STATE AID AND SYSTEMIC CRISES: APPROPRIATENESS OF THE EUROPEAN STATE AID REGIME IN MANAGING AND PREVENTING SYSTEMIC CRISES

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Abstract: *The purpose of this paper is to debate the material validity of State aid as a legally and economically rational mechanism to address systemic market crises. In the European Union, Member States shall only participate in the economy when they do so with the same rationality as that of a market investor. Apart from this, State intervention must be restricted to those situations where markets fail and it is necessary to artificially allocate goods and services. However, the 2007/8 financial crisis posed a new challenge for the legal perception of State aid: financial markets failed systemically, and Member States had to intervene to prevent the collapse of the current economic model.*

1. INTRODUCTION

The financial and economic crisis challenged not only the economic and legal perceptions of State aid control, but also the economic and political model that most western countries have engaged in. One of the core principles of a market economy points to the fact that, in a theoretical vacuum, competition

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between firms produces 'self-adjusting mechanisms' capable of regulating the behaviour of economic actors by punishing inefficient firms and awarding successful ones with an increase in their market share caused by the exit of the failing firms[1]. Hence, it is expected that the inefficient firm leaves the market without creating systemic risks and negative externalities for the remaining economic actors. And the same was supposed to apply to financial institutions.

However, political changes introduced enhanced deregulation in the 1970s, which consequently led to a new behaviour being taken on by financial institutions and its agents. Profits and bonuses increased, cheap money was made available throughout the whole economy, and banks and bankers engaged in extremely risky practices with prospects of even higher gains[2].

It is key to analyse the economic transformation of the past and how the financial crisis challenges the perceptions, principles and rationale of the European State aid control.

The starting point of the discussion I intend to follow departs from the central idea that, in the perspective of the European Commission, aids granted by Member States are a response to problems that occur within the system of a market economy. The Commission starts from the premise that the markets work properly with the exception of less common situations, where they fail[3]. This rationale presumes that the system of market economy can fully answer the problems of production, distribution and allocation of scarce commodities apart from exceptional situations of market failures, which can be seen as a minor setback to the system.

However, the financial and banking crisis has shown that this perception did not properly address the problem of systemic risks capable of leading to a meltdown of the economy. The current formulation of State aid in the TFEU and its interpretation by the European Commission cannot fully solve the problems when the challenges (crises) are systemic.

During the crisis, Member States had to intervene in the economy through a wide range of measures because there were no private operators interested in engaging in economic activities. One key element of Competition Policy in general is its asymmetrical character: on the one hand, it is pro-cyclical where

1 Merola, Derenne & Rivas, 2009: 33-34.

2 Brett, 2015.

3 Commission, 2012: para 4.

there is economic growth; on the other hand, it is anti-cyclical in the course of a crisis because economic actors are restricted, there are less incentives to enter a market and inefficient/failing firms will take longer to leave the market because there are no new investments being made by market participants[4]. In the course of the crisis, one of the challenges for State aid was precisely understanding which firms were affected by unusual market conditions linked to systemic risks and which ones were in difficulty due to their unsound and risky business practices.

I intend to assess whether State aid, according to its current conceptualization, is a suitable and appropriate policy instrument to respond to systemic risks. Furthermore, I seek to propose adjustments to the legal regime, where it does not address all economic, political and legal challenges. Finally, one must also comprehend all factors which led to the crisis, as the global intention of the European Union is the avoidance of another crisis, which requires a response at the regulatory and supervisory levels.

This Article departs from the legal context of EU State aid law. Both doctrine[5] and jurisprudence (*i.e.* the Commission and the CJEU) have based their understanding on a conceptualization of Article 107 of the TFEU: a given measure will fall within the scope of this Article when it confers, on a selective basis[6], an economic advantage[7] to a certain undertaking, through State imputable resources[8]; this measure must also distort, or have the potential to, competition[9] and must be likely to affect trade between Member States[10]. Exhaustive literature on this field has been published by numerous Authors and Scholars. For that reason, this Article will instead briefly explore the reasoning behind State aid control in the EU and its economic justification.

4 Heimler & Jenny, 2012: 347-348.

5 Jones & Sufrin, 2011; Bacon, 2013; Quigley, 2015; López, 2016.

6 *Commission* v. *France* (Cases 6 and 11/69) [1969] ECR 523.

7 *Commission v Italy* (Case 118/85) [1987] ECR 2599: para 11, *Hofner and Elser* (Case C-41/90) [1991] ECR I-1979: para 21 & *Commission v Italy* (Case C-35/96) [1998] ECR I-3851: para 47.

8 *PreussenElektra AG* (Case C-379/98) [2001] ECR I-2 099: para 58 & *Commission v. France* (Case 290/83) [1985] ECR 439: para 14-15.

9 *Phillip Morris* (Case 730/79) [1980] ECR 267: para 11.

10 *Friulia Venezia Giulia* (Case T-288/97) [2001] ECR II-1619: para 41.

Furthermore, this Article aims at explaining what a systemic crisis is, from a multi-disciplinary point of view, in order to understand why this crisis was of a different character[11].

It is pertinent to determine the legal options undertaken by the Commission in responding to the crisis, namely the differentiation made with regard to actions to support the real economy and those to rescue the financial system. Noticeably, the Commission's choice of legal technique[12] evolves throughout this period, influencing the content and aim of the several Communications adopted.

From a normative perspective, this Article will also assess the role of State aid at times of crisis when the risk is systemic. Upon this consideration one must investigate which the market failures were at the heart of the crisis and what caused those failures[13]. This exercise will allow one to question the implications of the crisis on the EU State aid framework and whether its underlying principles have changed.

Finally, and taking into account the repercussions of the crisis, the suitability and importance of State aid in managing financial and economic crisis will be assessed, in order to establish predictive recommendations of how the EU legal framework ought to develop. A crisis must be answered through different mechanisms, principally where its causes are related to a culmination of different factors which had not been addressed in due course.

2. RATIONALE BEHIND STATE AID CONTROL

While addressing the rationale behind European State aid rules, the first question is precisely related to why the European founders decided to include this set of provisions in the Rome Treaty. In fact, the primary concern was to avoid a 'subsidy race' which could prevent the achievement of the intended Internal Market[14]. If a Member State were to grant subsidies to a 'national champion', the remaining Member States would naturally do the same resulting in a misallocation of resources[15] that would undermine the normative objective of

11 Brett, 2015.

12 Ringe & Huber, 2014: 2-3.

13 Merola, Derenne & Rivas, 2009: 851.

14 Cecco, 2013: 43.

15 The also so-called 'state aid competition'. Ganoulis & Martin, 2001: 291.

achieving an Internal Market. The degree of integration and economic interdependence present in the Internal Market highlights the possible negative spillovers of State aid.

Moreover, there were also concerns centered on avoiding distortions of competition within the Internal Market, the so-called cross-border externalities caused by the intervention of Member States in their economy and their impact on the other Member States[16], and a clear political economy option intended to limit the freedom of governments to intervene in the economy and the consequent wasteful government spending.

Although the Treaties in principle prohibit the granting of State assistance to undertakings, regardless of whether this is direct or indirect, Article 107(2)(3) contains a number of derogations and exceptions to the general prohibition, as explained above.

Thus, one must question the reasoning behind the exemption of incompatible aid and the economic, social and political motives that governments have to grant aid to undertakings. The first set of arguments is based on efficiency and equity grounds, from which correcting market failures constitutes the primary argument for granting aid. The second set of arguments is linked with political economy considerations which take into account both intergovernmental competition and policy options taken by governments.

