in the immediate aftermath of the banking crisis of 2008 itself.³ In the face of often uncoordinated national intervention, rescue and stabilization actions being taken by member states to shore up both individual institutional and systemic stability, it was left to the European Union’s State aid regime to oversee each and every member state’s intervention in Europe’s banks and try to prevent further destabilization of the European financial system, as well as damage to the integrity of the single market for European banking.⁴

b) Banking regulation and financial stability

Legal and regulatory frameworks designed to enable the business of banking are motivated by a number of objectives.⁵ These commonly range from the paternalistic and protective within specific categories, for example, the conduct of business requirements or depositor protection schemes, through to prudential financial resources requirements designed to enhance safety and soundness of regulated institutions, such as regulatory capital requirements. Lessons learned from the 2008 banking crisis have resulted in

³ John Thornhill, ‘Brussels Looks Like Bewildered Bystander Amid Turmoil’ *Financial Times* (18 October 2015).

⁴ Francesco De Cecco, ‘State Aid Law Meets Financial Regulation’ in Joanna Gray and Orkun Akseli (eds), *Financial Regulation in Crisis? The Role of Law and the Failure of Northern Rock* (Edward Elgar 2011).

⁵ Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez and Steven Weisbrod, *Financial Regulation: Why, How and Where Now?* (Routledge 1998) (Goodhart *et al.* 1998).

national, European and global reforms that make the protection of financial stability a more explicit and central objective than it has been hitherto.⁶ This has led to a new paradigm in financial regulation, commonly termed “macroprudential” regulation⁷ and it has financial stability at its core.

This development has fuelled renewed scholarly interest in the politics of financial regulation as well as its capacity to prevent, manage and respond to crises and instability through its practical and operational aspects. The same is true of the State aid legal regime.⁸ Europe’s banking crisis forced the State aid authorities to fill the void of any effective pan-European bank resolution body, with power to override national governmental interventions in banks in the interests of stability of national financial systems and protecting their national depositors’ funds. It thus fell to the State aid regime to prevent further segmentation of the single market in banking and to ensure that concerns about financial stability did not crowd out the importance of promoting competition – even in times of strain and distress to institutions and systems. This is a

⁶ Bank of England Act 1998, 2A (Financial Stability Objective of Bank of England) and Part 1A (Financial Stability Strategy); European Parliament and Council Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB Regulation) [2010] OJ L331/1; at the global level financial stability now informs much international standard setting following the formal establishment of the Financial Stability Board in April 2009 (see G20 Communiqué on Strengthening the International Financial System, 2 April 2009 <https://www.imf.org/external/np/sec/pr/2009/pdf/g20_040209.pdf> accessed 12 September 2016).

⁷ Gabriele Galati and Richhild Moessner, ‘Macroprudential Policy – A Literature Review’ (Bank for International Settlements, Working Paper No. 337, 2011) <<http://www.bis.org/publ/work337.htm>> accessed 15 April 2016.

⁸ Hussein Kassim and Bruce Lyons, ‘The New Political Economy of EU State Aid Policy’ [2013] JICT 13, 1.

delicate role at the best of times, particularly in such a politicized sector as banking.⁹

State aid law performed a role that had not been originally envisaged and has been shaped and altered by it as a result.

c) *Tensions: complex interaction between stability and moral hazard concerns and competition*

Central to both the financial regulatory framework and that of State aid are continuing attempts to ensure the stability of, promote competition in, and minimize moral hazard to both individual financial institutions and the financial system as a whole. The first two terms are used widely in everyday life in contexts far removed from the economic sphere and are used to describe human traits, motivations and patterns of behavior.¹⁰ It is however from their significance in economics that all three derive their importance as primary concerns of financial regulation and State aid law. Perhaps the most fundamental intellectual legacy of the banking crisis of 2008 has been to turn the discipline of economics itself inside out as many of the assumptions it has made about the functioning of markets have been challenged. As the former UK financial regulator Lord Turner commented in his review of the regulatory response to the crisis: '[It] raises important questions about the intellectual assumptions on which previous regulatory approaches

⁹ Anat Admati and Martin Hellwig, *The Bankers' New Clothes* (Princeton University Press 2013) Chapter 12; Christine Desan, *Making Money: Coin, Currency and the Coming of Capitalism* (Oxford University Press 2014), Chapter 8.

¹⁰ Even the term "moral hazard" (hardly the stuff of everyday speech) has entered into popular culture. In the 2010 *Wall Street* movie on the banking crisis, the character played by Michael Douglas responds to a question from a member of the public by saying that: 'Moral hazard is when they take your money and then are not responsible for what they do with it'.

have largely been built. At the core of these assumptions has been the theory of efficient and rational markets.¹¹

Now we know that financial market innovation in the development of highly structured securitized credit products did not always diffuse and allocate risk so as to produce a stable equilibrium in financial markets.¹² The very opposite was often the case as an unhealthy degree of concentration and interlinkage arose between systemically important banks and these products were found on (or all too often off but nonetheless ultimately toxic to) the balance sheets and liquidity positions of many other banks too. The methodology of risk assessment employed in the valuation models around which much of this securitization activity that fuelled competition between banks (and indeed between financial centers), was itself tainted by “model risk” and therefore of little help to regulators and banks in predicting, preparing for and withstanding the ongoing extreme shocks that afflicted the banking system in 2008.¹³ The combined effect of these two factors coupled with cyclical changes in market conditions resulted in a perfect storm of

¹¹ ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ [2009] March FSA (Turner Review), para 1.4.

¹² Even the IMF claimed that debt securitization would bring about greater stability: ‘[T]he dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient’ (IMF Global Financial Stability Report April 2006).

¹³ Paragraph 1.4(iii) of the Turner Review summarizes four distinct failings of the basic risk Value at Risk (VaR) assessment model which, along with more sophisticated variants, lies at the heart of the banking industry’s – and its regulators’ – pre-crisis view of financial risk. Extensive literature exists around that critique and continues to develop around the problem, with too much trust being placed in financial models: e.g. Kevin Dowd, ‘Beyond Value at Risk: The New Science of Risk Management’ (Wiley 1998); Jón Daniélsson, ‘The Emperor Has No Clothes: Limits to Risk Modelling’ [2002] 26 *Journal of Banking and Finance* 4, 1273; Christophe M. Boucher, Jón Daniélsson, Patrick S. Kouontchou, Bertrand B. Maillet, ‘Risk Models-at-Risk’ [2014] *Journal of Banking and Finance* 44, 72.

financial instability which occurred as soon as sentiment in inter-bank lending and property markets changed.

d) *Why banks are special*

There is an inherent fragility at the heart of all banking activity. This is a consequence of the maturity mismatch that is the essence of financial intermediation whereby short-term deposit liabilities are converted into long-term credit assets. This special characteristic is used to justify the regulation of banks in the first place.¹⁴ Diamond and Dybvig have highlighted the role of regulation as a response to the inevitable susceptibility to runs and panics that necessarily accompanies the business model of all banks.¹⁵ But competition within the single market, in contrast to financial stability, was a longstanding European policy goal enshrined in the founding treaties and accompanied by an impressive array of hard powers of intervention, in relation to anti-competitive agreements, abuse of dominance, merger and State aid control, to be operated by the European Union.¹⁶ When competition is combined with the inherent fragility of the banking sector's business model, the potential for instability and bank runs is increased.¹⁷ The existence of deposit

¹⁴ A useful discussion of this aspect of the case for banking regulation along with a summary of literature on the point is provided in Chapter 1 (Goodhart *et al.* 1998), at 10-12.

¹⁵ Douglas W. Diamond and Philip H. Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' [1983] *Journal of Political Economy* 91, at 401, 403.

¹⁶ While Regulation 1/2003 has introduced decentralized enforcement of Article 101 and 102 TFEU, the European Commission retains a monopoly over the enforcement of the State aid provisions set out in Articles 108-9 TFEU.

¹⁷ Thomas F. Hellmann, Kevin C. Murdock and Joseph E. Stiglitz, 'Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?' [2001] *American Economic Review*, 147.

insurance schemes guaranteeing repayment of certain categories of bank deposits in the event of default is a widespread policy response to this in-built tendency towards instability.¹⁸ The ultimate global standard setter for financial regulation of banks, the Basel Committee on Banking Supervision, considers depositor protection a key element in guarding against financial instability although it does not make such a scheme an actual requirement in the most recent version of its Core Principles for Effective Banking Supervision.¹⁹ Despite their growing ubiquity it has been argued that the existence of such schemes can lead to adverse incentives and moral hazard.²⁰ The knowledge that the scheme will provide a safety net can incentivize the kinds of risk-taking and imprudent behavior that they were designed to guard against²¹ as well as diminish the importance of due diligence on the part of the depositor when it comes to determining bank safety and soundness.²² Indeed insurance is often used as the textbook illustration of an

¹⁸ A comprehensive bibliography of literature on deposit insurance schemes spanning their first inception in the 1930s to recent post-crisis reforms is provided by the International Association of Deposit Insurers (IAIDS) at <<http://www.iadi.org/Publications.aspx?id=52>> accessed 18 April 2016.

¹⁹ Preconditions for Effective Banking Supervision, Core Principles for Effective Banking Supervision Basel Committee on Banking Supervision (2012) <<http://www.bis.org/publ/bcbs230.htm> accessed 15 April 2016> accessed 12 May 2016, para. 52.

²⁰ The arguments around this are succinctly rehearsed by the EFTA Court in its January 2013 judgment in Case E-16/11 *EFTA Surveillance Authority v Iceland*, 28 January 2013.

²¹ As recently recognized by Advocate General Mengozzi in his opinion in Case C-127/14 *Andrejs Surmačš v Finanšu un kapitāla tirgus komisija* [2015] ECR I-000, 49-50, in his consideration of whether a Latvian national law could exclude the deposits of employees responsible for supervision, strategy and planning of a bank's business from the coverage of its domestic legislation which implemented the previously applicable Directive 94/19/EC of the European Parliament and Council of 30 May 1994 on deposit guarantee schemes [2004] OJ L135/5.

²² For a useful review of the argument on this point in both the US and European contexts, see Richard S. Grossman, 'Deposit Insurance, Regulation, and Moral Hazard in the Thrift Industry: Evidence from the

arrangement that is fraught with moral hazard.²³ Other instances of moral hazard creating market interventions in financial markets are said to include IMF support to sovereigns,²⁴ the availability and exercise of central bank lender of last resort assistance to banks,²⁵ loosening of monetary policy to support asset prices,²⁶ and of course the tax payer funded bail-outs and rescues across Europe's banking sector that went far beyond the external support provided by the deposit insurance schemes that existed pre-crisis and were extended during it.²⁷ Noss and Sowerbutts identify this latter implicit subsidy to banks as weakening market discipline as well as a source of competitive advantage to those banks that received it and are perceived as within its ambit in future.²⁸ The extent to which such

1930s' [1992] *The American Economic Review* 82, 800; and Nikoletta Klefouri, 'Deposit Insurance Systems and Moral Hazard' [2013] *JIBLR* 28, 271.

²³ Mark V. Pauly, 'The Economics of Moral Hazard' [1968] *American Economic Review* 58, 531.

²⁴ Andrew G. Haldane and Jörg Scheibe, 'IMF Lending and Creditor Moral Hazard' Bank of England Working Paper No. 216 <<http://ssrn.com/abstract=598905>> accessed 18 April 2016.

²⁵ Xavier Freixas, 'Optimal Bail Out Policy, Conditionality and Constructive Ambiguity' (1999) Centre for Economic Policy Research Working Paper No. 400 <<http://ssrn.com/abstract=199054>> accessed 18 April 2016.

²⁶ Gianni De Nicolò, Giovanni Dell'Ariccia, Luc Laeven and Fabian Valencia, 'Monetary Policy and Bank Risk Taking' (1 July 2010), <<http://ssrn.com/abstract=1654582>> accessed 18 April 2016. The potential for moral hazard arising in the European System for Central Banks (ECSB) Outright Monetary Transactions program was recognized by Advocate General Villalón in his opinion delivered on 14 January 2015 in Case C-62/14 *Peter Gauweiler et al v Deutscher Bundestag* [2015] ECR I-000.

