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## Audit preview

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# Control of State aid to banks

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State aid to businesses, including banks, is generally prohibited under EU law as it distorts competition. In order to ensure that state aid does not compromise the integrity of the EU's single market, it is subject to control by the European Commission. Given the large sums involved in state aid to banks and its potential to distort competition, the Commission's role in controlling it is of paramount importance.

In some circumstances, however, such government intervention may be necessary in order to make the economy work properly. The 2008 financial (or banking) crisis was considered one such instance. It saw an unprecedented increase in state aid to banks in the form of "bail-outs". These were deemed necessary in order to limit the threat to financial stability posed by failing banks, but also resulted in a significant burden on the taxpayer and thus contributed to the European debt crisis.

During the financial crisis, the financial services sector has received far more in state aid, in the form of bailouts, than any other sector of the economy. To this day, banks continue to be beneficiaries of large sums of state aid, even though the new recovery and resolution framework, as well as improved early intervention powers, are in place and the financial sector is gradually gaining strength.

The European Court of Auditors has recently launched a performance audit of the control of state aid to banks. The objective of this audit is to examine whether the Commission's procedures for controlling state aid to financial sector are effective and efficient. We will look at whether, in the post-crisis period, the Commission has managed to ensure that state aid rules are strictly and impartially adhered to, thereby keeping aid and resulting distortions of competition to the minimum necessary, and at the same time protecting taxpayers against the burden of bank rescues.

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## INTRODUCTION

State aid is any advantage selectively provided by a national government to a particular business, such as a bank. Because this goes against the principle of fair competition in the EU's internal market, EU law generally prohibits state aid.

Sometimes, however, markets fail and government intervention is necessary in order to make them work properly. State aid may be permitted under exceptional circumstances where, for example, it is necessary to remedy a serious disturbance in the economy of a Member State. However, state aid needs to be controlled, upholding the general prohibition while ensuring that exemptions are applied equally across the EU.

## STATE AID TO BANKS

### State aid during the financial crisis

During the financial crisis, the Commission, the EU's guardian of competition, *de facto* became a major player in financial stability. Taxpayer-funded bank bailouts were an important component in the EU's response to the financial crisis. Between 2008 and 2017<sup>1</sup>, the Commission approved aid to the financial sector for an overall amount of €1 459 billion (capital-like aid) plus €3 659 billion (liquidity aid). However, these bailouts contributed to ballooning government debt and to turning a banking crisis into the European debt crisis. The bailouts helped mitigate the impact on the real economy in the short run. However, they might have also increased banks' willingness to expose themselves to risk because it was not at their own cost ("moral hazard") and possibly delayed necessary restructuring.

### Developments since the financial crisis

Following the financial crisis, the EU went to considerable lengths, including regulatory reform, to prevent another financial crisis and to avoid future bailouts. A new recovery and resolution framework and improved early intervention powers have significantly improved the authorities' capacity for crisis management. The EU has since established the Banking Union, and a Bank Recovery and Resolution Directive (BRRD) came into force in 2016<sup>2</sup>.

The focus has shifted towards preventing taxpayer-funded bailouts in the future. "Bail-in instead of bailout" has become the new guiding principle. Under the BRRD, state aid should trigger resolution or insolvency procedures unless a measure is only precautionary and temporary.

In addition, the BRRD stipulates conditions for bank bailouts. First, they must not be granted to institutions that can no longer be relied on to fulfil their obligations towards their creditors (this is because, for example, they infringe or are likely to infringe prudential

capital, liquidity or governance requirements). Such banks must be declared failing or likely to fail by the supervisory or the resolution authority and wound down (or resolved if this is required in the public interest).

Under the BRRD regime, state aid measures must be precautionary and temporary, must not be used to offset incurred losses or losses likely in the near future, and can only be granted to solvent banks. For aid granted in the context of resolution, the Commission also needs to separately assess whether the aid complies with the minimum bail-in requirement of 8 % and whether a very extraordinary systemic crisis situation exists.

After 22 consecutive quarters of GDP growth, the economic climate has improved considerably since the crisis and, as a result, the authorities consider EU banks and the EU banking systems to be resilient. There is also increasing recognition that failing banks should be allowed to exit the market in an orderly manner.

Accordingly, cases where state aid is granted should have become an exception. However, this exception still seems to be the rule. Bank bailouts still keep the Commission busy, albeit to a lesser extent in recent years. Banks still receive state aid, including banks that have been bailed out before.

## EU STATE AID RULES FOR THE FINANCIAL SECTOR

The legal framework for the control of state aid to banks is broad. It consists of provisions from the EU Treaties, a series of Regulations<sup>3</sup> on their application, and non-binding guidelines set out in Communications from the European Commission and in the Commission's state aid manual<sup>4</sup>.

The legal foundations of EU policy on competition and state aid go back as far as the Treaty of Rome (1957), which contained provisions on anticompetitive agreements (Article 85) and abuse of dominant position (Article 86), and on state aid (Article 90).

Since 2009, Articles 101-109 of the Lisbon Treaty (the Treaty on the Functioning of the European Union or TFEU for short) have formed the legal basis of EU competition policy. In particular, Article 107(3)(b) permits state aid under exceptional circumstances if necessary in order to remedy a serious disturbance in a Member State's economy.

