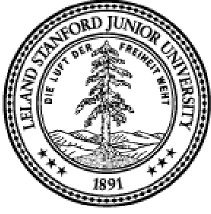

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A Vigilant Watchdog or a Paper Tiger?: An Analysis of the Application of EU State Aid Controls to Bank Bailouts During the Financial Crisis

Michael J. Austin

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edited by Siegfried Fina and Roland Vogl

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Abstract

This paper analyzes whether the European Union, in its review of its Member States' bailouts of financial institutions during the financial crisis of 2007-2009, violated its own prohibition on state aid. To do so, it provides a discussion of the definition and theory of state aid so as to provide a framework in which to interpret the bailouts. It then uses that theoretical framework to describe and analyze the five communications published by the European Commission that set out its guidelines and policies regarding its review of bailouts. After reviewing these general communications, this paper looks at how the European Commission reviewed a specific application for state aid on behalf of WestLB.

This paper concludes that the European Union appears to have strayed somewhat significantly from its original guidelines on the provision state aid. Specifically, it raises concerns about the European Commission's willingness to abandon the "one time, last time" principle in regards to state aid, as well as its continued extension of the time for state aid in the form of bailouts. However, the European Commission did continue to adhere to some its guiding principles, particularly in regards to requiring some beneficiary contribution and finding some way to limit the state aid being given. Additionally, this paper finds that the European Commission's adherence to those principles deteriorated as the financial crisis wore on. It is unclear based on this analysis, if the cause for this deviation was a result of structural weakness in the European Union or if this financial crisis was so catastrophic that it necessitated bending the rules.

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I. Introduction

Sparked by the sub-prime mortgage crisis in the United States, the global economy collapsed in on itself in 2008 and 2009, leading to trillions of dollars in losses and millions of jobs lost.[1] This collapse had devastating impacts across economic sectors and around the globe. In particular, the crisis hit the financial sector hard by drastically reducing the fair market value of the assets on many banks' balance sheets and by freezing inter-bank lending markets so that banks had significant difficulty in maintaining short-term liquidity.[2]

These effects were no less felt in Europe, where there became significant concerns about the stability and creditworthiness of financial institutions. After the failure of Lehman Brothers in September 2008, European banks quickly lost the confidence of investors and the public, such that within two days following the Lehman Brothers bankruptcy, five European banks had to be seized or bailed out by European Union ("EU") member states.[3] The EU felt that "these exceptional economic circumstances . . . necessitated exceptional measures."[4] By the end of the financial crisis, individual EU governments had committed more than three trillion euros in total to the financial system in the form of guarantees or cash injections.[5]

This collective response, regardless of its necessity or wisdom, runs into a legal challenge because the EU, in one of its foundational treaties, has put in place control mechanisms to limit Member States in granting financial aid to individual firms or sectors, a practice generally referred to as state aid. Member States are required to submit plans to provide state aid to the European Commissioner for Competition ("DG Competition") prior to issuing such aid and if the

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[1] DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS, EUROPEAN COMMISSION, ECONOMIC CRISIS IN EUROPE: CAUSES, CONSEQUENCES AND RESPONSES EUROPEAN COMMISSION REPORT 11 (2009).
[2] *See, e.g.*, *id.* at 8.
[3] Mark Landler, *At a Tipping Point*, N.Y. TIMES, Oct. 1, 2008, at C1.
[4] Resolution on the Report on Competition Policy 2008, EUR. PARL. DOC. A7-0025/2010 (2010)
[5] *Penance for Their Sins*, ECONOMIST, Oct. 10, 2009. I will focus on the financial crisis from 2007 to 2009 and not the sovereign debt crisis.

DG Competition finds the proposed aid incompatible with the internal market, it has the power to require the member state to "abolish or alter such aid."[6]

The Treaty on the Functioning of the European Union ("TFEU") does allow some exceptions to control of state aid, providing some blanket exceptions and some other categories of aid that the DG Competition has discretion in determining if it is compatible with the internal market.[7] Ultimately, the DG Competition decided that the bank bailouts were compatible with the internal market because they were intended to "remedy a serious disturbance in the economy of a Member State."[8] In order to streamline the review process, the DG Competition issued several communications indicating what would be required for the approval of a bank bailout either in the form of a loan guarantee, a recapitalization, or the purchase of impaired assets by a government.[9] Under those frameworks, the DG Competition has issued over 180 decisions.[10] As of May 12, 2011, the DG Competition has only outright rejected one of the requests and conditionally approved five of the requests; the rest have been approved unconditionally.[11]

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[6] Treaty of Lisbon amending the Treaty Establishing the European Community, art. 108(2), (3), Dec. 13 2007, 2008 O.J. (C 115) 41 [hereinafter "TFEU"]. As a result of the passage of the Treaty of Lisbon in 2008, all of the provisions of the TFEU, previously referred to as the Treaty establishing the European Communities, were renumbered. The state aid provisions remain substantively the same, so I will reference their numbers as reflected in the current TFEU throughout this paper.

[7] TFEU art. Art 107(2), (3).

[8] Commission Communication, The Application of State Aid rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C 270) 8, 9 [hereinafter October 2008 Communication]; TFEU art. 107(3)(b).

[9] October 2008 Communication, *supra* note 8; Commission Communication, The Recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition, 2009 O.J. (C 10) 2 [hereinafter January 2009 Communication]; Commission Communication, Treatment of Impaired Assets in the Community Banking Sector, 2009 O.J. (C 72) 1 [hereinafter March 2009 Communication]; Commission Communication, Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis Under State Aid Rules, 2009 O.J. (C1 195) 9 [hereinafter August 2009 Communication]; Commission Communication, Application, from 1 January 2011, of State Aid Rules to Support Measures in Favour of Banks in the Context of the Financial Crisis, 2010 O.J. (C 329) 7 [hereinafter December 2010 Communication].

[10] European Commission on Competition, Search for a State Aid Case (2011), http://ec.europa.eu/competition/elojade/isef/index.cfm?clear=1&policy_area_id=3. I arrived at the total by restricting the search to the secondary legal bases associated with the four communications regarding this crisis.

[11] *Id*. To determine the rejections and conditional decisions, I restricted the search of those decisions identified in note 10 to those Decision Types with a conditional decision or a negative decision of any kind.

This infrequent use of the DG Competition's power to abolish or alter any aid given by a Member State during this financial crisis appears incongruous with the over three trillion in euros distributed pursuant to approximately 180 decisions. This incongruity raises the question as to whether the DG Competition violated its own principles in approving aid, thereby weakening the power and authority of the EU in crisis situations or it simply showed a great deal of flexibility and creativity in dealing with a unprecedented crisis.

In addressing this question, I will first review the definition and theory of state aid and its control, with a focus on the exception for serious disturbances to provide a framework and some background for this discussion. I will then review the EU's doctrinal responses to the crisis, as set forth in the DG Competition's communications, and analyze them against the articulated principles of state aid control. I will close my analysis with a closer look at one of the recipients of significant state aid during the financial crisis, WestLB. Ultimately, I conclude that the EU, in promulgating its policy on state aid to the financial sector, appears to have stretched the doctrine of state aid control such that it is less meaningful than it was prior to the crisis, and an analysis of the WestLB decision reveals some of the practical problems associated with these new criteria.