²⁷ Kevin Dowd, 'Moral Hazard and the Financial Crisis' [2009] *Cato J.* 29, 141; Angelos A. Antzoulato and Chris Tsoumas, 'Institutions, Moral Hazard and Expected Government Support of Banks' [2014] *Journal of Financial Stability* 15, 161. This point about the public rescues and recapitalizations of Europe's banks was recognized by the General Court in Case T-319/11 *ABN Amro Group NV v European Commission* [2014] ECR I-000.

²⁸ Joseph Noss and Rhiannon Sowerbutts, 'The Implicit Subsidy of Banks' (Bank of England Financial Stability Paper 15, 2012).

moral hazard is real or exaggerated is a contestable question,²⁹ but there can be no doubt that the overall picture that emerges is of a tangled web of interrelationships between competition, financial stability and moral hazard.

e) *Financial instability in the internal market*

Historic evidence abounds that episodes of financial instability afflicting individual banks and sometimes entire regional or country banking systems are nothing new³⁰ and legal history shows us that a period of legislative and renewed regulatory reform and activity follows in the wake of such tipping points.³¹ However, this has been the first episode of financial instability that has beset banks operating across the European Union's internal market. Thus, member state governments could look to historical precedent for ways to curb banking panics and runs and protect depositor funds held in banks operating within their borders and, importantly, had, through their finance ministries and national regulatory authorities the legal wherewithal to do so, at least in the very short term.³²

But the European Union had no such advantages, despite its elaborate pre-crisis architecture of expert advisory committees tasked with ensuring an equivalent and appropriate implementation of the single market legislation for banking and other

²⁹ Lawrence Summers, 'Beware Moral Hazard Fundamentalists' *Financial Times* (23 September 2007).

³⁰ Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press 2012).

³¹ Matthew Hollow, Folarin Akinbami and Randal Michie (eds) *Complexity and Crisis in the Financial System: Critical Perspectives on American and British Banking* (Edward Elgar 2016).

³² In the case of member states in the Eurozone, the costs of State guarantees and transfers to the sovereign's balance sheet employed to stabilize banks fed into the continuing crises in sovereign debt markets in some Eurozone States and to the need for bail-outs and emergency lending programs to the sovereign government itself.

financial services. None of these bodies had the kind of legal competence that could override action taken by member state authorities or set aside the operation of national insolvency laws. The European Union was left powerless to intervene to order steps be taken by cross-border banks and the member states in which they conducted operations to co-ordinate action and thus prevent measures taken by one member state to reassure local depositors from having spillover destabilizing effects in other member states. As a consequence, capital hemorrhaged across borders from the banking systems of crisis-hit member states into whichever member state that had the most generous government guarantees to depositors at the time. The European Union thus learned the hard way that the former Bank of England Governor Mervyn King's description of some large financial groups as 'international in life if not in death' is equally applicable to the cross-border operations of European banks within the single market.³³

How then would the need to promote competition and protect competitiveness of banks sit alongside the need to reverse the negative sentiment surrounding their safety and soundness that imperiled their very existence? For competition and stability are often seen as oppositional values – too much of one can endanger the other. Where to set the balance point between the two is a hard and complex policy choice. It is a choice that inevitably will vary over time and the economic and political cycle as general awareness and interest in the need for competition and competitiveness within an industry or sector on the one hand, as opposed to the need for stability within it, waxes and wanes depending on the immediacy of societal and political concerns. There is no reason to

³³ Mervyn King, 'Banking: From Bagehot to Basel, and Back Again' (Second Bagehot Lecture, Buttonwood Gathering, New York City on Monday 25 October 2010)
<<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech455.pdf>>
accessed 18 April 2016.

suppose that it does not also vary across countries, cultures³⁴ and industry sectors in the same way as it does from person to person when we think of “competitiveness” and “stability” as individual human characteristics. In societies in turmoil we seek stability first and foremost. For those in atrophy and decay we seek the return of growth and renewal of enterprise profitability through a release of energy and spirit from greater competitiveness.

There is extensive scholarly discussion of the competition versus financial stability dichotomy in the academic literature in financial economics.³⁵ But as to how to judge the

³⁴ An illustrative example of the differences within the internal market itself is the very different position taken by the UK to that taken by the European Parliament and the Council as to the validity of the powers of the European Securities and Markets Authority (ESMA) to intervene in short selling activities conferred by Article 28 of Regulation 236/2012. These differences reveal a fundamental philosophical distinction between the two sides regarding the nature of financial stability (and hence amenability to the use of objective decision making criteria). The UK unsuccessfully argued that the regulation conferred too wide and subjective a discretion upon the ESMA to intervene in matters which were the proper province of economic policy and required more nuanced and careful judgment in each and every case. As the Court itself put it in its judgment description of the UK’s view of ESMA judgments about financial stability:

[S]uch decisions will require an analysis of the significant economic policy implications, such as the impact on liquidity and the level of uncertainty that will be created in financial markets, which, in turn, have long-term consequences as to general overall confidence in the markets. These are ‘unquantifiable [...] judgments’ and cannot be categorized as decisions made on the basis of set criteria amenable to objective review.

Case C-270/12 UK v European Parliament and Council of the European Union [2014] OJ C85/4, 31 (*UK v European Parliament and Council* 2014).

³⁵ Allen and Gale consider the nature of the optimal trade-off between competition and stability in banking and posit that ‘[g]reater competition may be good for (static) efficiency, but bad for financial stability’. See Franklin Allen and Douglas Gale, ‘Competition and Financial Stability’ [2004] *Journal of Money, Credit, and*

interrelationship between the two goals, or where the optimal balance might lie, no clear consensus emerges which could be of general application in practical decision making for every instance of banking distress. Unlike economists, those tasked with legal authority are often faced with concrete immediate questions as to whether and how to exercise their powers. The sources of and cures for bank distress can vary so widely that universal rules are unhelpful. As such it was left to the European Commission, through the use of its ability to police the distribution of State aid in the banking sector, to make that difficult policy choice between competition and stability on a case by case basis in an environment where the caseload assumed an urgency and scale that had not been previously envisaged. It had certainly not experienced such a systemic disturbance in any other industry or sector in which it had developed its State aid policy. The way in which it used those powers and could do so again in the next episode of financial instability (for there will surely be one) is the subject of enquiry in many of the essays contained in this work.

2. Rubber-stamping or mission creep? An assessment of the State aid regime during the financial crisis

The Commission's handling of the State aid dimension of the financial crisis has attracted praise for its efficiency in addressing an exponential increase in case load, and for its flexibility in adapting policy and practice to reflect the systemic nature of the crisis. The speed and flexibility of this response however and the near universal approval of State aid

Banking 36, 40; Elena Carletti and Philipp Hartmann, 'Competition and Financial Stability: What's Special About Banking?' in Paul Mizen (ed), *Monetary History, Exchange Rates and Financial Markets: Essays in Honour of Charles Goodhart* (Edward Elgar 2002, Vol. 2); ECB Working Paper No 146/2002; Klaus Schaeck, Martin Cihak and Simon Wolfe, 'Are Competitive Banking Systems More Stable?' [2009] *Journal of Money, Credit and Banking* 41, 711; Xavier Vives, 'Competition and Stability in Banking' (1 April 2010). IESE Business School Working Paper No. 852 <<http://ssrn.com/abstract=1593613>> accessed 18 April 2016.

measures during this period, also gave rise to the claim that, rather than keeping State aid at bay, the Commission's efforts were simply directed towards providing national interventions with a patina of legal respectability.³⁶ Concerns were also raised about the Commission's tendency to act as surrogate financial regulator. Such concerns over "mission creep" were fed by statements emanating from the Commission itself: in the early stages of the financial crisis, Neelie Kroes (then Commissioner for Competition Policy) appeared to endorse the view that the Commission was 'doing the work that banking regulators should be doing', and at a later stage, her successor in the role added that this institution had de facto become a 'central crisis management and resolution authority'.³⁷

On closer inspection, the claim that the Commission exercised excessive forbearance towards national bailout measures seems to be based on a narrow view of the purpose of State aid control, a view that sees the role of State aid law as preventing any form of State intervention that distorts competition. Yet, the high rate of positive (i.e. approval) decisions in the area of State aid is a function of the Commission's power to channel State intervention towards predefined common objectives and to shape

³⁶ On rare occasions, the Commission has found a national aid measure to be incompatible with the internal market. See Commission Decision 2011/346/EU on the State aid C 33/09 implemented by Portugal in the form of a State guarantee to Banco Privado Português [2011] OJ L159/95; Commission Decision on State aid SA.33927 (12/C) implemented by Belgium — Guarantee scheme protecting the shares of individual members of financial cooperatives [2014] OJ L284/53; Commission Decision of 23 December 2015 on the State aid SA.39451 (2015/C) implemented by Italy for Banca Tercas (not yet published).

³⁷ Respectively, Neelie Kroes, 'The Crisis and Beyond: For a Stronger, Cleaner, Fairer Economy' (OECD Forum, 23 June 2009 <http://europa.eu/rapid/press-release_SPEECH-09-306_en.htm?locale=en> accessed 12 May 2016; and Joaquín Almunia, 'Banks in Distress and Europe's Competition Regime: On the Road to the Banking Union' (Peterson Institute for International Economics, 25 September 2013 <http://europa.eu/rapid/press-release_SPEECH-13-750_en.htm> accessed 16 May 2016).

individual State aid measures. This power is exercised *ex ante*, by fleshing out the common objectives outlined in Articles 107(2) and 107(3) TFEU, and through Commission guidelines and communications. But the power is also exercised *ex post* via highly detailed conditions set forth in State aid decisions themselves. Thus, the value of the State aid regime does not simply lie in preventing unwarranted intervention but also in establishing a common approach to State intervention.

A certain level of public intervention is a common feature among all advanced economic systems, where it is used to address genuine market failures, or as a strategic trade policy tool, or even as a short-term tactic in the pursuit of electoral gain.³⁸ However, State intervention has the potential to unravel market integration and reintroduce barriers to trade, for even State intervention that pursues genuine policy concerns may create cross-border externalities and lock member states into a prisoner's dilemma scenario, in which the lack of credible mutual commitment leads to a harmful (and wasteful) subsidy war. The existence of central coordination is intended to prevent this scenario from arising. Indeed this was (arguably) the Commission's most valuable contribution to the management of the financial crisis. Had the Commission indulged in forbearance, it is most likely that a full-scale subsidy war would have emerged. One need only consider the panic initially triggered in September 2008 by the announcement of the Irish government that it would guarantee all (retail, commercial, institutional and interbank) deposits, covered bonds, senior debt and dated subordinated debt of Irish banks.³⁹ By the same token, had the Commission adopted a rigid interpretation of the

³⁸ Timothy Besley and Paul Seabright, 'The Effects and Policy Implications of State Aids to Industry: An Economic Analysis' [1999] 34 *Economic Policy* 13; Mathias Dewatripont and Paul Seabright, 'Wasteful Public Spending and State Aid Control' [2010] *Journal of the European Economic Association* 4, 513.

³⁹ Commission Decision on State aid NN48/2008 Ireland – Guarantee scheme for banks in Ireland [2008] OJ C312/1.

rules, it is likely that member states would have resorted to Article 108(2) TFEU (which gives the Council power to override a Commission State aid decision) — an avenue that would have led to undermining the normative authority of State aid control.