The EU treaties give the Commission broad discretion regarding the enforcement of EU state aid rules. For aid to the financial sector, it uses this discretion based on guidelines. An amended New Banking Communication adopted in 2013 has become the primary basis for the Commission's decisions. Previous Communications issued during the financial crisis still apply (see **Box 1**).

## Box 1 – Relevant Communications from the Commission

[Communication from the Commission](#) – The application of **State aid rules** to measures taken in relation to financial institutions in the context of the current global financial crisis, 13 October 2008 (see [IP/08/1495](#))

[Communication from the Commission](#) – The **recapitalisation of financial institutions** in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, 5 December 2008 (see [IP/08/1901](#))

[Communication from the Commission](#) on the Treatment of **Impaired Assets** in the Community Banking Sector, 25 February 2009 (see [IP/09/322](#))

[Communication from the Commission](#) – **Temporary framework** for state aid measures to **support access to finance in the current financial and economic crisis**, adopted on 17 December 2008 (see [IP/08/1993](#)), as amended on 25 February 2009

[Communication from the Commission](#) – The return to **viability** and the assessment of **restructuring** measures in the financial sector in the current crisis under the state aid rules, 23 July 2009 (see [IP/09/1180](#))

[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 (see [IP/10/1636](#))

[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 (see [IP/11/1488](#))

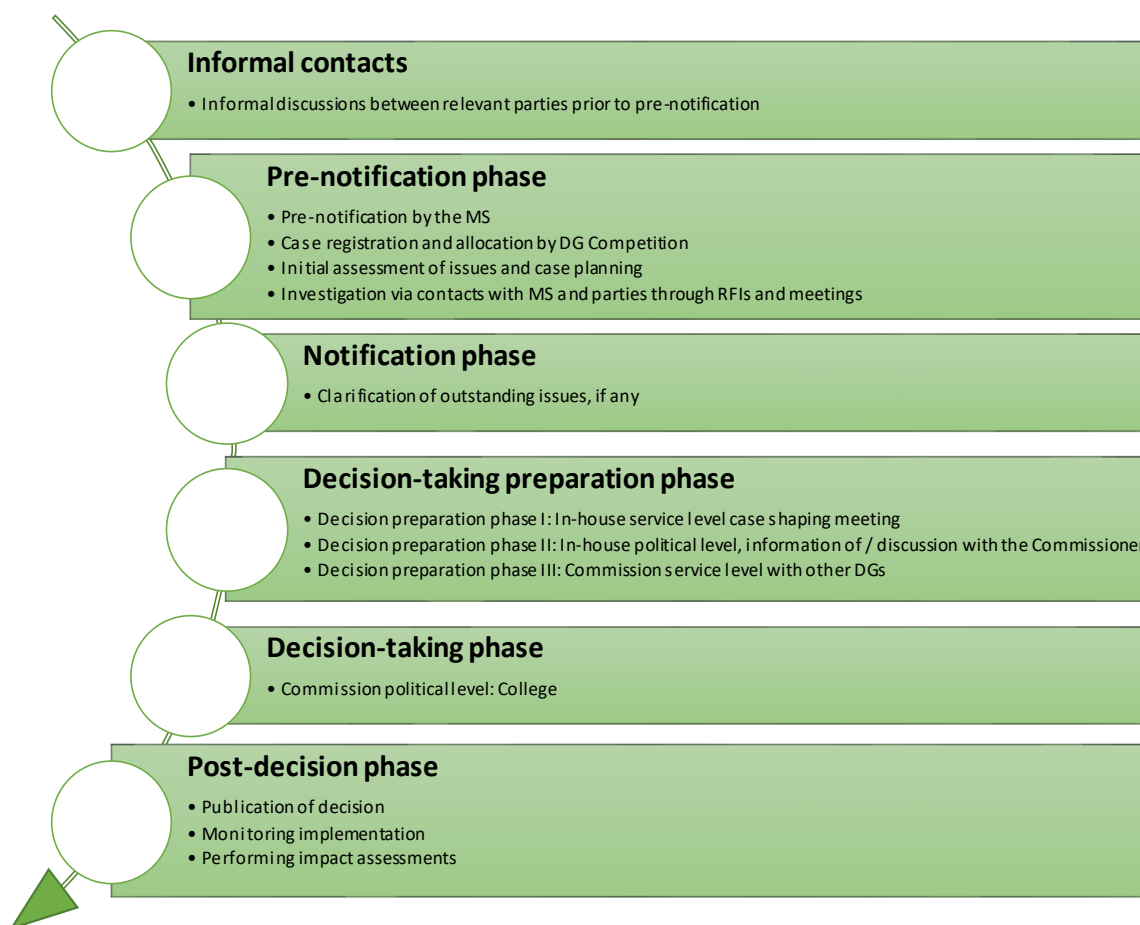
[Communication from the Commission](#) – on the application, from 1 August 2013, of **state aid rules** to support measures in favour of banks in the context of the financial crisis (see [IP/13/672](#))

## ROLES AND RESPONSIBILITIES

### The Commission

Responsibility for state aid control lies exclusively with the European Commission. Each case of state aid requires prior notification of all new aid measures to the Commission. As a general rule, Member States must wait for the Commission's decision before they can put the measure into effect. Each notification triggers a preliminary investigation by the Commission. There is no legal deadline to complete an in-depth investigation and its actual length depends on many factors, including the complexity of the case and the quality of the information provided. Upon completion of the investigation, the Commission adopts a final decision. The procedure is illustrated in [Box 2](#).