When granting subsidies to undertakings, governments may be pursuing a wide range of objectives which can go from protection of cultural heritage to economic development. Nevertheless, the grounds on which such aid may be granted are primarily related to efficiency gains: the State intervenes in the economy to address a market failure which typically originates from market imperfections such as: externalities, the situation where the action of one party has a consequence on another; distribution of public goods, those goods from which it is almost impossible from exclude consumers of using them; coordination problems, where firms do not coordinate in order to achieve mutual benefits; asymmetric/imperfect information, a situation where one side of the market has more information available than the other; and market power, where one firm can impose high prices due to the lack of competition[17].

The Commission defines market failure as '*a situation in which economic efficiency is not achieved owing to imperfections in the market mechanism. A market*

16 Friederiszick, Roller & Verouden 2006: 23-27.

17 See Nicolaides & Bilal, 1999 and Friederiszick, Röller & Verouden, 2007: 13-14.

failure may manifest itself either in the inability of the system to produce goods which are wanted (in this case a risk capital market), or by a misallocation of resources, which could be improved in such a way that some consumers would be better off and none worse off. As economic theory predicts that markets will usually fail in some sense except under conditions of perfect competition, the term market failure is reserved for cases where it is believed that a serious misallocation of resources has occurred'[18].

In such situations the State decides to intervene in the economy because the market, left to its own resources, is not capable, or it is unlikely to be capable, of achieving price, output and resource usage efficiency[19]. Although it would be profitable to engage in an economic activity[20], market participants were unwilling to offer a service or product in a given market, leading to State intervention in that market in order to correct its functioning. Such intervention will often take the form of compensation to the market actors either for the costs which they have incurred because of the market malfunction or to incentivize companies to adopt a behavior they would not engage in under normal conditions. Moreover, States often justify granting subsidies based on achieving economies of scale otherwise unavailable to firms, compensating and benefiting medium and small sized firms and promoting the development of peripheral regions[21].

Another conceptual argument for state subsidies resides in 'international trade theory': in a situation of imperfect competition the States have an incentive to grant export subsidies to their firms in order to 'improve the relative position of domestic firms in non-cooperative rivalry with other firms'[22]. As a result of the expansion of the market shares of domestic firms at the expense of foreign firms, it is possible to increase domestic welfare, a process called 'rent-shifting strategic trade policy'; though, this argument has diminished importance in an integrated market like the European Union where Member States have more to gain from cooperation than from not fulfilling their international agreements.

18 Commission , 2001: para VI.2-VI.3.

19 Friederiszick, Röller & Verouden, 2007: 12.

20 It is profitable in the sense that the economic benefits outweigh the economic costs.

21 Vives, 2009: 187-189.

22 Heimler & Jenny, 2012: 348.

However, granting subsidies to compensate firms for market failure is merely a second-best solution. It would be far more efficient to address the market failure itself instead of granting subsidies that will distort competition in the market by creating artificial conditions which are not foreseeable under normal conditions and increase expenses on taxpayers[23]. Unfortunately, it is not possible to directly address market failures at all times, either because there are social concerns or because the correction of the market failure at its source causes spillover and side effects more harmful to the global welfare than those caused by the market failure itself; in those situations, a second-best solution is preferable and subsidies may be granted on efficiency grounds.

Although the economies of the Member States can generally be seen as mixed economies and that, according to Article 345 TFEU, the European Union shall abstain from defining the nature of property law within the Member States[24], the Commission has preferred to allow State aid when it is intended to address market failures, stressing that a market oriented economy can solve the problem of production, distribution and allocation of scarce commodities apart from exceptional situations which constitute market failures.

However, this justification for granting State aid is subject to several constraints. Firstly, market failures are often difficult to identify and to measure, with special regard to their actual influence on the economy and on the behavior of market actors. Secondly, the impact on and costs to social welfare are equally problematic to pinpoint since it is necessary to render a subjective analysis of the potential effect of the subsidy on the economy, particularly with regard to potential anti-competitive side effects of the subsidy. Finally, the balancing assessment of the subsidy, pursuant to the costs for the government on the one hand and the benefit to the recipient undertakings on the other, raises difficult challenges for the political actors who have to bear in mind that the benefits of the aid for the recipient shall not surpass the costs to the total welfare[25].

Yet, even where markets function properly, reaching an efficient allocation of resources and providing for a fair number of opportunities for individuals, States decide to intervene in the economy on equity grounds, *i.e.* to achieve a redistribution of resources that is capable of reflecting the preferences of

23 Nicolaides & Rusu, 2010: 26.

24 Cecco, 2013: 73.

25 Ganoulis & Martin, 2001: 289-290.

society in terms of wealth distribution[26]. By pursuing State aid policies based on equity, governments can address less favored regions or social groups which consequently justify, for example, regional, employment or restructuring aid[27]. Nevertheless, it is not possible to separate that redistribution function from the other two objectives that States pursue when intervening in the economy: the allocation function, where the State is concerned with correcting the misallocation of resources; and the stabilization function, where the State wants to ensure not only the full employment of resources but also price stability and sustainable economic growth. There is an inherent idea of interdependence because each State measure will necessarily have an effect on other State functions, either benefiting or harming the achievement of that function.

In a nutshell, State intervention in the economy aims at promoting not only economic efficiency but also equity. Governments are both concerned with correcting market failures to achieve economic efficiency and with addressing wealth and resources distribution which are dependent on their conceptions of justice and welfare[28], demonstrating that these goals are not necessarily mutually exclusive, although it can be accepted that the achievement of equity objectives usually entails an efficiency cost[29].

3. STATE AID AND THE FINANCIAL AND ECONOMIC CRISIS – THE COMMISSION'S RESPONSE TO THE SYSTEMIC CRISIS

As is well known and debated, the collapse of Lehman Brothers in 2008 initiated an enormous financial crisis that quickly escalated to the real economy. Although the crisis was initially felt in the United States, its effects rapidly extended to Europe. In this context, governments around the world had to inject large amounts of money into their banks to mitigate the extraordinary losses the banking system was facing; the United States created a $700 billion plan to support its 'bad banks'[30].

If, in the United States, the questions raised in the State intervention were purely economic, in Europe the situation, and its respective debate, was rather

26 Friederiszick, Roller & Verouden, 2006: 17.

27 Bacon 2013: 8.

28 The general ideas of 'making the cake bigger and dividing it better'.

29 Nogueira Almeida, 2013: 20.

30 Emergency Economic Stabilization Act of 2008 (Division A of Pub.L. 110–343, 122 Stat. 3765).

distinct due to its State aid rules. Before the financial crisis, there were no sector specific State aid rules regarding the financial system. State measures to support a financial situation in the face of financial distress would be assessed under Article 107(3)(c). However, the systemic character of the financial crisis and its ramification on all major banks changed the paradigm of State aid rules and made it evident that the Rescue and Restructuring Guidelines[31] ought to be modified and adapted to address the upcoming challenges.

In the early stage of the crisis, European governments nationalized and bailed their banks out without much intervention by the Commission. Yet, when Ireland decided to extend its bank guarantees to Irish banks, in a € 400 billion plan directed at bank liabilities, the Commission started raising concerns that State rescue measures had the potential to distort competition[32]. Consequently, the importance of State aid rules could not be undermined and the Commission had a decisive role to play in enforcing these rules, which were far from ready to address a challenge of this magnitude.

Thus, the Commission gradually issued an extensive set of documents to be incorporated under a Crisis Framework, addressed not only to the chaotic situation of financial institutions, but also aimed at supporting the real economy, where firms were being highly constrained by the liquidity problems banks were facing.