If the “rubber-stamping” claim can easily be dismissed, the claim that State aid control overstepped into the domain of financial regulation deserves to be explored in greater depth, as it points to a feature that is both a strength and a weakness of this regulatory regime. The State aid regime’s openness to a wide range of policy concerns enables the peculiarities of the regulatory domains with which State aid policy interacts to be taken into account, but also allows State aid policy to adapt to fundamental developments in the economy and to reflect the evolution of societal priorities. In order to be able to interact with other policy domains, however, State aid often needs to internalize concepts, interests and values that are not part of the intellectual apparatus of competition law. This openness presents two fundamental challenges. First, the contours of the external concepts that the Commission is required to integrate may elude precise definition and predictable application. Second, despite talk of reconciling different objectives, the outcome of such a balancing process is never neutral, as trade-offs are inevitably made. This openness to other regulatory concerns is central to capturing the Commission’s State aid policy and decision making practice during the financial crisis. In particular the interaction between, on the one hand, typical State aid concerns such as the prevention of distortions of competition and, on the other, the containment of systemic risk and moral hazard, allows us to make sense of State aid policy during this turbulent period. This particular interaction was unprecedented in scope and intensity, but not entirely novel. A brief excursion into pre-crisis State aid practice helps to understand the extent to which the Commission’s policy and practice during the financial crisis broke new ground.

a) Competition, stability and moral hazard in pre-crisis State aid practice

References to moral hazard in State aid policy and practice pre-date the crisis. Indeed the soft budget constraint syndrome, a concept cognate to moral hazard, throws light on some fundamental legal principles of State aid law, which address both the threshold question, that is, whether there is State aid in the first place, and the compatibility question, that is, whether State aid can be authorized. The central insight of the soft budget constraint theory is that the expectation that a supporting organization (typically, the State) will regularly intervene to shield an economic actor from insolvency affects the latter's behavior. A firm that enjoys a soft budget constraint, safe in the knowledge that State assistance will always be forthcoming, is able to either pursue a quiet life or, on the contrary, to take excessive risks. According to the theory, two conditions give rise to the soft budget constraint syndrome: first, the possibility for the beneficiary to renegotiate *ex post* the terms of its funding and, second, a close relationship between the State and the beneficiary of its support. As Kornai, Maskin and Roland remark:⁴⁰

[...] the syndrome is truly at work only if organizations can expect to be rescued from trouble, and those expectations in turn affect their behavior. Such expectations have much to do with collective experience. The more frequently financial problems elicit support in some part of the economy, the more

⁴⁰ János Kornai, 'The Soft Budget Constraint' [1986] 39 *Kyklos* 3. The theory has been hugely influential and has given rise to a number of different applications. While its original formulation pertained to socialist economies, the theory has been applied to market economies as well. For an application of the theory to State aid, see Isabela Atanasiu, 'State Aid in Central and Eastern Europe' [2001] *World Competition* 24, 257; and Hans W. Friederiszick, Lars-Hendrik Röller and Vincent Verouden, 'European State Aid Control: An Economic Framework', in Paolo Buccirossi (ed) *Handbook of Antitrust Economics* (MIT Press 2007).

organizations in that part of the economy will count on getting support themselves.⁴¹

As far as the threshold question (of whether a State measure constitutes State aid) is concerned, the market operator principle asks whether the State measure confers an advantage on its recipient. The principle turns on the comparison between the behavior of the State and that of a hypothetical market operator. The purpose of its application is not to prevent State intervention in the economy, but to inject accountability into the relationship between the State and the market. State aid law seeks to harden the budget constraint of market actors and turn the relationship between State and market actors into an arm's length one.

The objective of preventing the soft budget constraint syndrome may also be seen at play at the compatibility stage, more specifically, in the context of the assessment of aid aimed at rescuing and restructuring firms in difficulty. Given the distortionary potential of rescuing firms in financial distress, the guidelines on rescue and restructuring aid require that such aid be a one-off intervention.⁴² The "one time last time" principle is justified '[i]n order to reduce moral hazard, excessive risk-taking incentives and potential competitive distortions'.⁴³ In keeping with the theory of the soft-budget constraint, which holds that a condition that allows this syndrome to emerge is the ability of the beneficiary to renegotiate *ex post* the terms of its funding, the guidelines go on to explain that 'repeated State interventions are likely to lead to problems of moral hazard and distortions of

⁴¹ János Kornai, Eric Maskin and Gérard Roland, 'Understanding the Soft Budget Constraint' [2003] *Journal of Economic Literature* 41, 1095.

⁴² Commission Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty [2014] OJ C249/1.

⁴³ *Ibid.*, at 70.

competition that are contrary to the common interest'. Consequently, aid may be granted only once over a period of ten years.

Yet, when aid is granted in the context of bank rescue operations, questions of moral hazard become more complicated, not only because the (often incestuous) relationship between governments and banks makes fertile ground for the soft budget constraint syndrome to emerge, but also because moral hazard concerns typically need to be balanced against concerns over the stability of the banking system. This was already clear in the *Crédit Lyonnais* decisions, which offered a preview of some the issues that would come to dominate the Commission's State aid practice a decade later.⁴⁴ In the 1990s, *Crédit Lyonnais* (CL) was the largest bank in Europe and one of the largest in the world.⁴⁵ CL had suffered catastrophic losses caused by a combination of factors, including spectacularly irresponsible lending decisions, regulatory capture, outright fraud, and the bursting of a real estate bubble. State aid came into question when the French government stepped in to prevent the bank's insolvency. Although CL's problems were not associated with a systemic banking crisis, but were a result of specific issues affecting the bank itself, at the same time, its size and international reach, and its potential to spread contagion to the banking system warranted careful handling. To this end, the Commission consulted a group of "wise men" made up of former central bank governors on the specific issues of the case and on the risks to stability deriving from the potential failure of a large systemic bank. Their advice was that there was no reason to dispense with the ordinary State aid rules, provided that account was taken of the potential impact

⁴⁴ Commission Decision giving conditional approval to the aid granted by France to the bank *Crédit Lyonnais* [1995] OJ L308/92; Commission Decision concerning aid granted by France to the *Crédit Lyonnais* group [1998] OJ L221/28 (1998 Decision).

⁴⁵ The vernacular of financial regulation would today describe the bank as a "SIFI" (Systemically Important Financial Institution).

of the decision on the financial system. As a result the Commission set out with the intention of following the rescue and restructuring guidelines, and the “one time last time” principle enshrined therein. Yet after the first State aid decision the considerable worsening of CL’s financial situation prompted the French government to step in to support the bank for a second time. While the second round of State aid was eventually authorized, thus derogating from the “one time last time” principle, the Commission imposed radical restructuring as a condition for its approval.⁴⁶

Crédit Lyonnais seems an apt demonstration of the salience of the soft budget constraint syndrome to State aid law in the banking sector. At the time, the French banking sector was characterized by a high level of public ownership, and by a close administrative relationship between the State and the management of the banks. As the Commission remarked, the relationship between the government and the banks was one that involved an expectation of ‘quasi-systematic state support’ for public banks in difficulty. These arrangements had made ‘a lasting contribution to the imprudent conduct of the managers of French nationalized banks’, which had relied on their shareholder (the State) for virtually automatic support.⁴⁷ The Commission concluded that ‘any lasting solution for CL and the nationalized banking system in France must entail a reform of the corporate governance of the group and its institutions and a solution to the moral hazard problem engendered by the State’s ultimate willingness to provide support [...]’.⁴⁸

b) Competition and stability in a systemic crisis

⁴⁶ Commission Decision giving conditional approval to the aid granted by France to the bank *Crédit Lyonnais* [1995] OJ L308/92; Commission Decision concerning aid granted by France to the *Crédit Lyonnais* group [1998] OJ L221/28 (1998 Decision).

⁴⁷ 1998 Decision, at 10.2.

⁴⁸ *Ibid.*

There are some similarities between the *Crédit Lyonnais* decision and the cases that emerged during the financial crisis, such as the difficulty in crystallizing the full extent of the bank's losses, or the invocation of the "too big to fail" argument. The Commission's response to the latter argument in *Crédit Lyonnais*, however, captures a fundamental difference between the isolated crisis developed around the French bank and the systemic crisis caused, in the following decade, by the collapse of Lehman Brothers. In *Crédit Lyonnais*, the Commission emphasized that the bailout could easily have been avoided if a combination of depositor protection and an orderly resolution mechanism had been introduced. With the latter framework in place, the bank would have been wound down without running the risk of triggering a systemic crisis and without inflicting a significant outlay of funds on French taxpayers. It was clear, from the Commission's point of view, that CL's crisis was idiosyncratic and not systemic in nature.

The situation that emerged during the financial crisis turned out to be far more complex, not only because of the (continuing) absence of a legislative framework for orderly resolution, and the greater degree of integration of the European banking system but, crucially, because by October 2008 the crisis had developed into a fully-fledged systemic crisis. If at the end of 2007, in its first Northern Rock decision, the Commission could still rely on the *Crédit Lyonnais* precedent, and reject the existence of a systemic crisis by pointing to the idiosyncratic risk yielded by the British bank's extreme business model, a year later the problems faced by European banks were no longer considered to be confined to some reckless outliers but were symptoms of a deeper malaise threatening the banking system and the wider economy.⁴⁹

⁴⁹ Commission Decision on State aid NN 70/2007 *Rescue Aid to Northern Rock* [2008] OJ C43/1. The second *Northern Rock* decision was handed down in 2009, at which point the State aid was considered in the context of the systemic crisis. Commission Decision on State aid C 14/2008 *Northern Rock* [2010] OJ L112/38.

The recognition of the systemic nature of the crisis (from October 2008) caused a shift in State aid policy as the Commission, prompted by the European Council's call for 'speedy and flexible action' in State aid control, began to rely consistently on Article 107(3)(b) TFEU, a provision that had remained dormant for decades.⁵⁰ Its wording, which refers to 'aid to remedy a serious disturbance in the economy of a Member State', opened up the possibility of adapting the existing rules to reflect the urgency and scale of the response by member states. Thus, the "one-time last-time" principle was set aside, the range of tools that could be used to rescue banks was extended beyond loans and guarantees to include recapitalization and impaired asset measures, and the duration of the rescue measures was extended beyond six months.⁵¹

However, there was a certain level of ambiguity in the flexibility of Article 107(3)(b). While it was clear that this flexibility was justified for as long as the crisis remained a systemic one, it was not as clear whether this provision applied only to banks of systemic relevance or whether all other banks would also be covered. One approach that the Commission could have taken, but did not, would have been to regard only institutions of significant size as having systemic importance, so that only "too big to fail"

⁵⁰ European Council of 15 and 16 October 2008, Presidency Conclusions (Doc 14368/08), 5. The fact that Article 107(3)(b) TFEU could be deployed to address a systemic *banking* crisis was already well understood at the time of the *Crédit Lyonnais* decision: see the panel discussion and the papers in 'Panel Two' of Claus-Dieter Ehlermann and Michelle Everson (eds) *European Competition Law Annual 1999: Selected Issues in the Field of State Aids* (Hart Publishing 2001).

⁵¹ The crisis framework was set out in Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global crisis [2008] OJ C270/8 (Banking Communication); Communication from the Commission on the recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2 (Recapitalization Communication); Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector [2009] OJ C72/1 (Impaired Assets Communication).

institutions would fall under the umbrella of Article 107(3)(b) TFEU. In the United States, where an orderly resolution regime had been in place for decades, the Federal Government's was able to focus its rescue efforts on all (except one) large, systemically important, financial institutions, while hundreds of small banks went into orderly resolution.⁵² In the absence of an equivalent regulatory regime, this approach had little chance of a successful transplant into Europe. Here, not only did the level of cross-border exposure and interdependence between banks blur the line between systemically important institutions and other banks, but a strict approach to systemic risk was certain to fail to command the support of the member states, an essential factor in securing effective implementation of any Commission State aid decision, let alone decisions taken during a period of global turmoil. Given this context, the Commission's failure to question the systemic relevance of even small, regional banks, and its willingness to treat each bank as systemically relevant, appears to have been a necessary upshot of the circumstances rather than a policy choice that was explicitly articulated.

c) *Moral hazard in a systemic crisis*

The moral hazard aspects of *Crédit Lyonnais* were relatively straightforward. Once the bank was radically restructured, and the links between its management and the government were severed, the soft budget constraint was less likely to re-emerge.

Although the greater ease with which the risk of contagion can be contained in an idiosyncratic crisis gives the Commission greater room to maneuver than in a systemic

⁵² In the United States, the Federal Deposit Insurance Corporation (FDIC), which was created in 1933 to administer a system of depositor protection, has the power to act as receiver for failed banks. That is not to say that all banks that benefited from the TARP Capital Purchase Program were systemically important. A number of smaller (solvent) institutions also received capital injections.

crisis, in which the challenge lies both in taking account of the differences between each affected bank, but also in taking account of the similarities between different banks.