II. Definitions and Theory of State Aid and Its Control

Before I delve into the actions of the EU regarding state aid and its control, it would be helpful to more fully define state aid and the relevant exception as well as the theory behind it. By doing so, it will clarify the boundaries of what constitutes state aid, and it will highlight the general principles that animate the EU's attempt to control the distribution of state aid. These concepts will then be helpful as a baseline in evaluating the EU's response to the financial crisis and the ensuing bank bailouts.

TFEU Article 107(1) defines state aid in very broad terms as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."[12] This definition essentially covers any aid given directly or indirectly by a member state to a particular firm or group of firms that gives the beneficiaries some type of advantage they would not otherwise have had.[13] European courts have taken this definition and used it to cover a broad array of aid given by Member States to individual firms or groups of firms ranging from loans and capital injections to purchases by the state at market conditions without a real need.[14] In determining the presence of state aid, courts focus on the effect of the state action rather than intent.[15] Though there are areas of uncertainty in regards to the definition of state aid, particularly around the extent to whose actions are imputable to the state and the definition of state resources, these questions are irrelevant to the financial crisis as most, if not all, of this aid was given in the form of instruments clearly defined as aid, either capital contributions or loan guarantees, and was given directly by the government.[16]

Prior to the financial crisis, the serious disturbance exception in TFEU Article 107(3)(b) has been much less defined than state aid generally. In fact, at the time of the crisis, the DG Competition did not have specific guidance in place in regards to this exception.[17] The European Court of Justice has dealt with it only rarely, holding that the exception must be interpreted

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[12] TFEU art. 107(1).
[13] TFEU art. 107(1); *see also* MOGENS UHD NIELSEN & PETER VESTERDORF, STATE AID LAW OF THE EUROPEAN UNION 11 (Stephen Harris trans., Sweet & Maxwell 2008) (2008).
[14] LUCA RUBINI, THE DEFINITION OF SUBSIDY AND STATE AID: WTO AND EC LAW IN COMPARATIVE PERSPECTIVE 151 (2009); *see also* NIELSEN & VESTERDORF, *supra* note 13 at 11-27. For an example of the breadth covered by the TFEU's definition of state aid, see Joined Cases C-72/91 and C-73/91, *Sloman Neptun* 1993 E.C.R. I-887, where the court held that aid given directly by private entities who get money from the government constitutes state aid.
[15] Case 173/73, *Italy v. Comm'n*, 1974 E.C.R. 709.
[16] For a fuller description of these questions, see RUBINI, *supra* note 14 at 152-178.
[17] *See* October 2008 Guidelines, *supra* note 8 at 10 (referring to principles associated with 107(3)(c)).

narrowly and that it should only cover a disturbance that affects the entire economy of a Member State, not just individual firms or even sectors within the economy.[18] Beyond these very general parameters, the DG Competition did not have much legal precedent to rely on in developing the use of this exception as it related to the financial crisis; however, there are some general theories on state aid control that animate the overall state aid control framework, which should suggest some parameters for the serious disturbance exception.

State aid control is premised on the idea that all firms within the EU should be competing on as level a playing field as possible with all the other firms within the EU. Generally speaking, it is seen as socially beneficial for inefficient firms to exit the market, and competition among firms creates an environment where those inefficient firms are forced to exit. This theory justifies state aid control because it prevents Member States from artificially keeping firms alive longer than they should be, economically speaking. Contained in that premise are two threads of economic theory that mostly overlap in this context: the competition theory and the internal market theory. The competition theory argues that state aid control is necessary only so far as it prevents Member States from distorting competition such that those distortions create a deadweight loss for the EU.[19] This school of thought focuses more on an economic analysis of state aid to determine what detrimental effects a grant of state aid may have on other individual firms in the market and on the market generally.[20] In contrast, the internal market theory suggests that while distortions to competition are significant in analyzing state aid, the EU should also be working to create a coherent internal market to prevent not only distortions of

[18] Case C-301/96, *Germany v. Comm'n* 2003 E.C.R. I-9919.
[19] RUBINI, *supra* note 14 at 60; David Spector, *State Aids: Economic Analysis and Practice in the European Union, in* COMPETITION POLICY IN THE EU: FIFTY YEARS ON FROM THE TREATY OF ROME 179, 181-185 (Xavier Vives ed., 2009) (describing this theory as a non-paternalistic justification).
[20] RUBINI, *supra* note 14 at 60.

competition but also to prevent "macro-economic rivalry between Member States."[21] David Spector, using somewhat different nomenclature, argues that these justifications to prevent macro-economic rivalry are paternalistic in that the EU is attempting to control what its Member States should control but cannot due to internal political pressures.[22] However, his overall argument remains that state aid control can be justified as necessary in order to prevent inefficient competition between Member States. While these two theories may disagree on some of the explanations, they both definitively identify one of the core goals of state aid control as an attempt to avoid giving some individual firms within the EU an unfair advantage in competing in the marketplace.

This theory is somewhat complicated as it is applied to the financial system as some commentators argue that a lack of direct competition among banks is actually socially beneficial. The banking system is much more interconnected than other markets, and a negative event, such as insolvency or even uncertainty about solvency, that affects one bank could have significant impact on other unrelated banks as a result of the predominance of inter-bank lending, thus causing a crisis to spread like contagion among banks.[23] This contagion effect seems much less likely in other industries. For example, the failure of a cheese producer seems unlikely to cause the public to doubt the stability of all other cheese producers; whereas, history has shown that the insolvency of one bank can lead to a run on an unrelated bank. This contagion effect for the financial sector is generally aggravated because most banks' customers are generally uninformed about the financial stability of their banks and may be likely to doubt the insolvency of a bank

[21] *Id.* at 61.
[22] Spector, *supra* note 19 at 177 - 181.
[23] THOMAS BECK ET AL., CENTER FOR ECONOMIC POLICY AND RESEARCH, BAILING OUT THE BANKS: RECONCILING STABILITY AND COMPETITION 14 (2010).

simply because another bank is feared insolvent.[24] Therefore, it is unclear that pure competition and the exit of inefficient firms is socially useful in the financial sector because the exit of an inefficient firm may cause efficient firms to suffer short-term liquidity crises. The economic analysis bears this conclusion out because economists cannot come to any kind of consensus on the value or detriment of competition in the banking industry.[25] However, prior to 2008, the EU does not appear to have addressed any specific legislation or regulation to the financial sector as regards state aid control and has not accounted for this potential nuance.

These definitions and theoretical frameworks provide a further description of state aid control, both its scope and its purpose, suggesting that state aid control is meant to prevent Member States from giving firms within their boundaries advantages over their competition that would otherwise be unavailable to them. As noted previously, the DG Competition had not provided much guidance on the serious disturbance exception prior to this crisis, and so in regards to this crisis, the DG Competition focused more on these principles to guide its communications and decisions.