3.1. The financial crisis of 2008 – what is a systemic crisis?

The 2008 crisis presented repercussions far greater than initially predicted by the authorities. If compared, for instance, with the crisis faced in the early 2000s[33], where US household wealth suffered a loss of $5 trillion, the 2008 crisis was not much greater, taking into account the inflation and economic growth observed in the meantime, since it reached losses of $8 trillion[34]. The origin and causes of the recent crisis were considerably different, particularly due to its systemic character which required the rescue of the banking system to avoid a financial and economic collapse.

31 Pursuant to Article 107(3)(c) the Commission had adopted the Rescue and Restructuring Guidelines of 2004. In addition, see Bacon, 2013: 400.

32 Szyszczak, 2011: 124.

33 The so-called 'stock crash'.

34 Krugman & Wells, 2010.

Even though this is being disputed, the primary causes found for the crisis are centered in excessive liquidity and low interest rates which led banks to abandon their reliance on core deposits and focus on wholesale borrowing and securitization and on new and innovative lending practices that exposed them to higher and greater risks[35]. The reasons behind these two major factors are related to loose monetary policies pursued by central banks both in setting out interest rates and in the control of money supply. Additionally, rapidly developing economies inflated developed countries in Europe with cheap money causing banks to misprice their assets and leading to asset price booms in real estate[36]. The financial practices at the time exposed banks to mortgage defaults and the obscurity and lack of transparency of the system made it difficult to distinguish between sound and toxic assets. This situation, consequently, turned into a 'snow-ball' effect with a wide fall in the confidence in the financial markets followed by liquidity problems in wholesale funding markets.

All in all, the shift in practices of the banking sector made it highly dependent on wholesale funding and when the confidence on banks' balance sheets collapsed, it became nearly impossible for them to find funding. Solvency issues arose for those banks which mispriced assets, consequently becoming vulnerable to the real estate market due to the collapse of prices[37].

However, the special character of the crisis at hand results from more factors than those already mentioned. In fact, the banking sector plays a determinant role in financing the 'real economy' and the financial crisis experienced in 2008 had implications not only on banks' funding but also on the borrowing costs for firms in non-financial sectors which needed banks to play the intermediate role of lending them money to finance their activities. In addition to this, it is necessary to understand the social costs that the collapse of a bank represents to the economy. Those social costs are explained because banks deal directly with uninformed depositors, with firms from other markets of which they gained valuable input and information that in the face of bankruptcy will result in a permanent loss of output, and because of the repercussions (contagion effect) of a bank failure on the rest of the banking sector[38].

35 Commission, 2009e.

36 Szyszczak, 2011: 124-125.

37 Szyszczak, 2011: 126.

38 Beck, 2010: 10.

The systemic risk of contagion was precisely the center of focus for the efforts to tackle the crisis. Where a bank fails, there is an inherent negative externality for the rest of the banking system associated to it. This results from its business model[39]: banks apply the money saved by depositors (which constitute liabilities) in the form of loans to borrowers (assets), which makes banks' balance sheets 'highly leveraged' because their assets exceed their equity base[40]. Since a bank is not required to retain 100% of the capital it makes available to borrowers in its reserves, they become dependent on the market for interbank lending to cover their illiquidity risk[41]. This negative externality outweighs the general positive outcome for competitors associated with the exit of a failing firm from the market due to panic and drop in confidence depositors will feel regarding the failing bank with the likely consequence of an escalation toward other banks.

In sum, it is not surprising that national governments had to address this urgent matter as quickly as possible, attending to the specific features of the banking sector. However, the identification of the market failures that justified State aid to support banks in difficulty and its conceptualization within the rationale usually postulated by the Commission when addressing State aid poses a greater challenge due to the systemic character of the crisis. Therefore, one must question whether State aid addressed market failures or whether it was used to prevent the whole system of market economy from fading. In answering this question it is possible to argue that the financial crisis represented, in itself, a market failure exacerbated by two main factors already referred to: the massive drop in confidence in banks and the interdependence of the banking system[42].

The assessment of the market failures associated with the economic crisis will be developed in the next chapters with a particular focus on those market failures which constitute a 'serious disturbance of the economy'[43], the crucial legal basis invoked by the Commission to respond to the crisis.

39 Musetescu, 2012: 180-183.

40 Gerard, 2014: 2.

41 Lyons & Zhu, 2012: 42.

42 Derenne, Merola & Rivas, 2014: 851-859.

43 TFEU, Article 107(3)(b).

3.2. Impact on the real economy and the European Temporary Framework

It is not surprising that the main focus of State aid policy during the crisis period was on the assistance to the financial sector. Hence, before stepping into the analysis of the Crisis Framework adopted by the Commission to respond to the failure of the banking sector, it is relevant to assess the impact of the financial and economic crisis on the 'real economy' and the Commission's responses to it.

The massive contraction of economic growth and industrial output experienced since 2008 is, to a great extent, related to the credit crunch caused by the slowdown in the lending activities of banks. It then became clear that there was a need to find State support measures that could help firms to finance themselves in the absence of a functional banking sector[44].

The Commission took rapid action by adopting the European Economic Recovery Plan[45], which encompassed the EU Temporary Framework[46]. Firstly, it is necessary to point out that the Commission, upon the release of its first Banking Communication[47], intended to make a distinction between the approach taken towards financial institutions and the one taken towards other individual sectors due to the 'absence of a comparable risk that they have an immediate impact on the economy of a Member State as a whole'[48]. The intention was to clarify the distinct legal basis to be used in respect of systemic financial institutions, Article 107(3)(b) instead of Article 107(3)(c), given that a systemic crisis not only puts unsound financial institutions at risk, but it may also have a detrimental effect on fundamentally sound institutions. Upon the release of the first Communication introducing the EU Temporary Framework, the Commission stated that it would also apply Article 107(3)(b) in the case of measures taken to support the 'real economy', for a limited period of time, due to the fact that 'the current global crisis requires exceptional policy responses'[49].

44 Szyszczak, 2011: 127-128.

45 Commission, 2008b.

46 Commission, 2009d.

47 Commission, 2008a.

48 Ibid: 11.

49 Commission, 2009d: 6.

The EU Temporary Framework was initially thought to be applicable between 2008 and 2010, but it was extended until December 2011[50], the date on which it expired. The Framework was vastly concerned with SMEs and its primary goal was to reach a simplification of existing State aid rules under which aid is declared compatible with the Internal Market. It adopted 5 different State measures to support undertakings which were not already in difficulty before the crisis started[51]. In order to facilitate the access of companies to finance, the Framework allows Member States to grant aid up to €500 000 per undertaking through sector aid schemes. To do so, Member States could have opted for subsidizing loan guarantee premiums or for reducing interest rates below the reference rate set by the Commission. Likewise, the rules to fund new environmentally friendly projects, or to refinance existing ones, were relaxed. Finally, the Commission decided to promote risk capital in respect of SMEs by relaxing the existing rules on risk capital aid from € 1.5 million to up to € 2.5 million per year per undertaking, and to ease the procedural requirements on short-term export credit insurance.

Another possible way to support undertakings under distress is to grant ad hoc aid pursuant to Article 107(3)(c) and in accordance with the Rescue and Restructuring Guidelines of 2004 (R&R Guidelines)[52], which have now been revised[53]. This type of aid is the main category of horizontal aid not covered by the General Block Exemption Regulation[54], which means that where Member States want to grant it, they must notify the Commission in order to receive the necessary approval under Article 107(3). It is worth pointing out that these Guidelines were also an important instrument in the rescue of financial institutions as they represented the Commission's choice of legal technique for these situations.