Granted a number of financial crisis cases involved bloated institutions that had expanded their balance sheet through exuberant acquisitions, and involved State-controlled banks whose problems replicated aspects of *Crédit Lyonnais*; however, often banks were also struck because of their sheer homogeneity. Where a high number of interrelated banks are affected, often the issues of individual banks cannot be isolated from those affecting similar banks, for the source of risk does not simply lie in the past behavior of an individual bank, but in the interaction between that bank's past behavior and that of numerous other banks. This scenario, known in the literature as the "too many to fail" phenomenon, occurs where banks cluster around the same source of risk (e.g. excessive reliance on short-term wholesale funding) and as a consequence are affected by the same shocks. In this situation, governments choose to rescue even relatively small banks in the knowledge that the benefit of avoiding contagion is greater than the cost of bailing out banks that are not "too big to fail". According to the literature on "too many to fail", the decision to rescue smaller banks is itself a source of moral hazard as it creates perverse incentives for banks to choose the same risk strategies.⁵³ In this scenario, herding becomes a safety net, as homogeneity makes the authorities' task of disentangling systemically important banks from other banks, and the pursuit of targeted bailouts, extremely challenging.

If redressing moral hazard, as far as State aid is concerned, with regard to banks that have engaged in reckless expansion may take the form of capacity reductions, and the soft-budget constraint syndrome in State-owned banks may be prevented for the future through changes in their governance structures, it is unclear how State aid policy should approach a situation in which banks have become systemic because of their

⁵³ Viral V. Acharya and Tanju Yorulmazer, 'Too Many to Fail – An Analysis of Time-inconsistency in Bank Closure Policies' [2007] *Journal of Financial Intermediation* 26, 31 (Acharya and Yorulmazer 2007).

collective behavior. Even if the conditions imposed by the Commission through its decisions may well target the common risk that has ultimately led to rescuing these banks (for instance, measures to rebalance and diversify funding structures) such conditions, together with the other typical remedies imposed as conditions for approval (such as burden-sharing, changes to management and limits to compensation), are unable to prevent future herding. No matter how far-reaching, the restructuring imposed by State aid decisions will never be able to prevent the moral hazard associated with this phenomenon.

d) *Collective moral hazard and sovereign debt*

Attempting to isolate moral hazard where risk-taking has taken a collective dimension is an exercise fraught with difficulty, a fact that became clear when the Commission was forced to confront the State aid implications of the Eurozone sovereign debt crisis. Although governments were slow to acknowledge the impact of the so-called “doom loop” or “deadly embrace” between banks and their sovereigns, eventually consensus began to crystallize around the idea that banks should build up a capital buffer against the risks associated with their sovereign debt exposures. In 2011 the European Banking Authority (EBA) carried out its “EU Capital Exercise” the purpose of which was to establish whether banks held sufficient capital against their holdings of sovereign debt and to require banks to improve their capital positions accordingly. This in turn prompted the Commission to recalibrate its State aid assessment of recapitalizations. While previously, it had been Commission policy to require any bank that received a capital injection to undergo restructuring, from 2012 banks that were being recapitalized as a result of the EU Capital Exercise were subject to a proportionate assessment. This meant that financial institutions could benefit from a complete or partial exemption from restructuring,

provided that three cumulative conditions were met: a) the capital shortfall was linked to a crisis of confidence in the sovereign debt market; b) the capital injection was limited to the amount necessary to offset losses stemming from marking sovereign bonds to market in banks that were otherwise viable; and c) the sovereign debt portfolio had not been acquired as a result of excessive risk-taking.⁵⁴

With the last condition for proportionate assessment, the Commission set itself a particularly challenging task. Had it chosen to stigmatize collective moral hazard, it would have treated the banks' common predilection for sovereign debt as both a source and a product of moral hazard. Indeed, the vicious cycle that fed the sovereign debt crisis, the bank-sovereign "doom loop", is regarded in the literature as a distinct example of collective moral hazard, an instance of the "too many to fail" phenomenon.⁵⁵ As has been widely documented, not only did banks simultaneously increase their holdings of government bonds, but their purchases clustered around domestic government bonds at a time when the risk of sovereign default was perceived to be at its highest level.⁵⁶ From this perspective, the behavior of banks, especially banks of the Eurozone periphery, would appear to amount to excessive risk-taking.

Yet, compelling as the collective moral hazard view may be, it does not readily translate into practice, at least not as far as State aid policy is concerned, as a number of competing considerations come to the fore. First, at which point in time does purchasing

⁵⁴ Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356/7 [14] [emphasis added].

⁵⁵ See E. Farhi and J. Tirole, 'Deadly Embrace: Sovereign and Financial Balance Sheets Doom Loops' (CEPR Discussion Paper No. DP11024 December 2015 <<http://ssrn.com/abstract=2714264>> accessed 18 April 2016.

⁵⁶ Viral V. Acharya and Sascha Steffen, 'The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks' [2015] *Journal of Financial Economics* 115, 215.

government bonds become risky? The answer is not straightforward because market-based assessments of sovereign risk, which banks rely on, are notoriously deficient. For instance, for the entire 2000-08 period, the spreads on ten-year government bonds of all Eurozone member states were close to zero meaning that the bond markets regarded the risk of default of Eurozone governments as virtually non-existent.⁵⁷ The risk associated with holding bonds of Eurozone periphery governments was only recognized as excessive by the markets once the Eurozone crisis had erupted. Importantly, capital adequacy regulations incentivized the accumulation of government bonds, as the latter attracted a low or zero risk weight (depending on the credit rating associated with the respective sovereign debt instrument).⁵⁸ Last but not least, during this period the Long Term Refinancing Operations (LTRO) of the European Central Bank (ECB), which permitted banks to pledge sovereign bonds as collateral for central bank liquidity, came to be perceived by banks, especially those of the Eurozone periphery, as an incentive to increase their exposure to government bonds.⁵⁹

⁵⁷ Paul de Grauwe and Yuemei Ji, 'Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone' [2012] JCMS 50, 866.

⁵⁸ This was clear from the Capital Requirements Directive (CRD III), Annex 6, point 1.2.4. See Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L177/1. The new CRD/CRR IV package *de facto* maintains the zero weight for government bonds. See Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338; Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance [2013] OJ L176/1. The zero risk weighting is set out at Article 114(4) of the CRR.

⁵⁹ Matteo Crosignani, Miguel Faria-e-Castro and Luís Fonseca, 'Central Bank Interventions, Demand for Collateral, and Sovereign Borrowing Costs' (18 May 2015 <<http://ssrn.com/abstract=2595786>> accessed 18 April 2016).

In light of these complexities it is not surprising that, when faced with the task of applying its own criteria for the proportionate assessment of recapitalizations, the Commission seemed to tread carefully around the domestic sovereign debt problem, and was reluctant to associate excessive risk-taking with the collective accumulation of domestic government bonds. The test that the Commission applied in these cases was whether an individual bank had displayed an attitude to risk that was comparable to the average bank in a specific Member State. It was a highly context-sensitive approach, which eschewed a collective moral hazard approach – if all banks were taking the same risks at a particular time in a particular country, according to the Commission, they were not engaging in excessive risk taking. For instance, in the *BPI* decision the bank’s capital needs were seen as being linked to a confidence crisis in the sovereign debt of Portugal. Although the bank had acquired its sovereign debt (in 2009) through carry trade transactions (financed by ECB one-year funding) and while, as the Commission remarked, ‘such transactions could under certain circumstances be considered above average risk-taking’, the acquired government bonds represented eligible collateral – at the time, the bonds were rated well above investment grade (AA- for Portugal).⁶⁰ On another occasion, in its *Eurobank* decision, the Commission found that part of the capital needs of the bank stemmed from ‘regular exposure’ to the sovereign risk of its domestic country (Greece), and that for this reason there was ‘less need for the Bank to address moral hazard issues in its restructuring plan than for other aided financial institutions which had accumulated excessive risks’.⁶¹ However, the proportionate assessment could not be applied to its full

⁶⁰ Commission Decision on State aid SA.35238 (2013/N) – Portugal – *BPI Restructuring* [2014] OJ C460/1, 61.

⁶¹ Commission Decision on State aid SA.34825 (2012/C), SA.34825 (2014/NN), SA.36006 (2013/NN), SA.34488 (2012/C) (ex 2012/NN), SA.31155 (2013/C) (2013/NN) (ex 2010/N) implemented by Greece for the Eurobank Group [2014] OJ L357/112, 358. See also Commission Decision on State aid SA.34823 (2012/C),

extent where a bank had displayed higher than average risk-taking. For instance, in *Piraeus Bank*, the Commission found that the Bank's exposure to the Greek sovereign risk was larger than the exposure of some other Greek banks of equivalent size and that not all the losses could be attributed to the 'standard exposure of a financial institution to the sovereign risk of its domestic country'.⁶²

At times however the conditions for the proportionate assessment were stretched to such an extent as to appear to undermine the coherence of the test. The *MPS* case seemed to have all the hallmarks of an outlier because of the nature and level of recklessness exhibited by the bank's senior management who, in the run up to the Eurozone crisis, had taken a series of ruinous decisions. First, MPS had acquired Banca Antonveneta from Banco Santander for a price that appeared to defy rationality. In the aftermath of the deal, given the significant difference between the purchase price (€9 billion) and the valuation of Antonveneta (€6 billion), Santander's shares soared while those of MPS slumped,⁶³ and the purchase resulted in goodwill impairments of approximately €5.5 billion. The second disastrous decision was taken between 2008 and 2009, when MPS entered into a set of parallel transactions with Nomura and Deutsche

SA.36004 (2013/NN), SA.37965 (2013/N), SA.37966 (2013/N), SA.37967 (2013/N) implemented by Greece for Alpha Bank Group [2015] OJ L80/1.

⁶² Commission Decision on the State aid SA.34826 (2012/C), SA.36005 (2013/NN) implemented by Greece for Piraeus Bank Group [2015] OJ L80/49, 321. As the higher than average sovereign exposure was only partly responsible for the bank's recourse to State aid, Piraeus Bank was still eligible for the proportionate assessment, albeit only in part. See also Commission Decision of 23 July 2014, *National Bank of Greece* [2015] OJ L283/29. The Commission took into account the deep recession that had affected Greece and the fact that Greek banks had been subject to Private Sector Involvement (PSI) program. PSI was a private sector bond exchange in which banks were offered new securities in exchange for their government bonds at a significant discount (a haircut) on existing ones and with longer maturities.

⁶³ See Adrian Michaels and Leslie Crawford, 'MPS shares slump after Antonveneta deal' *Financial Times* (9 November 2007).

Bank: MPS restructured loss-making derivatives with the two banks while simultaneously entering into long-term repo transactions based on long-term Italian government bonds (for the total value of €5 billion) with those same counterparties. One set of transactions was clearly a *quid pro quo* for the other; indeed the purpose of these transactions appeared to be to conceal losses accrued from previous derivatives trades. This link, which was not reported in MPS's accounts, became clear after the resignation of MPS's senior management, when the new management discovered the original contract. The bank was subsequently recapitalized twice: first in 2009, as part of a general scheme (the so-called "Tremonti bonds"); and the second time in 2013, as a result of the 2011 EBA's EU capital exercise.

In its decision on restructuring aid to MPS, the Commission approached the proportionate assessment from the premise that the EBA 'EU capital exercise' was the fundamental reason for MPS's request for State aid. 'Without the requirement for a sovereign buffer' it held 'there would have been no shortfall'.⁶⁴ And while it conceded that if MPS had not acquired the long-term Italian sovereign bonds at the center of the controversial deal with Nomura and Deutsche Bank 'the consequences of the EBA "EU capital exercise" would have [been] different in scope', the bank, it added, would still have needed extra capital so as to comply with the EBA's requirements.⁶⁵ When the Commission then went on to determine if the bank's sizeable sovereign exposure had arisen as a consequence of excessive risk-taking, it decided that MPS acquiring significant amounts of government bonds before the outbreak of the sovereign crisis could not in principle be considered as excessive risk-taking but added 'the status of such a strategy is less evident in case of the bonds acquired after 2010'. Nonetheless, given that the Italian

⁶⁴ Commission Decision on State aid SA. 36175 (2013/N) – Italy MPS – Restructuring [2014] OJ C 117/1, 160.