## Box 2 – State aid decisions: the procedure



Source: ECA

The Commission also has robust powers to investigate infringements, either on its own initiative or in response to complaints. The Commission's decisions and procedural conduct are subject to judicial review by the Court of Justice.

The Commission's aim in controlling state aid is to ensure that competition in the internal market is not obstructed by Member States through anticompetitive behaviour or distortive aid. State aid control should ensure that, where aid is granted, it enhances growth and does not restrict competition but addresses market failures to the benefit of society as a whole.

Decisions on state aid are taken by the Commissioners as a collective body ("the College"). The Directorate General for Competition (DG COMP) is responsible for enforcing EU state aid rules, including in respect of aid to banks. As of 1 July 2018, 28 of DG COMP's approximately 800 staff were working on state aid control in respect of banks. Policy work and coordination roles require additional resources. DG COMP's Chief Economist's office and staff also play a relevant role.

On matters specifically concerning state aid for banks, DG COMP closely cooperates with the Directorate General responsible for financial markets (DG FISMA), and the Legal Service.

Member States' representatives and the businesses (in this case banks) benefitting from the aid are involved in the proceedings. In cases involving state aid to banks, the Commission may well include other parties such as supervisory and resolution authorities.

## **MAIN ISSUES IDENTIFIED WHEN PREPARING THE AUDIT**

The purpose of the audit is to assess whether the Commission fulfils its obligations under the Treaties and ensures control of state aid to financial institutions. We will examine whether:

- the Commission has appropriate tools and resources to control state aid, including robust internal controls;
- current state aid rules and the Commission's procedures are fit for the purpose of identifying and controlling state aid to banks;
- the Commission's management of its case-handling and other activities is in line with internal rules and procedures, and whether it is effective in keeping distortions of competition to the minimum necessary;
- the Commission verifies that it is actually achieving the intended results.

Our audit will cover state aid control activities after the financial crisis, starting with the adoption of the new Banking Communication in 2013 and the Bank Recovery and Resolution Directive (BRRD) not long after. Since the Commission is both a maker and enforcer of state aid rules, we will consider both the design and the execution of the Commission's control of state aid to financial institutions, and look at the organisational setup and the relevant rules.

In the absence of widely accepted standards, where possible we will assess the Commission against its own criteria and objectives. We will also assess how the Commission enforces competition policy, for which it has exclusive responsibility in the EU's reformed legal and organisational framework for supervision, which includes the emergence of new players such as the EBA, the European Systemic Risk Board (ESRB), and the SSM and the SRB as part of the Banking Union.

As regards the design of the applicable state aid rules, we will assess whether the new Banking Communication reflects current market realities and is consistent with the new regulatory environment, and whether it was established and updated on the basis of (ex ante) evaluations and (ex post) impact assessments, in line with the Commission's requirements for better regulation.



Since the issues underlying these questions were identified before the audit work commences, they should not be regarded as audit observations, conclusions or recommendations.

State aid control has been the subject of previous ECA audits. We have already published two special reports on other aspects of EU competition policy, including state aid control: one in 2011<sup>5</sup> and one in 2016<sup>6</sup>.

## **ABOUT ECA SPECIAL REPORTS AND AUDIT PREVIEWS**

The ECA's special reports set out the results of its audits of EU policies and programmes or management topics related to specific budgetary areas.

Audit previews provide information in relation to an ongoing audit task. They are based on preparatory work undertaken before the start of the audit and are intended as a source of information for those interested in the policy and/or programme being audited.

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- <sup>1</sup> The most recent year for which figures are available.
- <sup>2</sup> 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.
- <sup>3</sup> Council Regulation (EC) 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 88 of the Treaty, OJ L 83, 27.3.1999, p. 1.
- Commission Regulation (EC) 794/2004 of 21 April 2004 implementing Council Regulation (EC) N° 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ L 140, 30.4.2004, p. 1.
- Commission Regulation (EC) No 271/2008 of 30 January 2008 amending Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ L 82, 25.3.2008, p. 1.
- Commission Regulation (EC) No 1147/2008 of 31 October 2008 amending Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, as regards Part III.10 of its Annex 1, OJ L 313, 22.11.2008, p. 1.
- <sup>4</sup> State Aid Manual of Procedures, Internal DG Competition working documents on procedures for the application of Articles 107 and 108 TFEU.
- <sup>5</sup> Special report 15/2011 “Do the Commission’s procedures ensure effective management of State aid control?”.
- <sup>6</sup> Special report 24/2016 “More efforts needed to raise awareness of and enforce compliance with State aid rules in cohesion policy”.

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