III. The EU's Systemic Response to the Crisis

In the three years since the financial crisis spread to Europe, the DG Competition has issued five communications outlining its approach to reviewing state aid to financial institutions during the crisis. These communications cover the following areas: general principles;[26] recapitalization guidelines;[27] impaired assets guidelines;[28] extension and expansion of the overall crisis guidelines;[29] and a further temporal extension of the crisis guidelines.[30] I will summarize

[24] *Id.* at 10-11.
[25] *Id.* at 18-23.
[26] October 2008 Communication, *supra* note 8.
[27] January 2009 Communication, *supra* note 9.
[28] March 2009 Communication, *supra* note 9.
[29] August 2009 Communication, *supra* note 9.
[30] December 2010 Communication, *supra* note 9.

and discuss each communication individually to analyze the evolution of the EU's response to assess whether it is truly keeping with the guiding principles of state aid control.

a. October 25, 2008 Communication - General Principles

One month following the collapse of Lehman Brothers, the DG Competition issued its first publication on the use of state aid to address this crisis, the October 2008 Communication, which was meant to promptly respond to the rapidly growing financial crisis.[31] In addition to affirming TFEU Article 107(3)(b) as the legal basis for addressing the crisis, the October 2008 Communication set out the basic framework for supporting ailing financial institutions during the crisis: loan guarantees and recapitalization by governments.[32] In formulating its guidance, the DG Competition relied on a 2004 communication providing guidelines on state aid for individual firms in need of rescue or restructuring.[33] This communication deals with a different but related provision of TFEU Article 107, Article 107(3)(c), allowing the DG Competition to approve aid to rescue or restructure individual firms in serious difficulty. In that 2004 Communication, the DG Competition lays out some basic guiding principles to be followed in evaluating proposed aid to firms in difficulty, while also noting that the exit of inefficient firms is a "normal part of the operation of the market."[34] Specifically, the aid must be necessary, appropriate and proportional to address the issue so as not to provide the firm in difficulty with more aid than absolutely necessary to effectuate the rescue or restructuring.[35] It defines firms in difficulty as those who may have trouble surviving in the short- to medium-term but not those that have long-term viability concerns.[36] Furthermore, the 2004 Communication sets out stringent guidelines

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[31] October 2008 Communication, *supra* note 8.
[32] *Id*. at 9 (paragraph13).
[33] *Id*. at 9 (paragraph 10); Commission Communication, Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty 2004 O.J. (C 244) 2 [hereinafter 2004 Communication].
[34] 2004 Communication, *supra* note 33 at 2 (paragraph 4).
[35] *Id.*
[36] *Id.* at 3 (paragraph 11).

that individual firms should only avail themselves of state aid on a "one time, last time" basis, such that they cannot return to the government for aid any time in the near future.[37] Finally, the 2004 Communication requires that the beneficiary of the aid contribute as much as possible given the firm's circumstances.[38]

The October 2008 Communication stated that the DG Competition's guiding principles for evaluating aid in this crisis derives from the 2004 Communication and reiterated some of those same principles, while allowing that the crisis may necessitate going beyond the 2004 Communication.[39] Specifically, the October 2008 Communication required that the beneficiary firm contribute as much as possible to a loan guarantee or that the Member State giving the aid receive equal value in return of a recapitalization, in order to ensure that the Member State gives minimal aid necessary.[40] The October 2008 Communication also provides that Member States should act only when the entire financial sector is jeopardized, further trying to ensure that state aid is given only when necessary.[41] However, the October 2008 Communication does seem to expand the pool of financial institutions to be saved to include those with endogenous problems relating to poor management or risky strategies.[42] Importantly, the October 2008 Communication does address the moral hazard issue of state aid directly, requiring that Member States only give state aid with conditions that constrain the behavior of the beneficiary so that it acts in a way to not distort competition, *e.g.*, not expanding while receiving aid or not advertising that the financial institution is receiving aid.[43] This Communication further explicitly concerns itself with creating a moral hazard when it acknowledged the possibility of winding up financial

[37] *Id.* at 11-12 (paragraphs 72-77) (limiting, in essence, a firm's receipt of state to once every ten years).
[38] *Id.* at 2 (paragraph 7).
[39] October 2008 Communication, *supra* note 8, at 9 (paragraph 10).
[40] *Id.* at 11, 13 (paragraphs 25 and 39) (the logic being that the beneficiary would only take as little aid as necessary so to avoid having to put up more of its resources than necessary).
[41] *Id.* at 9 (paragraph 11).
[42] *Id*. (paragraph. 14).
[43] *Id.* at 11 (paragraph 27).

institutions when they are not worth rescuing or restructuring, even going so far as to set out guidelines to prevent creditors, shareholders, or potential acquirers from benefiting from the liquidation.[44]

The October 2008 Communication appears to be mostly in line with the guiding principles of state aid control with its emphasis on avoiding distortions of competition and encouraging control of any moral hazard issues. The behavioral limitations on firms who receive aid seems particularly relevant as they work to ensure that firms cannot use state aid as a springboard for future success, thereby harming competitors who did not receive aid. Additionally, the continuing emphasis on beneficiary contribution and the necessity of a finding of jeopardy to the whole system speaks to the DG Competition's intent to limit state aid to only that necessary to protect the entire economy from further upheaval. These limitations likely served to limit beneficiaries to only those that truly needed the aid to continue to survive, meaning that Member States could only distribute the minimum aid necessary. By creating these general principles applicable to all applicants for state aid, the DG Competition ensures that there will be less macro-economic competition among Member States since these guidelines should prevent individual Member States from providing significantly better state aid than other Member States.

Despite the fact that the majority of the October 2008 Communication seems in line with the EU's guiding principles on state aid control, some inconsistencies start to emerge, which may indicate the weakness of the policy or the flexibility of the DG Competition. Specifically, the October 2008 Communication seems to be moving away from the idea that it is acceptable and normal for some inefficient firms to fail. It allows firms that have made poor risk assessments or employed inefficient managers to apply for and receive state aid, thereby allowing inefficient

[44] *Id*. at 13-14 (paragraphs 43 - 50).

firms to continue to exist in the marketplace. Admittedly, the October 2008 Communication does continue to emphasize the possibility that Member States could use aid to wind down inefficient firms, but the tone is changed from the 2004 Communication. In 2004, the DG Competition stated that "it cannot be the norm" that firms in difficulty receive aid.[45] By contrast, the October 2008 Communication only says that Member States "may also wish" to carry out liquidations.[46] This difference, while perhaps subtle, seems to suggest a move away from liquidation and the wind-up of inefficient firms, instead allowing Member States the latitude to support firms that may not be efficient participants in the market. This inference seems stronger when taken in combination with the October 2008 Communication's widening of the pool of candidates for state aid to those that were inefficient in their long-term risk-taking or management and not just those with short- or medium-term liquidity problems. And keeping inefficient firms in the market is, by its nature, a distortion of competition by preventing competition from weeding out some firms that cannot survive under their own power.