However, the R&R Guidelines were too form-based and lacked, at the time, a revised approach that would 'modernize' them by introducing a 'more economic approach'. In fact, they did not follow a balancing test (or an effects-based

50 Commission, 2011a.

51 Luja, 2009: 153-158.

52 Referred to in footnote 74.

53 Commission, 2014c.

54 Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty *OJ L 187, 26.6.2014, p. 1–78*. This type of aid is explicitly excluded by the Regulation on its paragraph 14.

approach) opting, instead, for form-based rules established on presumptions in respect of the benefits of the aid and the detrimental effect on competition[55]. While different types of aid may lead to the same effect, the application of the same measure to distinct situations has the potential to cause different effects. The Guidelines were developed under the idea that this type of aid is highly controversial since it usually results, due to its very nature, in a distortion of competition with affect on trade between Member States[56]. Therefore, there was a primary concern with limiting the scope of the Guidelines that can be observed in its main features. Firstly, the notion of 'firm in difficulty' was closely defined to only encompass those firms that would almost certainly be driven out of the market in the short or medium term if public authorities did not intervene[57]. Secondly, there is the general 'one-time last time'[58] principle, meaning that firms may only receive aid once every ten years, intended to prevent failing firms from 'being kept alive' through successive aids. Finally, where a firm is in line with these two conditions, it qualifies to receive this specific aid for a period of 6 months while it elaborates a restructuring plan aimed at returning it to viability or while it defines a liquidation plan[59]. Moreover, the restructuring plan has to respect three conditions: the plan must guarantee that the firm will return to viability without a continued reliance on State aid; there must be a burden sharing of the costs of the plan, *i.e.* the undertaking must sufficiently contribute to it from its own resources; and, the Commission may impose compensatory measures to mitigate distortions of competition created by the aid, such as divestment of assets or capacity reductions[60].

As previously mentioned, rescue aid is regarded amongst the most controversial and least efficient types of aid. In a market economy where the competitive process runs 'freely', it is normal to see firms exiting the market while others enter it. However, the Commission has identified other social benefits of this type of aid that might be worth pursuing, namely: social and/

55 Szyszczak, 2011: 130.

56 Farantouris, 2009: 3.

57 Commission, 2004: para 9-10. It is necessary to mention that a newly created firm does not qualify for rescue and restructuring aid.

58 Ibid: para 72. This principle aims at achieving optimal allocation of resources and therefore applies where a finding of aid has already been reached and the compatibility assessment is pending.

59 Ibid: para 25.

60 Szyszczak, 2011: 131-136.

or regional concerns; the importance of SMEs to the competitive process; and the avoidance of a monopoly or oligopoly by rehabilitating a competitor[61].

But even from a social welfare perspective the costs for tax payers, and the benefits for competitors of the failing firm will generally be greater than the benefits to consumers. An inefficient firm kept 'alive' in a functioning and competitive market will merely frustrate the normal course of competition and will impose an extra burden on taxpayers from which they will not benefit. And, unlike in the banking sector, the failure of a firm in other sectors will simply highlight and contribute to the success of its competitors, and it will not put the functioning of the whole system at risk in a systemic manner.

3.3. Rescuing the financial system

The Commission's approach towards the rescue of financial institutions since the outset of the crisis has been made through a variety of instruments and different legal choices. Initially it was difficult to understand and perceive the repercussions of the crisis, which explains why the Commission declined to authorize aids under Article 107(3)(b) in the first cases of rescue to banks[62]. It considered that the problems the banks were facing were due to their business models and not a consequence of a 'serious disturbance in the economy of a Member State'. Therefore, the Commission opted for authorizing such State measures under the standard Rescue & Restructuring Guidelines, which were clearly not meant to respond to a systematic crisis where the failure of one bank entails serious contagion effects on others.

As the crisis escalated and spread throughout the European financial institutions, some Member States expressed their concern with the rigidity of the State aid framework and claimed that a suspension of the framework could be desirable. However, the European Council put aside that option and reaffirmed the importance of the implementation and enforcement of the State aid rules[63]. In the face of this situation, the Commission had to undertake the challenging task of finding a framework capable of solving banks' liquidity problems in the short run while also guaranteeing a consistent change in their business model that would strengthen banks' capacity to respond to similar

61 Commission, 2004: para 8.

62 Notably the rescue of two banks: Northern Rock and IKB.

63 Press release from the European Council – Brussels of 15 and 16 October 2008 Presidency Conclusions on the Economic and Financial Situation.

economic shocks in the future[64]. The focus was put on three different State measures: State guarantees on bank liabilities; impaired assets measures; and governmental recapitalization of troubled banks.

Then, at the end of 2008, the Commission published its first two documents destined to respond to the crisis: the Banking Communication[65] and the Recapitalization Communication[66]. The adoption of these two Communications represented a change of approach from the Commission by acknowledging the gravity of the financial situation in Europe and its likely impact and disturbance on the economy in the whole Union, which meant the use of a different legal basis, Article 107(3)(b). This provision had been rarely invoked in the past because the Commission considered it was only applicable to situations where 'fundamentally sound' institutions were in difficulty due to a serious economic disturbance affecting the whole economy of a Member State and strictly subject to commitments to be undertaken by the undertakings concerned in order to ensure long-term viability or a sound liquidation[67].

Both Guidelines started out by stressing the difference between 'fundamentally sound' financial institutions, which were facing liquidity problems caused by a dried up interbank lending market, and those that had endogenous problems associated with their business models and practices. The relevance of this distinction was related to the greater need of the latter in implementing restructuring plans, while, on the other hand, the former could be exempted from adopting those plans[68]. In addition, the Banking Communication emphasized the particularity of the crisis at hand and the importance of upholding State aid rules, whereas the Recapitalization Communication centered its focus on the rules to be applied in case of State injection of capital into banks. Once more the Communication affirmed that the general principles of the R&R Guidelines should be followed and that distortions of competition should be kept to a minimum by finding appropriate compensatory measures[69].

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64 Mamdani, 2012: 242.

65 Commission, 2008a.

66 Commission, 2009a.

67 Décision de la Commission 88/167/CEE concernant la loi 1386/1983 par laquelle le gouvernement grec accorde une aide à l'industrie grecque, JO 1988, L76.

68 Commission, 2008a: para 30-35.

69 Bacon, 2013: 401.

The next step taken by the Communication was to issue the Impaired Assets Communication in February 2009[70], intended to respond to the problems raised by the dimension and location of toxic and impaired assets by conceding asset relief to the banks in order to restore confidence and stability in the markets. At this point, the Commission was abandoning the abovementioned distinction between banks because the markets were stabilizing and troubled institutions had already submitted their restructuring plans, which meant a return to the standard R&R Guidelines. By July 2009, the Commission adopted the Restructuring Communication[71] with the intention of hardening State aid rules in this respect. The Guidelines pointed out the importance of following the R&R Guidelines methodology. Furthermore, they imposed three conditions that State measures to recapitalize banks had to respect: a detailed analysis of the bank's situation in order to reach a plan capable of returning it to viability; the requirement for burden sharing between the Member State and the troubled bank, although the 50% own contribution expressed in the R&R Guidelines was adapted to avoid a fixed contribution; and the imposition of compensatory measures to limit the distortions of competition to a minimum[72].

