STATE AID FOR THE BANKING SYSTEM: POST-CRISIS REFLECTIONS REGARDING FINANCIAL FREEDOM AND HUMAN DIGNITY

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Abstract: The state aid policy was a main tool for acheivieng macro-stability after the crisis for the EU banking system. However, our paper's objective is to show that more reforms are needed in order to better assure the preservation of property rights for those who are keeping their money in the banks subjected to state aid and recapitalisation, because human dignity and human security are indisputable linked with financial security. Presently it is commonly accepted that the occurrence of the global economic crisis reshaped the EU state aid policy and, as a consequence, immediately after 2008 a series of special regulations concerning measures and schemes granted for stabilizing the financial and banking sector have been adopted. One of these regulations was the BRRD Directive (Bank Recovery and Resolution Directive) which allowed the creation of a common European framework regarding the tools for bailout in the European banking system in order to ensure business continuity of banks, credit institutions and investment firms. If before BRRD adoption the Member States have granted several State aids for rescue and restructuring in the banking sector, after its enforcement a number of restrictive conditions had to be met for such aid to be granted while minimizing the risks of competition distortion and the costs for taxpayers. Based on these realities, this paper discusses the implications of BRRD adoptions and of state aid granted for the stability of the European banking sector, for the financial freedom and for the human dignity in the EU.

Keywords: state aid, competition policy, BRRD, EU banking system, financial freedom, human dignity

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1. Introduction – background of crisis related State aid in the EU

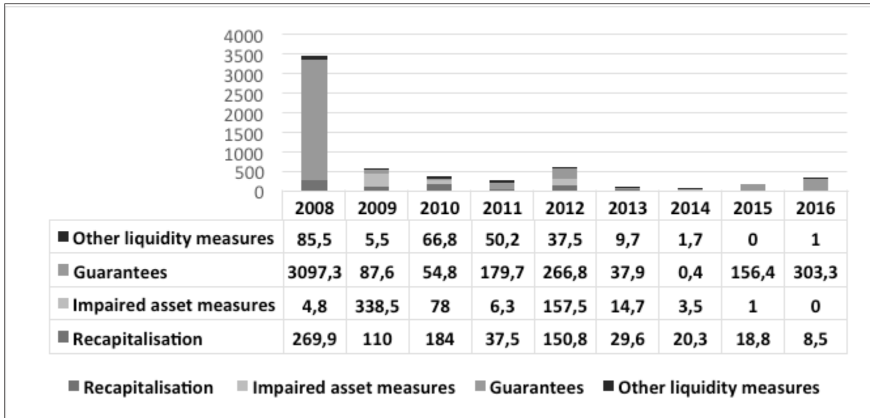
State aid control policy is one of the pillars of the free competition in the EU. Because it involves granting subsidies from public funds hence giving advantages to beneficiaries, especially those for "sensitive" sectors (energy, mining, and construction), this policy was one of the most reformed common policies. Prior to the international economic crisis, the most important reform regulations were the State Aid Action Plan (2005) and the Communication on State Aid Modernization (SAM Communication, 2012).

Both regulations aimed at achieving "less and better targeted" State aid in the EU by supporting Member States to grant measures and schemes for horizontal objectives (SMEs, RDI, environment, renewable energies). Before the special regulations adoption, banks and credit institutions were subject to the State aid regime for large companies, which was rather restrictive while allowing rescue or restructuring support only in exceptional circumstances.

Once the international financial crisis has spread its effects in the Member States economies, it has become obvious that the EU's financial and banking system faces systemic difficulties, with high contagion risks for the real economy.

Câmpeanu (2012) considers that new regulations specifically designed to avoid bank financial collapse and its negative repercussions on the Community economy were necessary because the old regulatory framework was no longer adequate. The first of these regulations was the Temporary State Aid Framework (EC, 2009), followed by the Banking Communication (EC, 2013) and other regulations, which have radically transformed the general regulatory framework for aid granted to the banking sector. According to the most recent State Aid Scoreboard (2017), numerous crisis related state aid for European banks were granted under these regulations during 2008-2016 (see Chart 1).

Chart 1: Crisis related aids approved for the banking system in EU during 2008-2016, by instrument type* (euro billion)



	2008	2009	2010	2011	2012	2013	2014	2015	2016
Other liquidity measures	85,5	5,5	66,8	50,2	37,5	9,7	1,7	0	1
Guarantees	3097,3	87,6	54,8	179,7	266,8	37,9	0,4	156,4	303,3
Impaired asset measures	4,8	338,5	78	6,3	157,5	14,7	3,5	1	0
Recapitalisation	269,9	110	184	37,5	150,8	29,6	20,3	18,8	8,5