The October 2008 Communication is certainly not a radical departure from the principles of state aid control, but it suggests a looser approach to those principles. At this point in the EU's response to the financial crisis, it is hard to tell whether that approach is just part of a more flexible response or if it indicates a weakness in the state aid doctrine. Future communications, however, seem to suggest the latter.

b. January 15, 2009 Communication - Restructuring Guidelines

Soon after the DG Competition issued its general guidelines for state aid in the financial crisis, the EU Economic and Financial Affairs Council requested more guidelines in regards to

[45] 2004 Communication, *supra* note 33 at 2 (paragraph 4).
[46] October 2008 Communication, *supra* note 8, at 13 (paragraph 43).

how recapitalization would be assessed as a form of state aid.[47] The DG Competition responded to this request with the January 2009 Communication, which laid out the purposes of a recapitalization as well as further guidance on what form an acceptable recapitalization should take. This Communication, while still mostly adhering to the principles behind state aid control, suggests further deviation from those principles than the October 2008 communication.

After the general principles set forth in the October 2008 Communication, the DG Competition used the January 2009 Communication to provide guidance more specific to recapitalization schemes. To begin, the January 2009 Communication lays out the rationale for allowing recapitalizations in case of a recession: restoring confidence in interbank lending, providing a cushion to absorb losses, responding to perceived need for higher capital ratios, encouraging real lending, and avoiding short-term systemic effects.[48] With those purposes in mind and with an explicit acknowledgement of the competition concerns, the DG Competition advised that recapitalization schemes should be structured to best mimic a well-functioning market.[49] However, this Communication does concede that distressed banks may not be able to pay to reflect the risks being taken in recapitalization, and so Member States are allowed to accept lower remuneration, though that remuneration should still be high enough that only those financial institutions that need it will take it.[50] The January 2009 Communication does also grant the Member States the ability to create incentives for beneficiaries to repay the state aid as soon as possible by increasing the required remuneration or restricting dividends.[51] This Communication reiterates many of the constraints as the October 2008 Communication,

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[47] January 2009 Communication, *supra* note 9 at 2 (paragraph 3). Recapitalization can take several different forms (silent participation, stock purchases, etc.), but in its fundamental form, it is the government injecting money to a bank in return for equity in the bank.
[48] *Id.* at 2-3 (paragraphs 4-6).
[49] *Id*. at 3 (paragraph 11) (also allowing for definitive acceptance of state aid if private participants make up more than 30% of the total recapitalization).
[50] *Id*. at 4 (paragraph 14).
[51] *Id*. at 7 (paragraphs 31-34).

including limiting aid to the minimum necessary, prohibiting advertising of aid receipt, and other behavioral safeguards.[52] Unlike the October 2008 Communication, the January 2009 Communication does explicitly allow for balance sheet growth for recipients of state aid in order to encourage lending to the real economy.[53]

The January 2009 Communication, while still adhering to many of the general principles, appears to continue the DG Competition's departure from the guiding principles of state aid. Certainly, there are a number of provisions that reflect those principles; for example, the January 2009 Communication emphasizes the importance of mimicking the market, which will likely reduce any distortions of the market if the mimicry is successful. This Communication emphasizes the importance of removing state aid as soon as possible by means of government incentives, which goes to the state aid principle of only providing aid as necessary and for the minimal time, since this mechanism will strongly encourage financial institutions to pay back the aid as quickly as possible. The Communication also reiterates the importance of behavioral safeguards as a way to prevent firms from gaining advantages over their competitors, thereby upsetting the playing field.

That being said, there are some significant deviations from state aid control theory. Most strikingly, the January 2009 Communication allows recapitalized banks to increase their balance sheets, which is in direct conflict with even the October 2008 Communication.[54] The DG Competition justifies this measure as a way to increase real lending, which is an important goal during a credit crisis; however, there were a number of other opportunities available to the DG Competition. Most apparently, the DG Competition could have required banks to divest themselves of some riskier assets to counterbalance any increased lending, as forced divestiture

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[52] *Id.* at 7-8 (paragraphs 35-39).
[53] *Id*. at 7 (footnote 4).
[54] October 2008 Communication, *supra* note 8, at 11 (paragraph 27).

is one of the tools available to the DG Competition.[55] Beyond the alternative means available to the DG Competition, it fails to address how this measure may distort competition. By allowing financial institutions to increase their balance sheets, the DG Competition is allowing banks, supported by state aid, to compete for business with banks that did not receive aid. This scenario, by definition, would go against the fundamental principle of state aid control - to avoid giving beneficiary firms an advantage against others. Thus, this approach appears to go against the theory justifying state aid control as well as principles set forth in the 2004 Communication.

Beyond this particularly problematic provision, the January 2009 Communication also creates some ambiguity in its guidance that may provide petitioning Member States latitude to avoid the purpose of state aid control. Specifically, this Communication allows for Member States to accept less remuneration than under normal market circumstances, but it does not provide any specific guidance on how low that remuneration can go before it becomes problematic. Without definitive guidelines, Member States would likely be uncertain about the extent of their powers and be subject to internal pressure from constituencies that would benefit from lower remuneration requirements. This uncertainty and pressure would seem to encourage Member States to rescue and restructure financial institutions of lower quality by allowing them to repay at lower remuneration to the point that it may be rescuing inefficient firms in the market. As a result, it may create some competition among Member States and thereby upset the balance of the internal market.

The January 2009 Communication, while continuing to mostly work within the principles of state aid control, shows a growing divergence from those principles. These

[55] The August 2009 Communication confirmed divestiture as one of the available means, but the 2004 Communication gave the DG Competition carte blanche to devise provisions to constrain beneficiaries' behavior. August 2009 Communication, *supra* note 9 at 15 (paragraph 35); 2004 Communication, *supra* note 33 at 8 (paragraph 46).

deviations suggest a fundamental movement away from those state aid control principles that animated the broad scope of the definition of state aid as well as the 2004 Communication. Specifically, the allowance of balance sheet growth seems so contrary to the principle of attempting to prevent any distortion to competition that it seems hard to justify as simply a practical solution to the financial crisis, especially in light of the available alternatives.

c. March 26, 2009 Communication - Impaired Assets

As the financial crisis continued into 2009, a new strategy emerged as a means to support troubled financial institutions: the creation of vehicles to take bad assets with uncertain fair market value, such as mortgage-backed securities off the balance sheets of banks. By taking these bad assets off the balance sheets of financial institutions, it would allow those institutions to have a more sustainable capital ratio as they would not need to hold back as much in loss reserves. The DG Competition responded to this new idea with the March 2009 Communication providing guidance on how to structure these arrangements in line with the EU's control of state aid. This Communication appears to adhere to some of the principles behind the control of state aid, but it allows for more disturbance of competition than necessary in service of the financial industry.