The Crisis Framework was foreseen as merely temporary and expected to last while there was a 'serious disturbance in the economy', despite the fact that only the Restructuring Communication had an expiry date. However, the European economy did not recover in the expected time nor did the financial markets stabilize to the extent needed. Consequently, the Commission decided to prolong the Restructuring Communication, and all the others: first, at the end of 2010 and until 2011 (First Prolongation Communication[73]); then in 2011 for an indefinite period of time due to the lasting effects of the disturbance in the economy (Second Prolongation Communication[74]); and lastly, in July 2013 the Commission decided to adopt a new approach in respect of bank restructuring by replacing the first Banking Communication with a new one[75].

70 Commission, 2009b.

71 Commission, 2009c.

72 Mamdani, 2012.

73 Commission, 2011a.

74 Commission, 2011b.

75 Commission, 2013.

The reasoning behind the change of approach was primarily related to the high fiscal costs involved in bailing out financial institutions, which made the financial crisis evolve into a sovereign debt crisis. In fact, the new Communication highlighted the need for greater burden-sharing by requiring a more demanding participation of banks' shareholders and creditors when rescuing and restructuring them. It is also of concern that banks located in Member States with superior fiscal flexibility are not treated more favorably than those located in Member State where the crisis continues sparking[76]. In order to meet an enhanced burden sharing and to create a level playing field for all stakeholders across Europe, the Commission implemented new requirements to be met prior to the aid's approval: where a bank faces a capital shortfall it must carry out all measures to raise capital in order to minimize the amount to be granted by the public authorities; where it does not raise sufficient capital, the Member State granting the aid must ensure the participation of shareholders and subordinated creditors in 'bailing in' the bank (depositors are excluded); where the bank understands that State rescue measures will be necessary, it must avoid outflows of capital and junior debt so it does not undermine the process envisaged by requiring it to undertake all measures to raise private capital[77]. The Communication also introduces a preference for delaying the actual State intervention in the financial institution so it becomes possible to follow the appropriate steps of bailing-in, rather than bailing-out, the banks. The intention is to take all possible measures to raise private capital to limit the amount of aid to be granted to the minimum necessary[78].

It remains to be said that the assessment of the compatibility of rescue aid is inherently interconnected to its potential effect in distorting competition. Although the main rationale for granting such State aid was/is to stabilize the financial system, it also has a high potential to distort competition in the Internal Market. Firstly, there are great concerns in respect of moral hazard: a financial institution may not repeal its risky business practices because it anticipates that if it encounters difficulties in the future, State aid will be available; thus, that institution may continue to engage in actions of high risk, of which considerable profits may arise, even though it is aware that those are not a safe strategy. Secondly, a recipient of aid may be positioned to increase or sustain

76 Lienemeyer, Clemens & Malikova, 2014: 278.

77 Ibid: para 280-282.

78 Commission, 2013: para 29.

its market power by engaging in aggressive market practices. However, it is necessary to point out that a firm which is in need of State aid may not be in a condition to pursue expansionist strategies since the firm itself is facing economic and financial constraints. Moreover, there is the potential that State aid to firms will shut down the incentives its non-aided competitors would have to compete, consequently leading to a reduction in investment and innovation[79]. The last detrimental possible outcome of State aid in relation to competition lies with the possibility of maintaining inefficient players in the market, which may prevent more efficient competitors from achieving economic success and growth[80].

Therefore, the assessment of the compatibility of crisis aid is to be made under a balancing test, which will be conducted through an effects-based approach and a cost-benefit analysis. As has already been mentioned, the Commission highlights, in its documents, the importance of State measures respecting both general State aid rules and the specific pre-conditions related to the banking sector in order to reach the least distortive aid; and it also requires, in the most serious scenarios[81], the adoption of a restructuring plan, which will lead the financial institutions back to economic viability, or of a liquidation plan capable of ensuring a sound liquidation with minimal spill--over effects to other institutions. All in all, the effects-based approach explains that the State measure must be in accordance with a triple conditionality: it must respond to a market failure or pursue an objective of common interest; the measure has to address the market failure/common objective (it also has to be appropriate, to trigger a change of behavior in the recipient and to be kept to the minimum necessary); and the positive effects of the measure must outweigh its impact on competition and on trade.

Furthermore, the compatibility assessment would generally be based on a counterfactual analysis. Yet, in respect of State measures pursuant Article 107(3)(b), the counterfactual analysis would point to the situation where the State does not grant aid to the bank, which would likely lead to severe instability

79 Decision 2012/660/EU *BPN* [2012] L301/1, para 265.

80 Szyszczak, 2011: 134-135 & Bacon, 2013: 423.

81 The requirement to adopt a restructuring plan may occur with regard to both structural and non-structural aid. In principle, funding guarantees and liquidity measures are deemed to be non-structural since they are only designed to improve the recipient's access to funding on a temporary basis whereas recapitalizations and asset relief measures are considered to be structural because they are designed to address deficiencies in the recipient's balance sheet.

in the financial sector. An elucidation to this problem could lay in using the counterfactual to find the most efficient, or least distortive, solution[82]. In any case, the Commission has referred to several remedies to limit distortions of competition including: tailor-made compensatory measures; divestment of assets or activities; balance sheet reductions; acquisition bans; behavioral commitments; and market opening measures.

4. STATE AID AND OTHER POLICY RESPONSES IN TIMES OF CRISIS: APPROPRIATE RESPONSES TO A SYSTEMIC CHALLENGE

In respect of what was exposed above, it is now appropriate to discuss whether the underlying principles of State aid policy have changed or not, and to measure the Commission's success on handling the crisis and upholding its rationale for State aid control. In addition, I will address the impact of the economic and financial crisis in the European Union, which also required a transversal regulatory and legislative response capable of preventing and mitigating the market failures which led to the crisis.

There is no doubt that, in the absence of other EU level coordination mechanisms, State aid control was the most appropriate instrument to ensure the rescue and restructuring of the financial system. Yet, if on the one hand, a flexible State aid regime is necessary to secure a suitable response to future crises, it is essential to address the specific market failures of the 2008 crisis in order to ascertain other policy responses capable of minimizing the systemic risk associated with the financial system on the other hand.

4.1. Market failures of the crisis and regulatory failures in their origin

According to the Commission's views on State aid control, the main justification for State intervention in the economy is the existence of a market failure that needs to be remedied[83]. It was with this in mind that State measures to support and rescue financial firms during the crisis were considered compatible with the Internal Market. Although the special character of the financial system has already been identified in this Article, it remains necessary to consider which market failures caused markets to collapse, which political choices potentially caused those market failures and which were the core elements of

82 Szyszczak, 2011: 146-147.

83 Commission, 2005: para 23: '*One key element* [in assessing compatibility] *is the analysis of market failures.*'

the crisis that led the Commission to build up the Crisis Framework under the umbrella of Article 107(3)(b).

Firstly, there were two different types of market failures at the heart of the financial crisis: on the one hand, there were those business practices and market conditions capable of causing the collapse of the financial system; on the other, there was the associated negative externality of the failure of one bank on other financial institutions.

In respect of the first type of market failure, one must point out the high incentives that financial institutions had for engaging in risk-taking practices. In theory, the market mechanism would be capable of correctly valuing the risks taken by financial firms. However, innovation in financial products, backed up by low capital requirements, and the opacity and lack of transparency of the institutions made it possible to operate 'under the radar' of financial regulation[84]. In addition to mispricing of risk, risk-taking practices englobed asset price bubbles, disproportionate leverage, and business models based on short-term transactions[85]. It is precisely this last feature that might have undermined the stability of the whole financial system since financial firms held, in their balance sheets, assets of long duration or low liquidity while their liabilities were short-term[86], which caused runs in the system that had to be backed by lenders of last resort.