⁶⁵ *Ibid.*

government had only sought partial application of the proportionate assessment approach, and in light of the fact that MPS has undertaken to carry out the burden-sharing measures as well as behavioral safeguards and a 25% balance sheet reduction, the Commission was satisfied that a partial application of that approach would be sufficient.

At first sight, the reasoning in the *MPS* decision appears to be in keeping with other decisions on the proportionate assessment. Yet it is questionable whether the conclusions reached in relation to the excessive risk-taking test follow from the facts of the case. An IMF country report from the same period as the European Commission's *MPS* Decision clearly states that the bank had entered into the structured transactions in 2008 and 2009 at a time when it held 'by far the largest sovereign bond portfolio of all Italian banks'.⁶⁶ Indeed, in 2014, the ECB's comprehensive assessment confirmed MPS's extraordinary weakness, as the bank had the worst capital shortfall of all the 130 Eurozone banks that underwent this stress test.⁶⁷

It is hard to deny in light of these facts that MPS stood out among Italian banks for its level of sovereign exposure both before and during the sovereign debt crisis. It is also questionable whether it is at all possible to separate the reckless decisions that brought about the bank's downfall from the prior accumulation of sovereign debt. The literature on the so-called "doom loop" holds that undercapitalized Eurozone periphery banks tend to increase their holdings of domestic sovereign bonds even (or especially) when the sovereign's probability of default increases. They do so, according to this literature, for a number of reasons, including the choice to gamble for resurrection, to remain under-

⁶⁶ Italy: Financial System Stability Assessment (IMF Country Report No. 13/300, 15 <<http://www.imf.org/external/pubs/ft/scr/2013/cr13300.pdf>> accessed 18 April 2016.

⁶⁷ See <<https://www.bankingsupervision.europa.eu/banking/comprehensive/html/index.en.html>> accessed 18 April 2016. Plainly, the level of sovereign debt exposure was part of the explanation for the shortfall identified by the ECB, as the scenario included the impact of a hypothetical interest rate rise (which would have a negative impact on the value of government bonds).

capitalized and to fund themselves through a carry trade which involves going long on high-yield sovereign debt and going short on low-yield debt (or borrowing from the ECB).⁶⁸ It is not unreasonable to suggest that the accumulation of sovereign bonds was the result of the bank's under-capitalization, nor it is unreasonable to surmise that the lack of sufficient capital was, at least in part, the result of the bank's hubristic acquisition. Even if the EBA's requirement of a sovereign buffer was the proximate cause of the request for State aid, the fact that the bank was under-capitalized seemed clear well before the EBA's assessment. While one can understand the Commission's desire not to single out MPS one may also wonder whether, in the Commission's view, a bank's large sovereign exposure can ever be regarded as a symptom of a peculiarly relaxed attitude to risk.

e) *Competing objectives and bailout design*

In a speech delivered in 2010, Joaquín Almunia held that the European Commission was 'the only jurisdiction in the world' to have 'explicitly tackled the moral-hazard issue'.⁶⁹ These (somewhat pompous) remarks contained an implicit reference to the design of the US Government's bailout program, the Troubled Asset Relief Fund Program (TARP) which, according to a number of observers, lacked safeguards against moral hazard.⁷⁰ As the dust

⁶⁸ Niccolò Battistini, Marco Pagano and Saverio Simonelli, 'Systemic Risk and Home Bias in the Euro Area' (European Economy Economic Papers 494, April 2013).

⁶⁹ Joaquín Almunia, 'State Aid Rules Can Help Europe Exit Crisis' (European State Aid Law Institute, 10 June 2010 <http://europa.eu/rapid/press-release_SPEECH-10-301_en.htm?locale=en> accessed 18 April 2016).

⁷⁰ Trouble Asset Relief Fund created under the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765. For a critique of TARP, see Joseph Stiglitz, 'We Aren't Done Yet: Comments on the Financial Crisis and Bailout' [2008] *The Economists' Voice* 5, 1553; and Pietro Veronesi and Luigi Zingales, 'Paulson's Gift' [2010] *Journal of Financial Economics* 97, 339.

settled on TARP, commentators began to hail the program as a success, albeit a deeply flawed one. Despite this, TARP is now credited with having contributed to the return to normality of lending at both the wholesale and retail levels.⁷¹ What is more, the impact of the program on US public finances has been more benign than was at first believed.⁷² Indeed by August 31, 2015, the US Treasury had recovered \$275 billion, that is, \$29.9 billion more than the \$245.1 billion originally expended.⁷³ By contrast, in the EU, while initial interventions by the member states managed to stabilize the banking system, lending to the real economy remained anemic for a protracted period. Furthermore, the fiscal impact of bailouts is still being felt across Europe. According to recent European Central Bank figures, as far as the Eurozone is concerned, over the period 2008-14 accumulated gross financial sector assistance amounted to 8% of (Eurozone) GDP (€800 billion), of which only 3.3% of GDP had been recovered.⁷⁴

A comprehensive comparison between the two jurisdictions (the US and the EU) is beyond the scope of this chapter, but it is useful to consider some fundamental

⁷¹ PL. Posner and D. Fantone, 'The United States' Response to the Global Financial Crisis' in John Wanna, Evert A. Lindquist and Jouke de Vries (eds) *The Global Financial Crisis and its Budget Impacts in OECD Nations: Fiscal Responses and Future Challenges* (Edward Elgar 2015), 31-58. Charles W. Calomiris and Urooj Khan, 'An Assessment of TARP Assistance to Financial Institutions' [2015] *Journal of Economic Perspectives* 29, 53 (Calomiris and Khan 2015).

⁷² This assessment does not take account of the long-term impact of moral hazard, which is hard (or impossible) to predict.

⁷³ For an assessment of the "intangible" costs of TARP (including moral hazard and corruption in administering the program), see Calomiris and Khan 2015. An early example of excessive risk-taking by one of the major beneficiaries of TARP is said to have been Citigroup's decision to lend to Dubai World in December 2008: see Thorsten Beck, Diane Coyle, Mathias Dewatripont, Xavier Freixas and Paul Seabright, *Bailing out the Banks: Reconciling Stability and Competition* (CEPR 2010), 65.

⁷⁴ ECB, 'The Fiscal Impact of Financial Sector Support during the Crisis' (*ECB Economic Bulletin* 2015, Issue 6).

differences in bailout design between TARP and the European approaches, as this allows to explore how the choices made under State aid policy have shaped member state responses to the financial crisis. Of course, any assessment of this type needs to be set against the backdrop of immense constitutional and economic differences.⁷⁵ It is also important to note that the European Commission's input in bailout design is limited by the lack of exclusive control over individual State aid measures. Granted, the Commission has exclusive power to authorize State aid measures and schemes. However, the fact that the Member States fund and administer State aid makes it impractical for the Commission to determine the precise detail of every national measure. Consequently, the design of State assistance to banks is the result of complex interactions between the Commission, the member states and (unofficially), the aid recipients and their competitors. Nonetheless, the regulatory framework for bank bailouts is the result of choices that the Commission makes between alternative approaches, and different trade-offs between competing interests follow from these choices.

There are broad similarities in the tools employed to stabilize banks during the financial crisis on the two sides of the Atlantic: mainly, recapitalizations, guarantees and asset relief measures. However, the European response was characterized by greater reluctance on the part of the governments to deploy these tools to their full extent, and on the part of banks to rely on them. This may have made crisis management on the European side less effective than on the North American side. This is particularly true of

⁷⁵ The list is potentially very long but, crucially, the EU's lack of fiscal capacity and the size of European banks relative to the economies of their member states, together with the obvious fact that in the EU the financial crisis was only the first act of a far lengthier drama, are all features that mark the difference between the EU and the US. The fact that European governments pursued radical retrenchment (willy-nilly), while the US government enacted demand-side stimulus measures may also need to be taken into account. Plainly, the presence of demand is a necessary condition for the success of any policy that aims to rekindle lending to the real economy.

bank recapitalizations. In particular, by 2009, while US banks had received 2.6% of GDP in capital injections, in the EU the total granted in the same period through such measures amounted 1.7% of EU GDP, although by 2014 the total had increased to 3.4%.⁷⁶ While the sovereign debt crisis explains the latter figure,⁷⁷ the initial cleavage between the two sides of the Atlantic is more striking, especially as the 1.7% of EU GDP figure masks significant variations in the size of capital injections across the Member States: by 2009, only half of the member states had granted aid in the form of capital injections.

There are a number of concurrent explanations for this state of affairs. These may include: complacency, or a “wait and see” approach both on the part of the banks and their respective governments, government capture (e.g. pressure to avoid shareholder dilution) and, most importantly, the fact that banks were “too big to rescue”, given that certain governments lacked the fiscal capacity to recapitalize banks with assets many times the size of their national GDP.⁷⁸ There is however some degree of consensus among economists, based on the experience of previous banking crises, that early recapitalizations of significant magnitude are key to successful crisis management. Indeed, in September 2008, a number of prominent economists urged European leaders to recapitalize banks, and to do so at European level.⁷⁹ The reasons behind the failure to go down the road of EU level bank recapitalization have been explored in great depth; yet it

⁷⁶ Data available from DG COMP’s website

<http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html#tables> accessed 18 April 2016.

⁷⁷ This affected member states in and out of the Eurozone, albeit to a different extent.

⁷⁸ Daniel Gros and Stefano Micossi, ‘The Beginning of the End Game’ *Vox* (20 September 2008)

<<http://www.voxeu.org/article/mother-all-bailouts-and-what-it-means-europe>> accessed 18 April 2016.

⁷⁹ Tito Boeri *et al.*, ‘Open Letter to European leaders on Europe’s Banking Crisis: A Call to Action’

<<http://www.voxeu.org/article/open-letter-european-leaders-europe-s-banking-crisis-call-action>> accessed 18 April 2016.

is worth asking whether State aid policy that may have inhibited more efficient, timely and more uniform recapitalizations at national level.

The answer to this question is necessarily tentative because it is virtually impossible to pinpoint a direct and precise causal relationship between EU State aid policy and national choices. Although with the benefit of hindsight, it is possible to argue that the design of State aid policy on recapitalization was not effective in counteracting the inherent aversion of governments and banks towards bold recapitalizations. At first glance, the EU approach to recapitalizations appeared to reflect to some extent the line taken by the US TARP recapitalization program of allowing both sound and distressed banks to benefit from public capital injections. However, in Europe, during the 2008-9 period, recapitalizations were generally reactive rather than pre-emptive – they were predominantly employed as a last ditch attempt to save insolvent banks. This may partially have been a result of Commission policy. In the first stage of the crisis (2008-11), the Commission's approach centered around the distinction between fundamentally sound and distressed banks, the idea being that distressed banks could only return to long-term viability, and avoid calling again on the taxpayer if they underwent restructuring.⁸⁰ The distinction between the two categories turned on the extent of the capital injection required: banks that required more than 2% of Risk Weighted Assets (RWA) were regarded as distressed. Banks that crossed that threshold would have to submit a restructuring plan within 6 months. Moreover, the extent of restructuring was directly (though not exactly) related to the amount of aid granted.⁸¹ By contrast, the US approach

⁸⁰ European Commission, 'The Recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards against Undue Distortions of Competition' [2009] OJ C10/2.

⁸¹ Though, as demonstrated by Laprévotte, the 'the tailoring of size reductions imposed to banks remains more an art at the Commission's discretion than a science subject to precise mathematical rules': see

limited eligibility for recapitalization to banks that required between 1% and 3% of RWA (raised to 3% to 5% of RWA for banks with assets under \$500,000), the idea being that banks that required more than 3% of RWA were destined to become insolvent. At the same time, the US recapitalization scheme did not provide for restructuring as a condition for the capital injection. The emphasis in TARP was on ensuring that all eligible (systemically important) banks would rapidly reach the required level of capitalization.⁸²

During a systemic crisis, however, the distinction between fundamentally sound and distressed banks is not as clear-cut as implied by the 2% threshold introduced by the Commission to distinguish between the two sets of banks. On the one hand, this threshold may have created a perverse incentive for banks to delay necessary restructuring, as it exacerbated their tendency to deliberately underestimate their capital needs (so as to minimize dilution and avoid restructuring), a strategy to which governments tend to be

François-Charles Lapr v te, 'Selected Issues Raised by Bank Restructuring Plans under EU State Aid Rules' [2012] *European State Aid Law Quarterly* 1, 105.