The March 2009 Communication is a somewhat different communication than the previous two because it addresses a new method for dealing with the crisis. This Communication acknowledges that taking impaired assets off of a bank's balance sheet state aid can, like any state aid, distort competition, and so it provides several safeguards against such distortion.[56] Since this approach to impaired assets is relatively new, this Communication starts by demanding a consistent approach across the EU.[57] The March 2009 Communication also

[56] March 2009 Communication, *supra* note 9 at 2-3 (paragraph 9).
[57] *Id*. at 3-4 (paragraphs 13-14).

requires financial institutions to fully disclose all of their assets and strongly recommends that Member States only keep this program open for a limited time.[58] These assets, according to this Communication, can be a wide range of assets so as to provide the Member States flexibility.[59] The importance of burden-sharing is emphasized as well, but this Communication does provide Member States the option of providing state aid to an insolvent bank if it is too large to fail and needs immediate support, which is in line with the Communication's provision to allow Member States to target specific banks rather than the whole sector.[60] The March 2009 Communication further emphasizes behavioral constraints as the prior communications did, but it also allows Member States to "include appropriate incentives (such as the provision of warrants or rights to existing shareholders . . .)" to encourage banks to participate in programs to deal with troubled assets.[61]

Here, again, the DG Competition continues to abide by some of the guiding principles of state aid control but appears to allow for some significant deviation from those principles. There are several instances of provisions that uphold those guiding principles; for example, the requirement of consistency across the EU means that any concern about macro-economic competition between countries would be mitigated as all Member States would deal with impaired assets in a similar manner. As a result, this provision addresses any concern about internal inconsistencies within the internal market. Furthermore, the emphasis on keeping the window for participation short and demanding as much burden-sharing as possible will mean that only banks that need this state aid will avail themselves of it, and it will prevent firms from trying to wait for a longer period of time to better take advantage of the opportunity at the

[58] *Id*. at 5, 6 (paragraphs 19-20, 26-27).
[59] *Id*. at 7 (paragraph 32).
[60] *Id*. at 3, 6 (paragraphs 12, 23).
[61] *Id*. at 7 (paragraph 28).

expense of other businesses. And, as discussed previously, behavioral constraints are important in preventing one firm from using its receipt of aid to its advantage over other competitors, and this Communication continues to reiterate those constraints.

The March 2009 Communication, however, strays from these principles in two key respects. First, it allows Member States to provide positive incentives, such as further equity in the bank in the form of warrants, to shareholders of banks to make those banks more likely to participate in the program. This concept appears to be, in some way, providing a reward to those banks for their poor management and risk analysis. While that reward is assuredly less than they started out with, the fact that they get something out of their failed investment invites a moral hazard because those shareholders will not bear the full downside of their risk. This moral hazard will create the possibility that firms in the future will take risks with expectations that its shareholders will not bear the full amount of that risk, thereby disturbing competition by altering the risk calculus of individual firms. Second, this Communication allows Member States to essentially provide life support to banks that are too big to fail regardless of their short- or long-term viability. This provision, while perhaps practically required, allows inefficient firms to continue to persist in the market without any concern for its future prospects. And, as discussed previously, the persistence of inefficient or failing firms is more than likely to distort competition by stifling the growth of competitors who are not receiving aid.

Thus the March 2009 Communication continues the trend in the EU response farther and farther away from the principles of its original state aid control framework. Certainly, the DG Competition has included some provisions to try to keep the playing field level, but it has also allowed for some significant possibility of financial institutions using their recovery and restructuring aid to better position themselves vis-à-vis their competitors, especially through the

provision of positive incentives. This approach seems incongruous with state principles regardless of its practicality and suggests that the DG Competition has possibly made a stronger move away from the original principles in favor of more pragmatic concerns. This possibility only becomes more pronounced in the next communication.

d. August 19, 2009 Communication and December 7, 2010 Communication - Extension Communications

The DG Competition put out two separate communications on August 19, 2009 and December 18, 2010, each extending the applicability of the previous communications, until their current expiration date of December 31, 2011. Both of these communications have the same overall purpose of extending the time during which Member States can offer financial institutions state aid under the previous communications and so will be addressed together. These two extension communication, both by the fact of extension as well as some other guidance included in them, move the furthest away from the guiding principles of state aid control previously articulated by the DG Competition.

The August 2009 communication is a more detailed and substantive communication, including both a time limit and an expansion of Member States' options in using the guidelines set forth in the prior communications. The August 2009 Communication reiterates the principles of the prior communications, and it also sets an expiration date on all of them at December 31, 2010.[62] In particular, the August 2009 Communication restates the dangers of state aid to banks, including important behavioral constraints to avoid them, and the importance of limiting distortions to the economy.[63] Also, the importance of burden-sharing by the beneficiary is stressed, though the Communication concedes that the level of burden-sharing should not be set

[62] August 2009 Communication, *supra* note 9 at 10, 16 (paragraphs 5 and 43).
[63] *Id*. at 10-11, 14-16 (paragraphs 7, 28-45).

ex ante due to the uncertainty of some banks' futures.[64] This Communication focuses on the importance of diagnosing the cause of the banks' current distress, a new point of emphasis from the previous guidance.[65] The Communication also focuses more on restoring the long-term viability of beneficiary banks, and a part of that focus is describing, in more detail, what needs to be included in a bank's restructuring plan.[66] There is a return to the emphasis that an orderly wind-up of a bank "should always be considered where [it] cannot return to long-term viability."[67] Finally, the August 2009 Communication allows Member States to give additional aid where necessary.[68]

The December 2010 communication provides little in terms of further substantive guidance regarding the financial crisis. The DG Competition, in this Communication, does suggest that the economy is better but not sufficiently stable to pull back on state aid.[69] As a result, it does extend the applicability of the previous guidance through 2011, and it does suggest that specific guidelines for rescuing or restructuring banks should be in place by January 1, 2012.[70] This Communication also incorporates a DG Competition working document from April 30, 2010, which lays out more stringent guidelines when it comes to government guarantee schemes, but it is unwilling to create further restrictions.[71]

These last revisions to the EU's guidance on state aid as it relates to financial institutions during this crisis is the most problematic in comparing it to the established precepts of state aid control. Most troubling is the provision in the August 2009 Communication that allows Member States to give repeat aid to beneficiaries who need it. The 2004 Communication, as the

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[64] *Id*. at 13 (paragraph 24).
[65] *Id*. at 10-11 (paragraph 7).
[66] *Id*. at 11-13 (paragraphs 9-21).
[67] *Id*. at 12-13 (paragraph 21).
[68] *Id*. at 10-11 (paragraph 7).
[69] *Id*. at 10 (paragraph 5).
[70] December 2010 Communication, *supra* note 9 at 7-8 (paragraphs 7-8)
[71] *Id*. at 8 (paragraph 10).

articulation of the DG Competition's general principles, stresses the "one time, last time" concept as a crucial means to control moral hazard and mitigate any distortion to competition.[72] This concept is now removed as a determinative criterion, so that financial institutions can continue to subsist on state aid for longer periods of time because of repeated injections of capital even though that firm may not be capable of survival. This change seems particularly problematic, when combined with the temporal extension of these guidelines because beneficiaries will have even more time to ask for more aid. This scenario would seem to lend itself to a significant distortion in competition by forcing those banks that had not received aid to compete with those that received multiple grants of aid over a longer period of time. Further, the August 2009 Communication shifts the emphasis on the scope of these guidelines to banks that need help restoring their long-term viability. This shift to restoring long-term viability is a shift away from the principles articulated in 2004, where the DG Competition indicated that rescue and restructuring aid was only meant for firms that needed temporary help to survive the short- or medium-term.[73] Instead, by allowing state aid to go to firms that are not currently viable in the long-term, the DG Competition appears to be allowing Member States to rescue inefficient firms that would have exited the market relatively quickly, regardless of any immediate liquidity problems. The existence of these inefficient firms in the market for a longer period of time creates an inherent disturbance of competition by populating the competitive landscape with more firms. This rescuing of fundamentally flawed firms is incongruous with the idea that state aid to floundering firms is meant more to be a bridge to allow the troubled firm to steady itself.