Source: Author based on State Aid Scoreboard, 2017

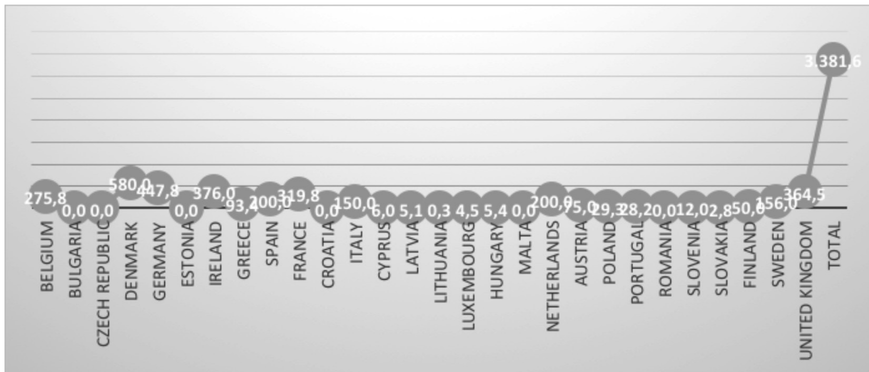
*The instrument type is capital-like aid (recapitalization and impaired asset measures) and liquidity instrument (guarantees and other liquidity measures)

Adamczyk and Windisch (2015) show that crisis related aids played an important role in dealing with the European sovereign crisis, while the European Commission swiftly adapted the State aid framework to put in place an effective response to the financial crisis. They are also highlighted the fact that the European Commission made sure that banks were restructured or resolved under State aid rules, which preserved financial stability and the integrity of the internal market.

As it is illustrated in Chart 1, the largest share of approved aids was granted through guarantees. At EU level, we may however notice a clear reduction of this type of aid in 2013-2014, followed by a new peek in 2016. Denmark and Germany were the Member States that granted the higher amount of guarantees aids during 2008-2016 (see Chart 2). In this regard, even prior the crisis Germany had a tradition in granting large aids as guarantees for banks. In an analysis dedicated to the guarantees aid granted by Germany (Moser, Pesaresi, 2002) it is mentioned the fact that, the German system of public guarantees has conferred more than EUR 1 000 million per year of economic advantage to the German public banking sector, making Germany one of the first

states that has ever granted equivalent amounts on a regular basis (as a scheme). Same study highlights the fact that although even larger aids have been granted in the 1990s to some banks in France and Italy, they were ad hoc interventions in the context of serious banking crises.

Chart 2: Crisis related State Aid approved as guarantees during 2008 - 2016 (euro billion)

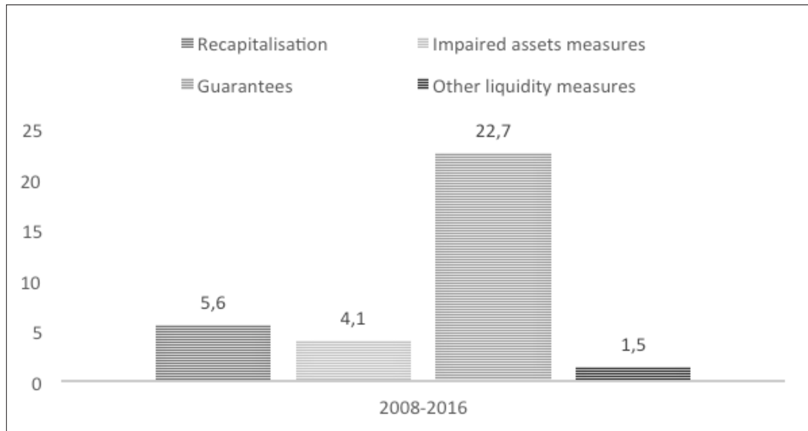


Source: Author based on State Aid Scoreboard (2017)

In a study issued post crisis (CEPS, 2010) it is was mentioned the fact that the financial crisis was one of the biggest challenges for the EU's State aid regime. While this regime was conceived to ensure a level playing field in the single market, the crisis required its adaption to exceptional circumstances. The same study (CEPS, 2010) underlies that the size and nature of the aid, the number of the schemes and the complexity of the cases that had to be examined and approved were overwhelming while never in the EU's half-century of history.

Consequently, the European Commission had to deal with numerous cases of state aid for banks in a very short period of time. During the crisis, 20 bank debt guarantee and 15 bank recapitalization schemes and 44 cases of individual bank aid cases had been analyzed by the European Commission under the State aid rules, while in the post crisis period, the total of crisis related aid amounted to 33.9 % of the GDP of the EU (see Chart 3).