⁸² The fact that the US government "forced" all systemically important banks to recapitalize is regarded by some as a pivotal feature of TARP's success. See Pepper D. Culpepper and Raphael Reinke, 'Structural Power and Bank Bailouts in the United Kingdom and the United States' [2014] *Politics and Society* 42, 427. Of course, there was nothing in State aid policy to prevent member states from adopting a similar approach. Indeed, the French scheme, which has some similarities with the US scheme in that the French government exercised "moral suasion" in persuading all French banks to be recapitalized, is seen by some as having had a similar success. Note, however, that the scheme was kept below the 2% RAW threshold to avoid restructuring. The strategy was successful in restoring confidence in the French banking system on the capital markets. See Ben Hall and Scheherazade Daneshkhu, 'French Banks Surge on State Injection' *Financial Times* (21 October 2008). See also St phanie Marie Stolz and Michael Wedow, 'Government Measures in Support of the Financial Sector in the EU and the United States' [2011] *Intereconomics* 46, 53. Some commentators have pointed out that French banks remained significantly undercapitalized even after these measures, e.g. Jakob Vestergaard and Mar a Retana, 'Behind Smoke and Mirrors: On the Alleged Capitalization of Europe's Banks' [2013] *Danish Institute of International Affairs* 10 <<http://subweb.diiis.dk/sw128648.asp>> accessed 1 December 2015.

sympathetic.⁸³ On the other hand, the 2% threshold was based on an optimistic assessment of the ability of prudential capital requirements to capture the extent of the capital shortfall in banks that were (then) perceived to be fundamentally sound. Given the level of exposure of the largest European banks to sovereign debt even before the onset of sovereign debt crisis, the same banks that appeared to be financially sound in terms of their prudential capital were banks that would have (or should have) benefited from more robust levels of capital.⁸⁴ It is entirely plausible, since sovereign debt did not feature on the denominator side of the prudential capital ratio, that building up optimal levels of capital would have required tipping the total amount injected over the 2% threshold. Yet, crossing that threshold would have caused the bank to be stigmatized as a “distressed” institution which, in turn, would have impacted on its share price and on its prospects of raising private capital in the short term.

At the end of 2010, when the sovereign debt crisis had already taken its toll on the economies of Greece, Ireland, Spain and Portugal, the Commission lifted the 2% threshold, and extended the requirement to submit a restructuring plan to all banks, regardless of

⁸³ Of course, in an ideal world, this strategy would be stopped in its tracks, as the national regulators of an ideal world would provide the Commission with a robustly accurate and fiercely independent representation of a bank’s financial situation and, in such a world, the Commission’s decision making would be free from any information asymmetry. One of the many examples of insufficient recapitalization can be seen in the *MPS* case cited above, where the bank initially benefited from a recapitalization in 2009, which was below the 2% RWA threshold and did not require a restructuring plan.

⁸⁴ Indeed, research based on data collected by the EBA shows that between 2009 and 2013 the level of sovereign exposure of the 54 largest Eurozone banks amounted to more than 200% of their tier 1 capital, with some banks having sovereign exposures as high as 15 to 20 times their regulatory capital. See Josef Korte and Sasha Steffen, ‘A “Sovereign Subsidy” – Zero Risk Weights and Sovereign Risk Spillovers’ *VoxEu* (7 September 2014) <<http://www.voxeu.org/article/sovereign-subsidy-zero-risk-weights-and-sovereign-risk-spillovers>> accessed 18 April 2016.

the size of the capital injection.⁸⁵ It did so on the basis of a rather sanguine view of the renewed ability of banks to meet their capital needs without having to rely on State aid and against the evidence of a new credit crunch that had already begun to affect the so-called “periphery” of the Eurozone.⁸⁶ It was only a year later, as seen above, that the so-called “proportionate assessment” was introduced.⁸⁷

In line with its role as competition regulator, the Commission’s emphasis was on keeping State aid to a minimum and on ensuring that aid beneficiaries would be able to return to viability; the objective of promoting stability was to be pursued in such a manner as to minimize distortions of competition and moral hazard. While the policy itself made clear that these objectives were to be mutually reconciled, in practice the emphasis on keeping intervention at a minimum inhibited bold State intervention to recapitalize national banking systems and to gradually wean banks off sovereign debt. In this sense, competition concerns prevailed over stability concerns. The focus on minimizing distortions of competition may also have had an indirect impact on the banks’ willingness to lend to the real economy, which remained anemic for a protracted period. Indeed, on occasion, the restructuring conditions imposed by the Commission seemed to be directly

⁸⁵ Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis [2010] OJ C329/7, 8.

⁸⁶ For instance, the *Financial Times* reported that, since the downgrading of Portugal’s sovereign debt in April 2010, Portuguese banks had been virtually ‘frozen out’ of international capital markets. Victor Mallet and Peter Wise, ‘Eurozone Banks Hit by Return of Credit Crunch’ *Financial Times* (30 November 2010) <<http://www.ft.com/cms/s/0/cd1bcfc0-fcb2-11df-bfdd-00144feab49a.html#axzz3oIrbvmiQ>> accessed 18 April 2016. The effect of sovereign ratings downgrades on the funding costs of banks is well documented in the literature. See e.g. Ricardo Correa and Horacio Sapriza, ‘Sovereign Debt Crises’ (Board of Governors of the Federal Reserve System International Finance Discussion Papers No 1104, May 2014).

⁸⁷ Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356/7 [14].

at odds with the requirement to increase lending to the real economy. For instance, RBS was requested to divest its SME lending (a package of customers and branches designated as “Rainbow”) in order to address competition concerns in a sector – SME and mid-corporate lending – in which it was dominant; at the same time RBS was required to observe lending targets to ensure that it would continue to lend to the real economy.⁸⁸ Levels of lending to the real economy may also have been affected by price leadership bans which were imposed as behavioral constraints to compensate competitors for the distortion of competition caused by the approval of the State aid measure. A particularly controversial price leadership ban was that imposed in separate decisions on three out of the four largest lenders on the Dutch mortgage market (ING, ABN-AMRO, AEGON).⁸⁹ These providers were prevented from offering a lower rate than that charged by their three best-priced direct competitors. As a consequence, Rabobank, the only Dutch lender not to have received State aid, was able to raise mortgage rates in the knowledge that its

⁸⁸ Commission Decision in State aid N 422/09 and N 621/09 Restructuring of Royal Bank of Scotland [2010] OJ C119/01. The divestment proved challenging and disruptive, as emerged from the lengthy negotiations between RBS and Santander which eventually led to the deal falling through and to the disposal being postponed. Commission Decision in State aid SA.38304 *Amendment* to the restructuring plan of Royal Bank of Scotland [2014] OJ C24/1. The existence of a trade-off between the divestment of Rainbow and the continued lending to the real economy is articulated by Sir Nicholas MacPherson, Chief Secretary to the UK Treasury giving evidence before the UK House of Commons Treasury Select Committee in 2012. House Of Commons, ‘Oral Evidence Taken Before the Public Accounts Committee Report On HM Treasury’s 2011/12 Accounts’, Questions, 22 October 2012, 105-6
<<http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/uc659-i/uc65901.htm>> accessed 1 September 2015.

⁸⁹ Commission Decision of 18 November 2009 on State aid No C 10/2009 (ex N 138/2009) implemented by the Netherlands for ING’s Illiquid Assets Back-Up Facility and Restructuring Plan [2009] OJ L274/139; Commission Decision of 5 April 2011 on the Measures No C 11/2009 (ex NN 53b/2008, NN 2/2010 and N 19/2010) implemented by Dutch State for ABN AMRO Group NV [2011] OJ L233.

direct competitors had to follow suit – indeed, it has been suggested that the significant rise in mortgage rates on the Dutch market in 2009 may not have been purely coincidental.⁹⁰

Another distinctive feature of the European response to the financial crisis was the introduction of very substantial guarantee schemes on debt issued by banks. These schemes, the bulk of which were introduced in 2009, appear to have been successful in reducing funding costs for banks, one of the main causes of the credit crunch. Yet, until the beginning of 2012, the Commission’s policy on guarantees gave rise to significant distortions, as the pricing mechanism on such guarantees, which was based on ECB recommendations, failed to account for the significant correlation between a bank’s funding costs and the credit risk of its sovereign guarantor.⁹¹ As a result, it was observed that ‘in many instances “weak” banks from “strong” countries had access to cheaper funding than “strong” banks from “weak” countries’.⁹² When member states raised this concern in 2009, the Commission’s initial response was that the problem was inherent in the fact that ‘banks are located and choose to be located in different Member States’.⁹³ It was only in 2012, after the yields on the sovereign debt of certain member states had

⁹⁰ Mark A. Dijkstra, Fleur Randag and Maarten Pieter Schinkel, ‘High Mortgage Rates in the Low Countries: What Happened in the Spring of 2009?’ [2014] *Journal of Competition Law and Economics* 10, 843.

⁹¹ Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt of 20 October 2008
<http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf> accessed 18 April 2016.

⁹² Aviram Levy and Andrea Zaghini, ‘The Pricing of Government-guaranteed Bank Bonds’ [2011] *Banks and Bank Systems* 6, 16.

⁹³ European Commission, ‘DG Competition’s Review of Guarantee and Recapitalisation Schemes in the Financial Sector in the Current Crisis’

<http://ec.europa.eu/competition/state_aid/legislation/review_of_schemes_en.pdf> accessed 18 April 2016, 27.

reached unsustainable levels, that this distortion was corrected by amending the pricing formula so as to reflect the creditworthiness of the sovereign backer.⁹⁴

What this overview illustrates is neither forbearance in State aid control, nor mission creep by State aid regulation into financial regulation. Certain policy choices made in the course of the financial and Eurozone crises may in retrospect appear questionable. However, the flaws in Commission decisions are more the product of inadequacies in regulatory systems at national, EU, and international levels, than the result of inherent weaknesses in the EU State aid regime. The catalogue of shortcomings at national level is too long to rehearse but the most immediate failing to have had an impact was the reluctance of national regulators to communicate the full extent of the losses incurred by banks from non-performing loans and toxic assets as well as their tendency to overestimate the viability of banks which led to piecemeal and/or belated interventions to strengthen core capital. For a time, such outward optimism appeared to be shared by the EU's regulatory agency charged with assessing the capital positions of European banks which, in its first set of stress tests, famously gave Dexia a clean bill of health shortly before it had to be recapitalized. Moreover, the Commission's assessment of recapitalization measures was shaped by what was until relatively recently a consensus among regulators at all levels over the measurement of prudential capital, over risk weighting in general, and in particular over the weight to be attributed to sovereign debt. It would be unreasonable, even in light of what we now know, to expect the Commission's Directorate of Competition (DG COMP) to depart from conventional wisdom in an area

⁹⁴ The formula was based on the ratio of the median five-year senior CDS spread of all member states to the median five-year senior CDS spread of the member state granting the guarantee. See Annex to Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356/7.

which was already outside of its comfort zone; or, for that matter, to disregard the recommendations of the ECB in relation to the pricing of guarantees.