That is not to say that the two extension communications do not maintain some adherence to the guiding principles. They do emphasize some important provisions supportive of those

[72] 2004 Communication, *supra* note 33 at 11-12 (paragraphs 72-77).
[73] *Id.* at 3 (paragraph 11).

principles, such as the emphasis on burden-sharing, which reduces the possibility of moral hazard. However, the discussion on burden-sharing does release Member States from the obligation of setting that amount ex ante. This decision, while perhaps practical, means that beneficiaries have the opportunity to take on a larger appetite for risk because if they fail to be as successful as they envisioned then, presumably, the Member State will require them to take on less of the burden because they will have fewer resources. The emphasis on diagnosis of the underlying cause of the problem also seems geared toward maintaining the guiding principles. By understanding a distressed bank's underlying problem, the Member State can specifically target the aid to the bank such that it is the minimum necessary and proportional to the actual problem confronting the bank. Furthermore, the inclusion of behavioral constraints, such as the requirement of divestiture or limitation on expansion, again militates against a moral hazard as the recipient of the aid will be limited in what benefit they can derive from it above and beyond that which the Member State approves.

As the EU's responses to the financial crisis evolved, it appears that it became more pliant in its application of the principles behind state aid control, culminating in the significant deviation in the most recent communications. Certainly, the DG Competition has not thrown away all of its principles, and it has implemented some of them consistently throughout, particularly its focus on behavioral restraints. But, its willingness to discard some core principles such as the "one time, last time" for receipt of aid, and the movement away from preventing any moral hazard, suggests that the state aid control policy is not that strong of a policy and will be sublimated to other goals of the EU or its Member States.

IV. WestLB - A Case Study

The previous section has outlined some of the ways in which the EU guidelines for state aid could be used to undermine the principles of state aid control, but it cannot provide any idea as to how the DG Competition actually implemented these guidelines and to what effect those guidelines were used. To arrive at a better understanding of the use of the guidelines on the ground, I believe it would be useful to examine one case study from the over 180 decided under these communications. Studying one particular case in detail will provide the opportunity to see how these tensions between the principles of state aid control and the DG Competition's guidelines for addressing this crisis played themselves out in a single case. I have tried to pick an illustrative example, but it should be noted that it is impossible to draw definitive conclusions from a singular case study; rather, it can provide evidence about the conclusions drawn based on the theoretical framework.

In choosing a case study, I initially focused on the six decisions that were either conditional or rejected by the DG Competition. I chose to work with conditional decisions or rejections because they were most likely to be borderline cases where the DG Competition had to wrestle with some of the tension discussed above. Within those six decisions, the only request for state aid that had been denied under these guidelines was the Bank of Portugal, which has not been published as of May 12, 2011.[74] Additionally, the ABN Amro and Fortis Bank conditional decision is also unpublished as of May 12, 2011.[75] Of the remaining four, the Northern Rock conditional decision seemed less than ideal as its Member State is the United Kingdom, which is

[74] Commission Decision C33/2009, Restructuring of BPP, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C33_2009 (indicating that the decision had not been published but that it "will be displayed as soon as it has been cleansed of any confidential information").
[75] Commission Decision C11/2009, Monitoring on the Conditional Decision on ABN Amro and Fortis Bank Nederland, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_26674 (indicating that the decision had not been published but that it "will be displayed as soon as it has been cleansed of any confidential information").

not a wholly integrated member of the EU.[76] One of the other cases involved Dexia, whose complexity seemed preclusive for a case study, given it involved three Member States providing aid in one form or another.[77] This analysis left two German banks who received aid: WestLB and Sparkasse Koln. Of those two, WestLB seemed the most illustrative because it is a prominent bank in a major region of Germany and is therefore likely of more significance to the global economy than Sparkasse Koln.[78] WestLB was, prior to the crisis, a bank with over 280 billion euros in assets with major trading desks throughout the world; whereas, Sparkasse Koln, while the second largest savings bank in Germany, had only thirty-one billion euros in assets and appears more focused on the less risky savings aspect of its business.[79]

Having selected WestLB as the case study, it would perhaps be helpful to review the complex recent history of WestLB as succinctly as possible.[80] As noted previously, WestLB had approximately 280 billion euros in assets as of the end of 2006, and it was a major "provider of corporate banking services in the North-Rhine Westphalia region."[81] When the financial crisis hit, WestLB was particularly vulnerable due to its "relatively large investments in structured credits."[82] Furthermore, it made several trading errors that cost it over 300 million euros in

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[76] Commission Decision C14/08, State Aid Implemented by the United Kingdom for Northern Rock, 2010 O.J. (L 112) 38.
[77] Commission Decision C 9/09, State Aid Implemented by the Kingdom of Belgium, the French Republic and the Grand Duchy of Luxembourg for Dexia SA, 2010 O.J. (L 274) 54.
[78] Commission Decision NN25/2008, WestLB Riskshield, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_NN25_2008 1 (paragraph 5) [hereinafter April 2008 Decision]
[79] *Id.*; Commission Decision C32/2009, Restructuring of Sparkasse Koln/Bonn, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C32_2009 (providing the decision as a letter to the member state, there was no indication of its publication in the Official Journal).
[80] In the first WestLB decision, DG Competition used 107(3)(c), but it later switched the legal basis to 107(3)(b). Commission Decision C 43/08, On State Aid which Germany Proposes to Grant Towards the Restructuring WestLB AG 2009 O.J. (L 345) 1, 8 (paragraphs 61-64) [hereinafter May 2009 Decision]. This shift in the legal basis does not appear to affect the analysis.
[81] April 2008 Decision, *supra* note 78 at 1 (paragraph 5); Carter Daugherty, *WestLB to Cut 1,500 Jobs and Receive a €5 billion bailout*, N.Y. TIMES, Feb. 8, 2008.
[82] Katherine Griffiths, *WestLB Becomes Latest Bank to Tap German State's Bailout Fund*, TELEGRAPH, Nov. 4, 2008, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/3378851/WestLB-becomes-latest-bank-to-tap-German-states-bail-out-fund.html.

2007.[83] As a result of these worsening conditions, on January 2008, the owners of WestLB injected one billion euros worth of capital into WestLB.[84] When that appeared insufficient, WestLB requested that the state of North-Rhine Westphalia contribute a guarantee of three billion euros to its proposed five billion euro risk shield.[85] This risk shield would allow WestLB to move twenty-three billion euros worth of questionable assets into a special purpose vehicle equipped with that risk shield, allowing WestLB to maintain an appropriate capital ratio and credit rating, for which guarantee the special purpose vehicle would pay a fee.[86] The DG Competition approved this as a rescue plan requiring that a restructuring plan be submitted within six months, which WestLB did in August 2008 with the caveat that it would submit more detailed plans by December 2008.[87] The DG Competition decided to investigate the restructuring plan based on the material submitted in August 2008, and WestLB did not provide the fully completed restructuring plan until April 17, 2009, after having requested an extension until March 31, 2009.[88] The DG Competition conditionally approved this restructuring plan, which included the following measures:

- Make the five billion euro risk shield permanent;[89]
- Effect a complete change in control of WestLB;[90]
- Reduce WestLB's balance sheet by 25% by March 2010 and 50% by March 2011;[91]
- Unbundle the three core businesses by October 2009 and divest or wind-up any non-core businesses;[92] and

[83] Rhys Blakely, *WestLB admits trading errors cost it €300m*, TIMES ONLINE, Aug. 30, 2007, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2355537.ece.
[84] April 2008 Decision, *supra* note 78 at 3 (paragraph 13).
[85] *Id.* at page 4 (paragraph 19).
[86] *Id.* at 4-5 (paragraphs 19-20).
[87] May 2009 Decision, *supra* note 80 at 1 (paragraph 2).
[88] *Id*. at 1-2 (paragraphs 3-9).
[89] *Id*. at 3 (paragraph 21).
[90] *Id*. at 4 (paragraph 31).
[91] *Id*. at 5 (paragraph 34).