The interconnectivity of banks explains why the failure of one institution may impose unexpected difficulties on others: the failure of one bank and its associated costs are not internalized in an absolute manner due to cross balance sheets and can, therefore, spread out to 'fundamentally sound' institutions which did not handle malicious assets[87]. This negative externality is aggravated by the situation where banks can no longer sell their assets in the market because market operators stop being able to distinguish between toxic and valuable assets (creating impaired assets). On top of everything, the eruption of the financial crisis caused an extraordinary confidence crisis in the financial system which dried up the wholesale funding market. Consequently, this caused

84 Acharya & others, 2011: 11-12.

85 Derenne, Merola & Rivas, 2014: 852.

86 Acharya & others, 2011: 20.

87 Ibid: 15.

tremendous liquidity constraints and a generalized panic on depositors afraid that banks could not meet their obligations (bank runs)[88].

At this stage it remains crucial to specify the market failure on which the Commission based its Crisis Framework and its respective legal basis. Article 107 grants the Commission a sufficient margin of maneuver to adjust its State aid rules in times of crisis by allowing it to have the ultimate word on the compatibility of a State measure with the Internal Market. Attending to the fact that the R&R Guidelines did not mention the specificity of the financial sector and to the circumstance that aid granted under the Guidelines was thought to avoid 'serious social difficulties', the Commission found itself in the position of having to adapt its framework[89]. Additionally, there was a lot of pressure from Member States to change the legal basis from Article 107(3)(c) to Article 107(3)(b), although both the Commission and the CJEU have held that this legal basis has to be interpreted narrowly[90]. The reason why there was finally a change of legal basis seems to be related to the systemic character of the crisis and to the contagion risks that 'even fundamentally sound financial institutions' faced, with the threat of these being driven out of the market. The Commission considered this to be an 'international market failure' with repercussions on the real economy and, therefore, a significant disturbance on the economy of the whole European Union[91].

Some authors have argued that the financial crisis was triggered by regulatory and supervisory failures rather than market failures[92]. Although it is undisputable that there were regulatory and supervisory failures and that those are among the causes which triggered the crisis, it also appears clear that these regulatory and supervisory failures are at the origin of the market failures which justified State intervention in the economy.

The understanding of the regulatory and supervisory conditions which led to a failing market provide valuable insights not only into the development of State aid control but also into the course of action undertaken by the European

88 Gerard, 2014: 1-3.

89 Gebski, 2009: 97-100.

90 T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, para 167.

91 Case N 507/2008, para 44 and 47 and Case NN51/2008, para. 40.

92 Böheim, 2011: 323.

Union with the creation of a Banking Union intended to strengthen financial stability and avoid the fragmentation of the Internal Market[93].

In the 1970s the United States initiated a process of deregulation in the financial system that was later followed in the European Union. In the United States, one of the most notorious changes was the introduction of capital requirements as the sole backup for risk shifting, which incited banks to engage in excessively risky practices by mispricing their guarantees with the expectation of reaching high profits. However, the relevant regulatory failure was that prudential banking regulation focused merely on the individual risk of financial firms rather than on the risk of the whole financial sector, therefore, neglecting the systemic risk of the financial system[94].

In Europe, the situation was somehow similar due to the absence of a macroprudential supervisor to target systemic risk[95]. In addition, the failure at the level of capital requirements was similar since there was only pro-cyclical regulation, which meant that banks could expand and contract their balance sheets depending on whether the economy was growing or in recession[96]. Yet, another problem affecting both Europe and the US was the increased interdependence and integration between banks while the regulatory frameworks remained at the national level, which created tremendous problems of cross--border coordination between home and host country supervisors. Concerns related with the lack of coordination between supervisory structures were not novel; and despite the recommendations presented by the Basel Committee, the national and European authorities only took action after the crisis started[97].

4.2. Implications of the Crisis Framework on EU State aid

The offset of the financial crisis required rapid and energetic action by the European Commission to allow Member States to support and rescue their banks in order to stabilize the financial markets. Nevertheless, such action required adapting the EU State Aid framework and its substantive and procedural principles.

93 Commission, 2012b.

94 Acharya & others, 2011: 13-15.

95 The situation is nowadays different with the creation of the EU Banking Union and the introduction of a Single Supervisory Mechanism of which the ECB is in charge.

96 Commission, 2014: para 30.

97 Norgren, 2010.

One of the most interesting issues in this regard resides in which role is left for the market economy principle to play in a situation of crisis. As it has already been mentioned, this is a key principle in distinguishing between State measures which will grant an economic advantage to an undertaking and those where the State acts under normal market conditions, *i.e.* within the rationale of the market[98]. However, during the financial crisis there was no market available for some bank products and services because no private investor would dare to intervene. The Commission has stated that, under this test, it must be assumed that a private investor will act based on the actual circumstances of the market at the time of the transactions and not those preceding it[99]. This means that if no private investor takes action, any investing action engaged in by the State will constitute an economic advantage. Conversely, where the State is solely acting as the seller, for example of a financial institution that has been rescued through a transparent and public tender procedure, it is considered that the State is not granting an advantage to the buyer. It is considered so even where the State sells the assets at distressed prices, because the actual investment made by the private party means that there is a market for that product[100].

Another legal challenge raised by the crisis points to the definition of 'firm in difficulty'. By choosing the R&R Guidelines as its legal technique, the Commission faced the problem of the inappropriateness of the legal definition of this concept, particularly because the crisis also affected 'fundamentally sound institutions' which did not meet the substantive elements presented by the Guidelines[101]. In this context the Commission adopted a new set of Guidelines[102] where it 'filtered' the legal definition by introducing new objective criteria, such as the sustainability of a firm's debt and how its level of profit generation is in relation to its expenses. Most remarkably, the Commission also accepted that sound and stable firms may also face liquidity problems during exceptional crisis periods.

98 Cecco, 2013: 59.

99 Commission Decision of 5 April 2011 on the measures C 11/09 (ex NN 53b/08, NN 2/10 and N 19/10) implemented by the Dutch State for ABN AMRO Group NV) (notified under document C(2011) 2114).

100 Derenne, Merola & Rivas: 666-669.

101 Müller-Graff & Selvig, 2012: 78.

102 Commission, 2014c.

However, it is important to note that the Commission upheld most of the substantive principles constituting the EU State aid framework. The need for a rapid response and the change of legal basis naturally required a more flexible approach to be applied to the types of aid, namely in respect of duration and repetition[103]. It was precisely with regard to the urgency of responding to the crisis that the Commission introduced exceptional procedural rules. Since the primary objective was to stabilize and calm the financial markets down, the Commission introduced a new framework where Member States could directly support and rescue their banks during a period of six months through a provisional authorization. If after that period the Member States wished to extend the rescue measures, the Commission would proceed to an assessment of the implementation of the measures and of whether a restructuring plan would be needed. This procedural efficiency, where the Commission adopted decisions within days, contrasts with what used to be common practice in the Commission and has led it to adopt a simplified procedure for the authorization of aid[104]. If during the initial stage of the crisis the Commission clearly adopted a principle of 'clear first, ask questions later', it was obvious that it was necessary to make the procedure tighter after the stabilization of the markets. Nevertheless, in one of its most recent documents, the State Aid Modernization, the Commission reaffirmed the idea of accelerating its procedure by implementing a principle of 'trust and verify'[105], moving its focus to an *ex post* assessment rather than *ex ante*[106].