3. Transition to Banking Union

As noted in the first section of this chapter the manner in which Europe experienced the financial crisis that began in 2008 revealed that the actions member states took to stabilize their own financial institutions and to protect the interests of their depositors was motivated by the need to minimize the call on the member states' own fiscal resources. There was scant concern in national financial ministries for spillover effects elsewhere in the single market from these banks' cross-border operations. Of far greater concern to member states was the need to avoid the bank and payment system failure on their own soil. Andenas and Chiu, in a powerful critique of the conflation of market integration and financial stability, make the important point that appears to continue to be overlooked at the level of European policy making,⁹⁵ that these two policy objectives

⁹⁵ Witness the ECJ's rejection of the UK's arguments about systemic risk and financial stability in *UK v European Parliament and Council* 2014. Further evidence of European institutional resistance to any sense that the different peoples and societies within Europe's border may have differing priorities and levels of tolerance for and ability to withstand risk to the banking system was apparent in the difficulties experienced in implementing the Basel III Capital Accord. The UK and European Commission took very different views on the nature of systemic risk and the sources of financial instability that it made for great difficulty in reaching agreement on the final texts of the Capital Requirements Directive and Capital Requirements Regulation (CRDIV). These differences centered around the extent to which member state authorities could impose higher capital requirements on its systemically important banks judged to pose particular risk to national financial stability and national taxpayers. See Stephen Kinsella and Vincent O'Sullivan, 'Regulatory Complexity and Uncertainty the Capital Requirements Directive IV' (Blog Post 19 May 2012 <<http://corpgov.law.harvard.edu/2012/05/19/regulatory-complexity-and-uncertainty-the-capital-requirements-directive-iv/#5>> accessed 18 April 2016). The compromise that emerged takes effect through

have entirely different meanings and serve different sets of interests and may in fact be in direct conflict insofar as market integration of banks' operations across European borders can be the very fuel of financial instability and systemic risk.⁹⁶

However, it is no surprise that the turmoil across the European banking system was seen by European policy makers as an opportunity to further strengthen European competence in financial supervision rather than to pause and reflect on the risks of further integration of cross-border financial intermediation activity within Europe. To call time out and to reflect in greater depth on what purposes and whose interests banking activity is there to serve in the first place has yet to percolate through to mainstream policy debate within Europe.

Therefore it was not surprising that the Commission's mandate to conduct a Europe-level inquiry into the causes of, and remedies for, the financial crisis was relatively narrow, and had built into it an assumption that the appropriate response to the risks and problems caused by market integration was to achieve greater supervisory integration. In 2008 a high-level group of experts under the chairmanship of Jacques de Larosière was 'requested to make proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective to establish a more efficient, integrated and sustainable European system of supervision'.⁹⁷ The publication in February 2009 of the report of this group, widely referred to as the "de Larosière Report", was swiftly followed up by two Commission Communications. The first of these, entitled 'Driving European Recovery', signaled that it saw a stable and reliable financial system as key to driving

Article 133 Capital Requirements Directive Article 458 Regulation (EU) No 575/2013 [2013] OJ L176/1; its effect is summarized in a letter of 29 March 2012 from Mario Draghi writing as Chair of the European Systemic Risk Board to the Council, Commission and Parliament ESRB/2012/0050.

⁹⁶ Mads Andenas and Iris H.-Y. Chiu, 'Financial Stability and Legal Integration in Financial Regulation' [2013] *European Law Review* 38, 335.

⁹⁷ Report of High Level Group on Financial Supervision (Brussels, February 2009), Annex 1 Mandate.

forward economic recovery across Europe and signaled a major program of substantive law reform would be proposed for the financial sector at European level.⁹⁸ The second, entitled 'European Financial Supervision', proposed the creation of the four new European bodies, the EBA, the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Council ('Council' became 'Board' and it now bears the acronym ESRB).⁹⁹ These bodies replaced the old pre-crisis "Lamfalussy Committees"-based architecture and, in the case of the EBA, EIOPA and ESMA, were to comprise the new European System of Financial Supervision (ESFS) and take principal responsibility for developing and implementing rules and standards for, and oversight of, financial sector institutions operating in the European single market. They were to work towards developing a Single Rulebook for the various financial market sectors and would, in tandem with national competent authorities, ensure that application and enforcement of that rulebook was consistent across the single market. In the case of the European Systemic Risk Council/Board it assumed responsibility for macro-prudential oversight of, and responsibility for, the European financial system as whole. In June 2010 the Commission published a further Communication¹⁰⁰ which proposed an ambitious program to harmonize and strengthen European level regulation of financial services and much of this has been enacted by now and forms the basis of the ESFS' Single Rulebook. Quaglia examines Europe's post-crisis tidal wave of detailed institutional and substantive law reform from the perspective of what it tells us about shifts in the competing political and ideological groupings that drive European policy

⁹⁸ Communication from the Commission of 4 March 2009 'Driving European Recovery' COM(2009) 114.

⁹⁹ Communication from the Commission of 27 May 2009 'European Financial Supervision' COM(2009) 252 final.

¹⁰⁰ Communication from the Commission of 2 June 2010 'Regulating Financial Services for Sustainable Growth' COM(2010) 301 final.

making in the financial sector. She sees these competing groups as being a 'market-making' coalition and a 'market-shaping' coalition where 'the market-making approach emphasized the objectives of competition and market efficiency, whereas the market-shaping approach privileged the objectives of financial stability and consumer protection, as well as forms of veiled protectionism'.¹⁰¹ She detects a change of emphasis within the market-making coalition insofar as the heightened emphasis on financial stability. The UK in particular pushed for reforms to prudential regulation of its systemically important banks and this led to a retreat from a less interventionist model of banking regulation.¹⁰² At the same time the market shaping coalition, she argues, seized the political opportunity of crisis and used it to push a more consumer protective regulatory agenda accompanied by an expansion of European legislative competence that was justified by the need for financial stability rather than a need for greater emphasis on competition and market efficiency. These latter two values appear to be waning within banking regulation.

a) *From bank rescues to sovereign refinancings*

Despite these extensive reforms to European supervision and substantive European regulation of the financial sector, 2010 saw the start of what became a series of eruptions in the markets for government bonds in a number of European countries within the Eurozone. Some of these governments now encountered solvency and liquidity problems of their own in ways that at times mirrored the banks in the preceding years. Contagion

¹⁰¹ Lucia Quaglia, 'The "Old" and "New" Politics of Financial Services Regulation in the European Union' [2012] *New Political Economy* 17, 515, at 520.

¹⁰² See discussion at note 92 of UK's opposition to maximum harmonization of capital requirements in Capital Requirements Regulation as favored by the Commission and its desire to impose further countercyclical capital charges on systemically important banks in the UK given their size and significance in proportion to the UK economy and hence cost of their failure.

spread throughout the rest of the monetary zone and borrowing for many other Eurozone countries became more expensive and the value of the Euro suffered as a consequence. The mandate of the ECB constrained it from doing anything that would amount to direct or indirect financing of a member state and its treaty objective to pursue price stability prevented it from engaging in the type of monetary policy that might have stabilized confidence in the markets.¹⁰³ The episodes during the crisis in Eurozone government bond markets along with the development of a series of *ad hoc* policies in response culminated in an Intergovernmental Treaty being concluded on March 2012 whereby Eurozone governments and several non-Eurozone member states pooled sovereignty as to decision making over public finances and macroeconomic governance and established a European Stability Mechanism.¹⁰⁴ These developments are extensively discussed elsewhere and will not be covered in detail or critiqued in this chapter.¹⁰⁵ For the instant purpose their significance lies in the fact that the sovereign debt problems within the Eurozone were seen to be due in major part to the cost of government support to their banks as well as the bond markets' judgment of the fiscal risk posed by continuing weakness of their banks.¹⁰⁶ This led to the problems within the Eurozone being characterized as a result of a vicious circle linking the solvency of banks and of sovereign governments in their place of establishment and this feedback effect was seen as imperiling financial stability in the wider Eurozone. Realization dawned that a strengthening and deepening of the

¹⁰³ This is explained and critiqued in Patrick O'Callaghan, 'Collective Memory in Law and Policy: The Problem of the Sovereign Debt Crisis' [2012] *Legal Studies* 32, 642.

¹⁰⁴ Treaty on Stability, Coordination and Governance, 2 March 2012.

¹⁰⁵ PR Lane 'The European Sovereign Debt Crisis' [2012] *The Journal of Economic Perspectives* 26, 49.

¹⁰⁶ Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union, COM (2012) 510 Final (September 2012) <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012DC0510:EN:NOT>> accessed 12 May 2016, Paragraph 1.

integration of the arrangements for supervision of all banks and some degree of mutualization of the cost of resolution of troubled banks was needed within the Eurozone and so the first of a series of steps towards what is now termed Banking Union was taken by the Commission in September 2012. The Commission set out its plans as being part of a 'longer term vision of fiscal and economic integration' and signaled the need for '[...]ifting the supervision of banks to the European level [...] which must subsequently be combined with other steps such as a common system for deposit protection, and integrated bank crisis management'.¹⁰⁷ The various legislative changes that have ensued since 2012 have resulted in a Banking Union resting on three pillars: (i) the Single Supervisory Mechanism (SSM)¹⁰⁸; (ii) the Single Resolution Mechanism (SRM)¹⁰⁹; and (iii) the Single Rulebook.¹¹⁰ This last pillar, which is formulated and overseen by the EBA in conjunction with national supervisory authorities, applies throughout the entire single market for banking, and covers banks in non-Euro states as well. Conversely, the SSM, which is in fact a new set of functions and a discrete operating unit within the ECB, and the SRM, administered by an independent Single Resolution Board and containing within

¹⁰⁷ *Ibid.*

¹⁰⁸ Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63.

¹⁰⁹ Council Regulation (EU) No 806/2014 (Establishment of the Single Resolution Mechanism) [2014] OJ L225/1; Council Regulation (EU) 2015/81 specifying uniform conditions of application of Regulation (EU) No 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the SRF [2014] OJ L15/1.

¹¹⁰ The single rulebook refers to a set of main legislative instruments along with a host of implementing ones. It consists of Capital Requirements Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV) and Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR)); Deposit Guarantee Scheme requirements (Directive 2014/49/EU on deposit guarantee schemes) [2013] OJ L176/1 and a new Bank Recovery and Resolution legal regime (Directive 2014/59/EU – BRRD) [2014] OJ L173/190.

it a Single Resolution Fund (SRF), while technically open to participation by non-Eurozone states, owe their design and *raison d'être* to the perceived needs of countries within the Eurozone. No non-Eurozone States have joined the SSM and the SRM and as a result a new reality is emerging for economic governance and banking regulation within Europe.¹¹¹ Europe is a two-layered governance space consisting of a wider single market within which banks are ostensibly free to operate across borders and compete on a level playing field with those banks established within Eurozone states which are subject to ECB supervision and intervention and stabilization measures from the SRM with those costs of future resolution of banks within the SSM (insofar as these costs are not borne by bank shareholders and creditors)¹¹² being shared out among all banks and governments of Eurozone States (within very strict limits).¹¹³

The 2012 Commission Communication mapping out the route to Banking Union was followed up by a second Communication in 2014¹¹⁴ which gave an exhaustive account of all the substantive law and institutional reforms that had taken place since 2008 to strengthen Europe's financial sector, as well as how the emergent Banking Union would bring stability to the markets and member states most affected by turmoil within monetary union. Although both Communications place financial stability firmly at the core

¹¹¹ Although seven non-Eurozone States have manifested their intention to join the Banking Union <http://www.consilium.europa.eu/en/meetings/ecofin/2015/10/st12672_en15_pdf/> accessed 18 April 2016.

¹¹² One of the central aims of the BRRD is to ensure that the costs of bank resolution and rescue are borne first and foremost by shareholders and creditors rather than external resolution by governments or the new resolution mechanism of the SRM needing to be employed.

¹¹³ Council Implementing Regulation (EU) 2015/81 specifying uniform conditions of application of Regulation (EU) No 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the SRF [2014] OJ L15/1.

¹¹⁴ Communication from the Commission of 15 May 2014, 'A Reformed Financial Sector for Europe' COM(2014) 279 final (Commission Communication 2014).

of all the reforms discussed and explained there is only a single reference made to competition in relation to proposed structural reforms¹¹⁵ of systemically important banks.¹¹⁶ Issues such as the importance to resilience of the financial system of fostering more general competition in financial intermediation within Europe are not discussed.¹¹⁷ Neither is there any consideration of the level of risk of moral hazard attendant on the reforms that are discussed. More recent explanatory material on Banking Union,¹¹⁸ along with the Commission videos on how the different elements of Banking Union knit together and function, paint a reassuring picture from the point of view of financial stability of both banks and the banking system within the Eurozone but make scant mention of competition or competitiveness within the internal market.¹¹⁹ Scrutiny of the legislative texts that establish and empower the SSM and SRM reveals that the need to minimize moral hazard and to remain vigilant to risks to financial stability feature prominently in the mandates of both of these mechanisms. Yet how decisions taken within them might

¹¹⁵ Following the 2012 Report from the High-level Expert Group on reforming the structure of the EU banking sector <http://ec.europa.eu/finance/bank/docs/high-level_expert_group/report_en.pdf > accessed 12 May 2016 (the Likkanen Report), the text of a proposed regulation was adopted by the Commission and agreed by ECOFIN for structural reform of EU banks (Proposal for a Regulation of the European Parliament and of the Council on Structural Measures Improving the Resilience of EU Credit Institutions /* COM/2014/043 final - 2014/0020 (COD) */).