- Require WestLB to pay all restructuring charges.[93]

The DG Competition's conditions on approval of this plan was to provide a more detailed listing of requirements in regards to the divestment of assets, restrictions on business activities during the divestitures, and the independence qualifications of any buyer of WestLB's divestitures.[94]

After receiving conditional approval, WestLB began the process of following the plan set forth in the restructuring document. However, the financial crisis continued to worsen, and WestLB requested on September 23, 2009 a further guarantee of 6.4 billion euros to WestLB in order to cover its bad assets that had been delayed in being moved to the special purpose vehicle.[95] WestLB would pay a fee on this extra guarantee as well.[96] On the basis of the August 2009 Communication, the DG Competition approved the additional aid on October 7, 2009 because, without it, WestLB would fall below its required capital ratio and would more than likely have to enter into bankruptcy.[97] This extra guarantee also exceeded the ceiling of allowable guarantees to an individual firm in this particular situation, but the DG Competition acquiesced because Germany had committed to providing a restructuring plan within two months.[98]

WestLB submitted a revised restructuring plan on December 15, 2009 and indicated that it would spin-off a 'bad bank' to house a number of distressed assets with a nominal value of 85.1 billion euros, including the 23 billion euros housed in the special purpose vehicle

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[92] *Id*. at 5,6 (paragraphs 36, 42).
[93] *Id*. at 10 (paragraph 77).
[94] *Id*. at 13-17.
[95] Commission Decision N 531/2009, Assumption of Risk for WestLB, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_N531_2009, 1 (paragraph 1) [hereinafter October 2009 Decision].
[96] *Id.* at 3 (paragraph 14).
[97] *Id.* at 4, 5, 6 (paragraphs 24, 29, 34).
[98] *Id*. at 5-6 (paragraph 30).

envisioned by the first restructuring plan.[99] As part of its revised restructuring plan, WestLB requested further recapitalization because its shareholders had refused to contribute, contrary to Germany's commitment noted in the previous decision.[100] Instead, Germany planned to contribute three billion more euros that would convert into equity, with a commitment to provide more if necessary.[101] The restructuring plan also provided details of creating the 'bad bank,' which assured that private shareholders and WestLB would cover up to three billion euros worth of losses incurred by the 'bad bank.[102] The plan also noted that the 'bad bank' would house a wide variety of assets, including "corporate, State, municipal and student loans."[103] The DG Competition did note that WestLB had only reduced its balance sheet by thirty billion euros rather than the drastic reduction promised in the first restructuring plan, though it had committed to the same behavioral constraints identified in previous decisions.[104] The plan also envisaged that WestLB would return to profitability two years later than originally anticipated.[105]

The DG Competition's response to WestLB plan's was not positive. It doubted whether the plan could restore WestLB to viability, and it held that the shareholders were not sharing enough of the burden, in particular a failure to pay any remuneration for the state aid.[106] The DG Competition also found the 'bad bank' plan problematic because WestLB failed to provide a valuation of the approximately 83 billion euros worth of assets going into the 'bad bank,' so that it could properly determine the appropriate loss requirement.[107] Even without the valuation, the DG Competition felt that the three billion euro guarantee by WestLB and its shareholders was

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[99] Commission Decision C 40/09, Additional Aid for WestLB AG Related to Spin-Off of Assets, 2010 O.J. (C 66) 15, 16 (paragraphs 3, 4) [hereinafter December 2009 Decision].
[100] *Id*. at 17 (paragraph 15).
[101] *Id*. at 17, 18 (paragraphs 16, 23).
[102] *Id*. at 17-18 (paragraphs 17-24).
[103] *Id*. at 21 (paragraph 55).
[104] *Id*. at 16-17, 21 (paragraphs 7, 51).
[105] *Id*. at 19 (paragraph 27)
[106] *Id*. at 22, 23 (paragraphs 69, 72, 76).
[107] *Id*. at 21 (paragraph 58).

insufficient.[108] However, the DG Competition approved the temporary recapitalization and the 'bad bank' plan because WestLB was on the cusp of bankruptcy, but it did decide to investigate the 'bad bank' plan.[109]

The DG Competition issued its last decision in English regarding WestLB in June 2010, prolonging the investigation by another six months.[110] According to WestLB's 2010 Annual Report, it moved approximately 71 billion euros into the 'bad bank' in April 2010.[111] According to the popular press, WestLB has submitted revised restructuring plans in February and April of this year, which would essentially turn WestLB into a savings bank with a balance sheet of approximately 45 billion euros.[112] However, it appears the DG Competition is unsatisfied with these plans and has required WestLB to submit further plans by June 30, 2011.[113] According to the press, WestLB has accumulated approximately 5.7 billion euros in losses over the last eight years.[114]

This relatively long and convoluted history raises several issues about the DG Competition's implementation of the financial crisis guidelines, specifically the length of time, the repetitiveness of the aid, and the inability to effectively share the burden with shareholders.

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[108] *Id*. at 22 (paragraph 64).
[109] *Id*. at 24 (paragraphs 84-85).
[110] Commission Decision N 249/10, Prolongation of Temporary Authorisation of Additional Aid for WestLB AG Related to the Spin-Off of Assets, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_N249_2010 [hereinafter the June 2010 Decision]. The Commission published a very brief communication in January 2011, extending the period for comment on the 'bad bank' plan, while also agreeing on the proper valuation of the 'bad bank's' assets. Commission Decision C 40/09, Extension of Formal Investigation Procedure, WestLB AG, 2011 O.J. (C 23) 9.
[111] WESTLB AG, 2010 ANNUAL REPORT 15 (2011).
[112] Niklas Magnusson & Oliver Seuss, *WestLB Owners Propose Turning Lender into Regionally-Focused Verbundbank*, BLOOMBERG, Apr. 15, 2011, http://www.bloomberg.com/news/2011-04-15/westlb-owners-propose-turning-lender-into-regionally-focused-verbundbank.html.
[113] Eyk Henning, *WestLB Has New Deadline to Submit Revamp Plans-Sources*, WALL ST. JOURNAL DEALBOOK, May 4, 2011, http://online.wsj.com/article_email/BT-CO-20110504-714028-kIyVDAtMUMxTzAtNTIwMDUxWj.html.
[114] Oliver Seuss & Aoife White, *WestLB Proposes Breakup, Asset Cut to Win EU Approval*, BLOOMBERG, Feb. 16 2011, http://www.bloomberg.com/news/2011-02-16/westlb-proposes-bank-breakup-asset-reduction-to-win-aid-approval-from-eu.html.