Finally, with regard to the assessment of the compatibility of a certain State measure with the Internal Market, the Commission uphled most of its criteria in the new Guidelines for supporting firms in difficulty[107]. Firstly, the State measure continues to have to address a market failure or an objective of common interest. Secondly, the measure must be appropriate to its objective and has to entail an incentive effect. Subsequently, the Commission continues to apply the principle of proportionality and the overall assessment whereby the positive effects of the measure must outweigh the impact on competition

103 Gerard, 2014: 7.

104 Ibid: 20.

105 Commission, 2012: para 19-23.

106 Sanchez-Graells, 2015: 3-6.

107 Commission, 2014d: para 38.

and trade between Member States. The last criterion introduces a requirement of transparency where the Member States shall make public and accessible all the documentation related to the State measure.

4.3. Suitability of State aid in managing crises: post-crisis regime

The financial and economic crisis represented the most challenging of times for EU State aid control. The legal regime put in practice before the crisis was clearly not suited to address all legal, economic and political issues raised by the failure of the financial market. Thus, the Commission was in a position of great distress due to the necessity of developing and adopting *ad hoc* documents capable of adapting the framework. Some of the most critical changes in the legal framework have already been tackled in the previous section, however, it remains relevant to question whether the current legal choices are suitable to address a systemic crisis and to assess the pivotal role that both State aid and the Commission play in managing a crisis.

As noted, the Commission decided to adopt its Crisis Communications and to declare the compatibility of State measures addressed to financial institutions with the Internal Market on the basis of the rarely invoked Article 107(3)(b). At first, this provision was only applicable to a disturbance in the economy also affecting 'fundamentally sound institutions'. In the case involving *Credit Lyonnais*[108], the Commission addressed the applicability of this provision to financial institutions by pointing out that State measures can only be declared compatible with the Internal Market where they ought to solve a problem transversal to more than one operator in the financial sector.

However, the recent crisis was an exceptional situation due to the systemic failure of the market and the loss of confidence in banks. Member States had to react to restore confidence and liquidity in the market, which, in this situation, corresponded to nearly the entire European Union. One of the core issues raised by the application of this provision is related to moral hazard[109]. In fact, if the financial institutions can rely on the State as a lender of last resort, they will have a weaker incentive to adopt less risky business practices. Aligned with the systemic nature of the financial system, moral hazard represents one of the primary concerns of the suitability of Article 107(3)(b) to address financial

108 Commission Decision 95/547/EC of 26.07.1995 giving conditional approval to the aid granted by France to the bank Credit Lyonnais, OJ 1995, L308 (*Credit Lyonnais I*).

109 Gebski, 2009: 99-100.

crises. Even though the Commission showed concern with this incongruence by emphasizing the need for compensatory measures to limit distortions on competition and by waiving liquidation plans as a concrete option, it is doubtful that these solutions are capable of addressing moral hazard[110].

One of the most prominent arguments in favor of this claim lies with the fact that financial institutions were not deterred by the risk of high losses as a consequence of their behavior. Therefore, it seems unlikely that compensatory measures and the risk of liquidation will be more efficient tools where the banks can rely on the State as a lender of last resort[111]. In respect of State aid control, a possible solution would encompass a stronger conditionality in the access to national measures with the imposition of heavy commitments, divestment of assets and behavioral measures (for example, commercial practices, changes in management or remuneration limitations). The main objective of State support must be the return to viability or a sound liquidation. However, the legal regime must be as imposing as economically possible in order to constraint banks in accessing State funds and to minimize distortions of competition.

Although enhanced burden-sharing, as defined in the 2013 Banking Communication[112], may not be sufficient to fully address moral hazard concerns, it is a notorious first step. The requirement imposed on banks to exhaust all private funding possibilities (shareholders and junior creditors must convert their claims on the bank into equity[113]) before State aid is granted means that a bank facing a credit shortfall will be bailed in instead of bailed out by the State. This requirement shifts the focus from the State to the financial system itself with the clear advantage of reducing costs on taxpayers.

In addition, the exceptional character of Article 107(3)(b) ought to be reaffirmed with the definition of a stricter compatibility assessment and its scope should be narrowed. A systemic crisis might be the result of different market failures, which should be directly addressed. The Commission must give effect to Article 107(3)(b) on a case-by-case basis, because the rules must be adapted to changing market conditions and return to a strict interpretation in order to avoid a reliance on this provision by the banks.

110 Szyszczak, 20: 147.

111 Ibid: 148-149.

112 Commission, 2013: para 15.

113 Micossi, Bruzzone & Cassella, 2014: 3.

Moreover, the compatibility assessment must be developed in accordance with legal, economic and political principles as identified in this section and in the State Aid Modernization Communication. The focus must be directed towards a more economic and effects-based approach reflecting market characteristics. The compatibility assessment must require a clear identification of the market failure or common objective to be addressed. The measure has to be necessary, proportionate and appropriate to minimize distortions on competition and the Commission must require a restructuring or liquidation plan. The rationale behind State aid control must not be to bail-out banks and their shareholders to the detriment of taxpayers. Instead, it must contribute to preserving stability in a financial system where banks play their intermediary economic role. Article 107(3)(b) allowed Member States to respond to the macroeconomic disturbances in the economy and to avoid the grave social which follow market failures. However, its suitability to allow for a 'more economic approach' in respect of State aid remains unclear. In the EU State Aid Modernization Communication the Commission highlighted the requisite for a 'clearer definition of market failures'[114] because State aid will only be beneficial to the economy when one is targeted and when there is an incentive effect. The Commission maintains that this policy action will always be a second optimal solution. Yet, neither the EU Crisis Framework nor the Commission's decisions approving State aid always respected the principle of addressing a market failure through the least distortive means. Nor were the measures in question the most adequate solutions at all times. Furthermore, the relaxation of procedural and other substantive rules undertaken by the Commission proved the inadequacy of EU State aid control to respond to systemic challenges, particularly in respect of finding a correct balance between flexibility and enforcement. Nonetheless, more flexible procedural rules are welcome, and allowed the Commission to better manage changing market conditions.

But if the legal regime may be inadequate in the terms *supra* mentioned on the one hand, it has proven effective, up to a certain extent, on the other. Most State measures approved by the Commission can be considered to have not had automatic distortive effects on competition because some of the market failures addressed were common to all financial institutions and the remedies

114 Commission, 2012a: para 18.

were available to most institutions[115]. In this sequence, one positive aspect of State intervention in the economy is correlated with the ability to exercise a superior scrutiny of the banks' business models and practices and the possibility to 'force' a change of behavior when this change is not achieved earlier.

In order to tackle future crises the EU State aid framework cannot be seen as the only appropriate tool for achieveing coordination and stabilization of financial markets. It is undeniable that State aid minimized the problem of the lack of instruments at the EU level (for instance the inexistence of a EU treasury) and enabled the Commission to assume a decisive role in the management of the crisis[116]. However, the attainment of regulatory objectives and the avoidance of further systemic crises of this magnitude must be achieved through the introduction of other EU legal mechanisms and of enhanced supervision[117]. The interconnectivity of the financial system, which in itself justified the adoption of measures pursuant Article 107(3)(b), must be taken into account in order to create a level playing field for all institutions across the European Union.

In the face of these considerations, the best path to address the limitations of State aid control in preventing crises is through a regulatory reform capable of complementing the role played by State aid control. It is pertinent to note that the connection between bank and sovereign debt, for instance where public debt is owned by banks, justifies the existence of implicit and explicit State (and European) guarantees and of the facility of liquidity by the ECB and other Central Banks. The escalation of the financial crisis into a sovereign debt crisis highlighted the requirement of developing a regulatory and supervisory reform.