¹¹⁶ Commission Communication 2014, at 7-8

¹¹⁷ ESRB, 'Is Europe Overbanked?' (Report of the Advisory and Scientific Committee of the European Systemic Risk Board, June 2014 <https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_4_1406.pdf> accessed 18 April 2016.

¹¹⁸ Explanatory Memorandum Commission Newsletter of 2 February 2015, 'Understanding Banking Union' <http://ec.europa.eu/information_society/newsroom/cf/fisma/item-detail.cfm?item_id=20758&newsletter_id=166&lang=en> accessed 18 April 2016.

¹¹⁹ The 2012 Communication on Banking Union gives occasional emphasis on the integrity of the internal market but makes no mention of the need to ensure a competitive banking market.

impact upon the overall efficiency and competitiveness of financial intermediation within Europe is an issue that is largely avoided save for the requirement for the SRB to take steps to ensure that the State aid regime and its decision-making processes are observed in any use of the SRF.¹²⁰

b) State aid and the new framework for bank resolution

By requiring bail-in as a pre-condition for State aid, the recent Commission practice under the 2013 Banking Communication has provided a dry run for the incoming regulatory framework for bank recovery and resolution.¹²¹ The coming into force of the latter however does not consign the policy and practice developed during the financial crisis to legal history. That experience has not only shaped the new regulatory framework, but remains relevant even as the new rules come into effect.¹²² Moreover, the trade-offs between competition, stability and moral hazard that were highlighted above are bound to recur in the future, albeit in different and unpredictable ways. There is general agreement among commentators that the type of idiosyncratic/endogenous risk that

¹²⁰ Council Regulation (EU) No 806/2014 [2014] OJ L225/1, Art. 19.

¹²¹ Banking Communication. In its ruling in *Kotnik*, the CJEU clarified that while the Banking Communication fetters the Commission's discretion, it does not bind the Member States. See Case C-526/14 *Kotnik and others* [2016] ECR I-000.

¹²² This interaction between State aid rules and the new regulatory framework is highlighted by the Commission's assessment of the compatibility of State aid with the BRRD even before the transposition into national law of that directive. Commission Decision in State aid SA.41503 (2015/N) *Panellinia Bank* [2015] OJ C325/1; Commission Decision in State aid SA.41924 (2015/N) (ex 2015/PN) *Banca Romagna Cooperativa* [2015] OJ C369/1.

caused the demise of *Crédit Lyonnais* may be resolved effectively through bail-in.¹²³ However, some have expressed concern that bail-in may run into insurmountable obstacles in the context of a systemic crisis, in particular, where large interconnected banks are concerned.¹²⁴ While one may retort that bail-in has already been applied in State aid practice since 2013 without triggering contagion, these cases only go part of the way towards dispelling doubts over the future effectiveness of the new regulatory framework because their context is a far cry from that of October 2008 which would be the real test for the resilience of the new system.¹²⁵

In effect, both the BRRD and the Banking Communication contain safeguard clauses which allow for some degree of State intervention independent of bail-in. The BRRD contemplates that State aid may be granted without triggering resolution (which is normally a consequence of “extra-ordinary public financial assistance”, i.e. State aid), provided that the aid is approved by the Commission, if the State measures are of a precautionary and temporary nature and are proportionate to remedy the consequences of the serious disturbance and are not being used to offset losses that the institution has incurred or is likely to incur in the near future. Recapitalizations are permitted to the

¹²³ Dirk Schoemaker, ‘On the Need for a Fiscal Backstop to the Banking System’ [2014] DSF Policy Paper, No. 44.

¹²⁴ See Charles Goodhart and Emiliios Avgouleas ‘A Critical Evaluation of Bail-in as a Bank Recapitalisation Mechanism’ in Franklin Allen, Elena Carletti and Joanna Gray (eds) *Bearing the Losses from Bank and Sovereign Default in the Eurozone* (FIC Press 2014), 65.

¹²⁵ Indeed, the fallout from the decision by the Italian authorities in 2015 to bail in subordinated debt holders as part of the resolution of four small regional banks does not bode well for any future decision to trigger creditor bail-in under the new framework for bank recovery and resolution. See Commission Decisions on resolution plans for Banca delle Marche, Banca Popolare dell’Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio della Provincia di Chieti registered under SA.39543, SA.41134, SA.41925 and SA.43547 (not yet published). For an account of the backlash from these decisions see Jim Brunsten and Alex Barker, ‘Bank Turmoil: Are Europe’s New Bail-in Rules to Blame?’ *Financial Times* (11 February 2016).

extent that they are precautionary, i.e. they address a capital shortfall, as opposed to covering losses, identified through a stress test, asset quality review or equivalent exercise by the competent supervisory authority, and provided that the aid is temporary and the bank is solvent.¹²⁶ The Banking Communication (point 45) provides for an exception to burden-sharing where conversion or bail-in would threaten financial stability and where it would be disproportionate e.g. where the amount of aid is relatively small.¹²⁷ The rationale of these combined exceptions is that in a systemic crisis, even solvent banks may require urgent intervention.

Some may regard this exception to burden sharing as having the potential to increase moral hazard and to create distortions of competition. Much will depend on the effectiveness of the interaction between the relevant regulators, who will be required to assess the existence of the capital shortfall and the Commission, and how strictly the link between bail-in and systemic risk is interpreted. With regard to the issue of regulatory cooperation, the fragmentation that characterizes financial supervision even after the Banking Union does not rule out the possibility of discrepancies in the way in which capital shortfalls are identified and in the promptness with which shortfalls are flagged up.¹²⁸ As far as the Commission is concerned, however, if it is true that during the financial crisis the absence of a pan-European framework for bank resolution was at the root of its readiness to accept the systemic importance of every bank, by analogy and by contrast the presence of such a framework is likely to yield a rigorous interpretation of the link between bail-in

¹²⁶ BRRD, Art. 32(4)(d).

¹²⁷ See Opinion of Advocate General Wahl in *Kotnik* pending, 125-30.

¹²⁸ The EBA has provided some guidance in its Guidelines on the Types of Tests, Reviews or Exercises that may Lead to Support Measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive BA/GL/2014/09.

and systemic risk.¹²⁹ Since the Banking Communication entered into effect on 1 August 2013, there have been no instances of this exception being applied in the Commission's decision-making. Nonetheless, given the crucial importance of early recapitalizations for the effective management of a systemic crisis, this guarded flexibility is to be welcomed.¹³⁰

A striking novelty of the Banking Union is the new role assigned to State aid control in the context of the SRM. While the SRM falls short of expectations in terms of providing a common fiscal backstop, its SRF is intended to replace taxpayer funds with mutualized funds originating from the banks. Given the private origin of its resources, and that these resources are not managed by member states but by an agency of the EU, the use of the SRF would not normally fall within the scope of the notion of State aid in light of Article 107(1) TFEU. Yet Article 19 of the SRM Regulation, which draws on the TFEU's State aid provisions, ensures that Fund aid is subject to the same regime as State aid. The point of this provision is to ensure the substantive coherence of EU law, that is, that different areas of EU law are mutually compatible. In the case of the SRM, this concern for coherence takes on a heightened significance as the avoidance of asymmetries that translate into potential distortions of competition in the internal market is a key challenge of the Banking Union. Thus, through its State aid/Fund aid control, the Commission is

¹²⁹ The analogy is between distinct legal questions: on the one hand, the question of whether the flexibility entailed by Article 107(3)(b) was justified by the systemic nature of the individual aid recipient; on the other, whether the application of the financial stability safeguard clause in point 45 of the Banking Communication was justified by the threat to stability that bail-in would engender. The contrast is between the regulatory environment before and after the BRRD and SRM.

¹³⁰ There is a remote but not insignificant risk that these safeguard clauses may incentivize the underestimation of capital shortfalls by national regulators so as to avoid bail-in. It is to be hoped that the new SSM (as far as Banking Union member states are concerned) will minimize that risk.

tasked with the constitutionally pivotal role of protecting the interests of non-Banking Union member states in order to safeguard the integrity of the internal market.

4. Concluding comments

State aid law and policy display remarkable openness to the concerns that animate financial regulation and, to a certain extent, employs concepts such as moral hazard that are central to financial regulation. However, a number of challenges come with this openness. First, there is a certain fuzziness about systemic risk and moral hazard, which affects the congruence between theory, policy and practice. This was particularly true during the sovereign debt crisis in which State aid policy appeared to struggle with the collective moral hazard problem and, at times, the Commission's practice appeared to struggle to fit with its own policy on State aid. Second, the language of "reconciling" multiple regulatory objectives tends to obfuscate some difficult trade-offs that occur in attempting to pursue stability, the prevention of moral hazard and the preservation of lending to the real economy simultaneously, while attempting to minimize distortions of competition. The natural inclination of State aid policy is to focus on keeping State aid to a minimum in order to reduce the resulting distortions of competition. Yet this policy did not succeed in overcoming the inherent resistance of governments and banks towards building up adequate capital buffers and may have exacerbated the tendency of undercapitalized banks to gamble for resurrection. The comparison with the US TARP recapitalization scheme is at the same time misleading and instructive. It is misleading because it neglects the significant differences between the two objects of the comparison. The Commission's role as competition regulator in a supranational organization that lacks fiscal competence could only go so far in shaping intervention by national governments. The comparison is instructive as it sheds some light on the effectiveness of the member

states' response and on the extent to which that response was influenced or constrained by State aid policy. As the dust has settled on the financial crisis, and to some extent on the Eurozone crisis, reflecting on these challenges and on possible interactions between State aid policy and national bailout design is an exercise that is worth engaging in as a new regulatory and economic environment sets in. In principle, the response to future crises should take an altogether different form, as shareholders and creditors and uninsured depositors will take the hit before any outlay of public funds. Whether this will turn out to be the case in extreme scenarios such as the one that materialized in October 2008 is open to question. Yet the challenge of the new regime for bank recovery and resolution is not limited to ensuring the robustness of the bail-in mechanism, but also to preserving the integrity of the internal market. As the institution charged with the control of both SRF aid and State aid (from non-Banking Union member states), the Commission will continue to play a crucial role in the context of banking crises. However, this role will not only focus on preventing or limiting distortions of competition in the banking sector, but also preventing or limiting jurisdictional competition between Banking Union "ins" and "outs". The positive features¹³¹ and shortcomings¹³² in the design of Banking Union have been widely discussed with suggestions made to improve its efficacy.¹³³ It is an experiment in governance that is uniquely European. To the extent to which it represents real agreement amongst the Eurozone member states to integrate sovereignty over, and to share the burden of, any future bail-outs of the financial institutions that operate

¹³¹ Eilis Ferran, 'Banking Union: Imperfect, But it Can Work' (Legal Studies Research Paper Series 2014, Paper No 30/2014).

¹³² Martin Hellwig, 'Yes Virginia, There is a Banking Union! But It May Not Make Your Wishes Come True' (Max Planck Institute for Research on Collective Goods 2014/12).

¹³³ Ignazio Angeloni, 'Rethinking Banking Supervision and the SSM Perspective' in Franklin Allen, Elena Carletti and Joanna Gray (eds), *The New Financial Architecture in the Eurozone* (European University Institute 2015, RSCAS, Florence School of Banking and Finance), 9.

within them, it marks a step in political integration. How the decisions taken within the Banking Union will impact upon the competitiveness of the wider single market, and take account of and relate to the values underlying the State aid and competition law framework of that wider European space, is of profound interest going forward.