First, in regards to the timing, WestLB applied for aid at the beginning of 2008, meaning that it has been in limbo for over three years. This lengthy approval process has allowed WestLB, which even the DG Competition doubts as a viable bank, to continue as a market participant, thus leaving an inefficient firm in the market much longer than it would have been without government intervention. This outcome seems inappropriate and out of proportion to rescue a firm that even the DG Competition doubts can continue as a functional bank. The length of time WestLB has existed in limbo has likely hurt its competitors as they had to compete with another participant in the market as well as with a significant uncertainty about the near future of their market given WestLB's size and market presence. For example, the 2010 WestLB Annual Report boasts that WestLB is ranked first for bond issuers in Germany and participated in fifteen capital increases in the past year.[115] These accomplishments seem incongruous with a bank that has received billions in state aid over the last several years while losing nearly six billion euros in the last eight years and certainly suggest that WestLB is competing fiercely with other banks for business in the area. Especially given WestLB has been on the cusp of bankruptcy, it is clear that WestLB has gotten advantages from state aid, such as its continued existence, that would be unavailable to it without the state aid

As part of the lengthy approval process, WestLB has also failed to meet a number of its deadlines without serious consequence. For example, the May 2009 restructuring plan required significant divestiture in a relatively short period of time so as to constrain WestLB thereby preventing it from benefiting unfairly from its receipt of state aid. Instead, WestLB still had 191 billion euros worth assets on its books as of December 31, 2010.[116] This failure to meet goals, while not only harmful on an economic basis, also damages the credibility of the DG

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[115] WESTLB AG, 2010 ANNUAL REPORT 6 (2011).

[116] *Id.* at p. 85. WestLB's deadline for divestiture of 50% of its assets is March 2011, and there does not appear to have been any movement on WestLB's part to meet that goal between January and March 2011.

Competition. The EU is still relatively young, and this inability to require Member States to adhere to their commitments could seriously weaken the credibility of the EU as an entity distinct from its Member States going forward.

Beyond timing issues, the fact that WestLB has received several distinct grants of state aid over the last several years is contrary to the guiding principles of state aid control, specifically the "one time, last time" principle. As noted previously, the August 2009 Communication authorized the provision of additional aid where necessary, and WestLB has taken full advantage of that provision. It has received multiple guarantees and recapitalizations over the past three years, and the last one was granted in order to prevent WestLB from going into bankruptcy. This outcome seems to directly contrast the goal of state aid control. State aid control is meant to prevent Member States from saving inefficient firms, and WestLB seems to have established itself as an inefficient firm based on its need for repeated state aid in order to even stay afloat and its accumulated losses of nearly six billion euros over the last eight years. Further, the 300 million euro trading errors and the significant exposure to structured markets seems to suggest poor long-term management. Despite two guarantees and a recapitalization, it still needed more aid in December 2009, which seems to reflect a firm that either cannot calculate how much money it needs or is exceptionally bad at using that money. Neither of those conclusions would support the argument that WestLB is a long-term viable firm.

Finally, the DG Competition does not appear to be demanding as much burden sharing as possible. Most egregiously, the WestLB shareholders refused to inject one billion euros into the firm despite the government's commitment that they would, but the DG Competition approved a later injection by the German government so as to prevent possible bankruptcy. Additionally, WestLB planned to place a wide variety of assets into the 'bad bank,' including student loans,

which the DG Competition noted would significantly benefit the shareholders.[117] As a result, shareholders are allowed to benefit from the state aid while not being required to inject any more of their capital, despite commitments made by the German government to the contrary.

The WestLB case was not an easy one for the DG Competition to handle, but it appears to have bent its principles pretty significantly in certain aspects of the case, relying on the DG Competition's communications. Its inability to force WestLB to adhere to its original timetable, its acquiescence in multiple aid grants, and its inability thus far to hold WestLB shareholders accountable seems to suggest that the DG Competition failed to fully uphold its guiding principles in dealing with WestLB. Certainly some of that could come from the exigencies of the circumstances, but this willingness to bend principle greatly lessens the ability of the DG Competition to shape behavior.

V. Conclusion

Throughout this paper, I have argued that both in theory and in a particular instance the DG Competition has not fully kept to its guiding state aid control principles in attempting to address the global financial crisis. Instead, it appears to have altered its approach to suit the crisis as well as supporting requests to keep inefficient firms afloat. Though it has attempted to adhere to some of its guiding principles, it appears that as the crisis continued on, the DG Competition became more willing to move away from the guiding principles of state aid control to allow states to provide more aid to ailing banks. This divergence could result from the EU sublimating its state aid control goals to other broad EU goals, such as the stability of its financial system, or it could result from specific Member States exerting control as a result of domestic political pressure. The former conclusion is mildly troubling because it suggests that the EU has reduced the importance of one of its foundational policies without a public

[117] December 2009 Decision, *supra* note 99 at 10 (paragraph 76).

explanation. Certainly, there may be a basis for that decision to sublimate state aid control, especially in the context of the financial system where competition is debatably less important for arriving at the socially optimum level, but there has been no discussion of whether that is what the DG Competition doing. Rather, the DG Competition has unilaterally acted in order to serve other EU goals beside state aid control, which makes it difficult for actors within this area to plan for the near future.

If the latter conclusion regarding individual Member State action is playing a significant role in decision-making, it does not bode well for the future of the EU as a coherent whole. It suggests that when difficulties arise, Member States will focus on their own interests and prevent the EU from implementing a coherent, principled approach to crises. This conclusion does not seem completely unsurprising as Member States and their governments are still answerable to their constituencies rather than the EU, though it should be noted that this financial crisis was one of the worst financial crises in the last seventy years. As a result, one could argue that these were highly unusual circumstances that are unlikely to happen again for a long period of time. Ultimately, it is unclear whether overall EU policies or Member States are driving this change. Regardless, it is generally not good governance practice to vary from stated principles, as it can cause confusion and inefficiencies as firms will be unclear as to the rules for which they are accountable. This damage is especially challenging to the EU as an organization since it is a young institution without much in the way of long-term institutional staying power.

That being said, this paper does not fully address the intersection between state aid and the financial crisis. It would perhaps be most useful for a broader economic study of the impacts of state aid on the financial sector to determine what effect it has had on competition and the smooth functioning of the financial sector. Additionally, it will be instructive to see how the DG

Competition ultimately resolves WestLB and whether it attempts to revoke some or all of the aid given to the bank. Further, an investigation into whether other EU policies might have been vindicated by the DG Competition's decisions might shed some light on what is motivating the EU in charting this course away from its state aid control principles.

All in all, the EU's attempt to control state aid seems to have encountered some significant problems during the financial crisis. And it remains unclear whether those challenges are indicative of a crack in the solidarity of Member States within the EU or just the growing pains of a developing entity. The shape of the EU's planned 2012 regulations regarding the financial system and state aid control will provide some insight into the EU's motives, but the truth will be borne out as the DG Competition continues to find itself in difficult situations.