4.4. Other policy responses for crises prevention

The considerations already drawn in respect of the regulatory and supervisory failures which led to the crisis show that the most appropriate means to prevent future crises lie with legislative reforms at this level. Notwithstanding these remarks falling outside the scope of this Article, the undermined role that State aid control can play as an instrument to prevent crises requires a brief

115 Derenne, Merola & Rivas, 2014: 860-863.

116 Gerard, 2014: 13-14.

117 These concerns have been partly addressed with the adoption, for example, of the Banking Union and the new role to be played by the European Central Bank supervising financial institutions.

orientation of the necessary policy responses. In fact, the European Institutions have already addressed most of the regulatory failures *supra* mentioned with the introduction of the EU Financial Regulation Agenda[118], aimed at achieving a stable financial system capable of performing its decisive role in the economy and of contributing to sustainable economic growth.

The overall objective of the EU is the achievement of a fully functioning Banking Union (BU)[119] designed to complete the Economic Monetary Union and capable of performing enhanced supervision, of securing a sound resolution of banks and of breaking the vicious circle between banks' and sovereigns' debt[120]. As is demonstrated by the wording used by the Commission, these legislative documents are a clear response to the financial crisis in a demonstration that the Commission 'has worked hard to learn all the lessons from the crisis and to create a safer and sounder financial sector'[121]. The BU applies to Eurozone Members (non-Members may also join) and aims at solving the problems which led to the Financial and Economic Crisis and consequent escalation to the Eurozone sovereign debt crisis[122]; introduces new regulatory prudential rules, periodic reviews of banks' balance sheets and new monitoring of restructuring, return to viability and liquidation of banks.

The BU is founded on the Single Rulebook[123], which encompasses a set of legislative measures intended to address the regulatory failures at the heart of the crisis and with which all banks in the Union must comply. Two further complementary mechanisms were established: the Single Supervision

118 Commission, 2014c: 49.

119 Commission, 2012b: para 3.

120 Merler, 2014: 3.

121 Commission, 2014b: para 2.

122 In respect of the Eurozone crisis see: Pagano, 2014.

123 Regulation (EU) No 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 *OJ L 176, 27.6.2013, p. 1–337* (CRR); 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC *OJ L 176, 27.6.2013, p. 338–436* (CRD IV); and Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council *OJ L 173, 12.6.2014, p. 190–348* (BRRD).

Mechanism (SSM)[124] and the Single Resolution Mechanism (SRM)[125]. The former institutes the European Central Bank (ECB) as the prudential regulator for all banks in the Eurozone (and those of the Members which join the BU). The latter addresses the failure of financial institutions by introducing a Single Resolution Board and a Single Resolution Fund.

One of the core changes introduced by the Single Rulebook is the stronger prudential requirements required by the Capital Requirements Regulation and Directive[126]. In detail, these documents address the inadequate levels of capital and liquidity, which led to State intervention in the economy, by requiring higher capital buffers, counterparty risk and liquidity. Likewise, concerns at the management level were also addressed with new governance reforms and administrative sanctions for individuals and undertakings. All in all, enhanced prudential supervision, as contemplated in the Capital Requirements Regulation and Directive, aims at restoring market confidence in banks, preventing bank runs through higher capital requirements, reducing risk management practices and at strengthening financial stability in the EU.

Another important pillar of these initiatives is the crucial supervisory role the ECB will assume. As the Commission pointed out, strong supervision is crucial to avoid undermining all regulatory efforts undertaken[127]. The EU intends to reach better coordination between National Competent Authorities and the four European Supervisory Authorities (ECB, the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority in order to minimize risk practices and spillover and cross-border effects.

124 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions *OJ L 287, 29.10.2013, p. 63–89*.

125 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 *OJ L 225, 30.7.2014, p. 1–90*.

126 Regulation (EU) No 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 *OJ L 176, 27.6.2013, p. 1–337* and 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC *OJ L 176, 27.6.2013, p. 338–436*.

127 Commission, 2014a.

Finally, the EU adopted the Bank Recovery and Resolution Directive[128] establishing greater requirements which go beyond those imposed by State aid control, with particular regard to burden sharing (an additional requirement of senior debt, and not only of equity and junior debt, establishing the level of liabilities to be bailed-in). A complementary mechanism to this Directive is the SRM. Both address the resolution of banks in an orderly manner which does not undermine the stability of the financial system and introduces the idea that financial institutions cannot be 'too systemic/big too fail'. The SRM is of great importance in addressing both moral hazard and taxpayers concerns since it imposes stricter conditions on banks to access State funds. Finally, it is partly based on direct contributions from financial institutions, thereby relieving the costs on taxpayers, imposing the losses on banks' shareholders and achieving greater legal certainty in the financial system[129].

5. CONCLUSION

The exercise of State aid control by the Commission creates governmental constraints on Member States as to which economic and social objectives they wish to pursue. It represents the political economy orientation of tracking a market economy in the European Union[130]. The Commission has made use of this option since the creation of the Union by defining State aid as a fundamental policy to 'ensure a well-functioning Internal Market'[131], where undertakings shall not be protected by their host States nor rely on State resources to achieve economic efficiency. Although there are exceptional situations where State aid may be declared compatible with the Internal Market and among those public measures to address market failures are of primary importance, State aid will always remain a second optimal solution because it creates artificial market conditions. It is far more efficient to directly address a market failure and therefore avoiding the creation of undesired artificiality in the markets.

128 Directive of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council PE-CONS, 24 April 2014.

129 Tornese, 2014.

130 Cecco, 2013: 12.

131 One example can be found in Commission, 2012: para 15.

In 2008, at the outset of the economic and financial crisis, the Member States found themselves with the responsibility to rescue financial institutions. Other measures were partly extended to the real economy to avoid a meltdown of the economy. The Commission needed to find an instrument capable of coordinating the State efforts undertaken during the crisis due to the absence of an EU Treasury[132].

The Commission considered itself successful in achieving a coordinated rescue of the financial system and in restoring liquidity to the markets[133]. Although this is true in principle, there are important consequences for EU State aid control. The crisis has shown that in extreme times, there may be social and political objectives that outweigh a strict enforcement of Competition law because the social costs of a collapse of the financial system are considerably severe[134]. The introduction of more flexible rules in respect of State aid demonstrated the incapability of the regime to respond to a systemic crisis on its own and the return to the framework prior to the crisis has been more consistent with regard to the real economy than to the financial system.

Thus, the financial and economic crisis, predominantly because of its systemic nature, has necessarily changed the paradigm surrounding State aid control and its underlying principles and rationale. Substantive and procedural rules have already changed; yet, issues such as moral hazard, the burden imposed on taxpayers and the need for a more economic approach in the compatibility assessment still need to be restructured.

The market failures addressed by State aid were not necessarily identified in a clear manner, nor did a diverse number of measures pursue specific loopholes in the market. Likewise, the origin of those market failures was directly related to transversal regulatory failures at the global level.

In addition, the development of the crisis into a sovereign debt crisis exposed the disparities between the fiscal sustainability of Member States[135]. State aid was undeniably a part of the solution to address the crisis. However, the lack of other, or complementary, EU instruments exacerbated the impact of the crisis on specific economies of the Union. In this regard, several legislative measures have already been undertaken the adoption of the Banking Union

132 Quaglia, Eastwood & Holmes, 2009.

133 Commission, 2009f.

134 Voszka, 2012: 85.

135 Ibid: 82.

and with the implementation of the SSM, the SRM and the European System of Financial Supervision[136].

All in all, the changes undertaken in EU State aid control in response to the financial and economic crisis must be taken further and aligned with enhanced supervision of financial operators. The ramifications of the crisis have not yet been fully dealt with and the way forward must address the systemic risk of the financial system in order to avoid drastic social costs to total welfare.

136 Pagano, 2014: 11-14.

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