Chart 3: Share of crisis related aid (% of 2016 EU GDP)



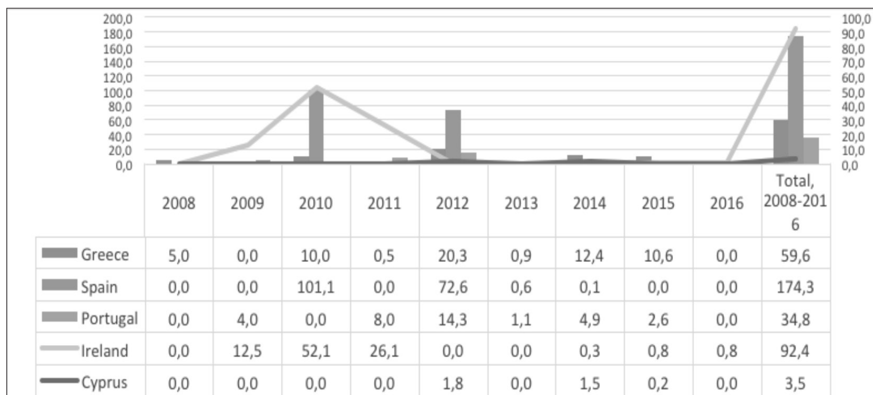
Source: Authors based on State Aid Scoreboard (2017)

2. Sovereign debt crisis impact on State Aid for the banking system and financial freedom

As we have already mentioned, the largest share of capital-like aid instruments was granted for recapitalization. Some studies (Laprévote, Gray and de Cecco, 2017) show that although the funds allocated for rescuing banks through State aids were important, the share of liquidity measures granted in the EU was significantly lower compared with the US. For instance, by 2009 the US banks had received 2.6 percent of GDP in capital injection, while in the EU the total funds granted in the same period was of only 1.7 percent of GDP. Laprévote et al. (2017) are also underlying the fact that many explanation may be given for that state of the affairs: the "wait and see" approach of the banks and their governments, the government capture (the pressure to avoid share holder dilution) and the fact that some of those banks were "too big to rescue" (some governments lacked the fiscal capacity to recapitalize banks with assets many times larger than the size of their national GDP). It should be noted that, during 2008-2014 (the year of BRRD adoption), the Member States which granted the largest share of crisis related state aid were the following: Ireland (EUR 285.2 billion), followed by the United Kingdom (EUR 191.5 billion) and Denmark (146.9 billion euros)

while a number of Member States, including Romania, did not provide such state aid: Bulgaria, Croatia, the Czech Republic, Estonia, Finland, Lithuania, Malta, Poland and Slovakia. It should also be noted that the Member States most affected by the sovereign debt crisis have provided, during the same mentioned period, a high volume of crisis-related State aid (through all instruments) to the financial and banking sector: Spain (EUR 91.3 billion), Italy (EUR 85.7 billion) and Greece (EUR 69.2 billion). Many of those aids were aid for recapitalisation, while in the case of Greece and Spain the peak for such aids has been registered in 2012, with EUR 20.3 billion and respectively in 2010 with 101.1 EUR billion granted as State aid for the recapitalization of banks and of other financial institutions (see Chart 4).

Chart 4: State Aid approved for recapitalisation in the states affected by sovereign debt crisis (euro billion)



	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2008-2016
Greece	5,0	0,0	10,0	0,5	20,3	0,9	12,4	10,6	0,0	59,6
Spain	0,0	0,0	101,1	0,0	72,6	0,6	0,1	0,0	0,0	174,3
Portugal	0,0	4,0	0,0	8,0	14,3	1,1	4,9	2,6	0,0	34,8
Ireland	0,0	12,5	52,1	26,1	0,0	0,0	0,3	0,8	0,8	92,4
Cyprus	0,0	0,0	0,0	0,0	1,8	0,0	1,5	0,2	0,0	3,5

Source: Author based on State Aid Scoreboard, 2017

Since the beginning of the crisis a total of 112 banks in the EU, representing around 30% of the EU banking system by assets, have received State aid. Kroes (2010) has appreciated that banks and financial institutions from EU that faced difficulties during the crisis, but which were otherwise fundamentally sound, were urgently needed to be granted state aid for recapitalisation because their viability problems were inherently exogenous and related to the extreme nature of the crisis-induced financial market situation, rather than to their inefficiency or

excessive risk-taking. With this in mind, however, in order to eliminate the possibility of "moral hazard" intervention, some of the analysis (Foecking, Ohrlander, Ferdinandusse, 2009) showed that recapitalization of vulnerable financial institutions, relevant at EU level, even though it was one way to ensure the proper protection of the interests of depositors and the stability of the system as a whole, should be subject to a number of common conditions applicable to all Member States. In this context, after four years of granting such state aid, the adoption of the BRRD (in 2014) proved to be this framework that would allow the adoption of coordinated measures to support the banking sector in the EU.

3. Consequences of BRRD adoption. Case studies on Italian banks regarding precautionary recapitalisation and implications for shareholders rights

The bank resolution involves an analysis of the situation of a bank by which the authorities of a Member State determine whether the financial institution is facing the risk of bankruptcy and whether, in the absence of an offer of intervention by the private sector, it needs to receive State aid to return to viability in the shortest possible time. Such State aid shall be granted if, by starting the insolvency proceedings, the stability of the banking sector from that Member State could be affected. The BRRD provides the necessary regulations for bank resolution and restructuring especially for large cross-border banking institutions that have benefited from a number of State aid measures in the years immediately following the crisis (see the case of Dexia[1]). The adoption of the BRRD was therefore necessary because the financial crisis has demonstrated that there is a significant lack of harmonized instruments at the level of the

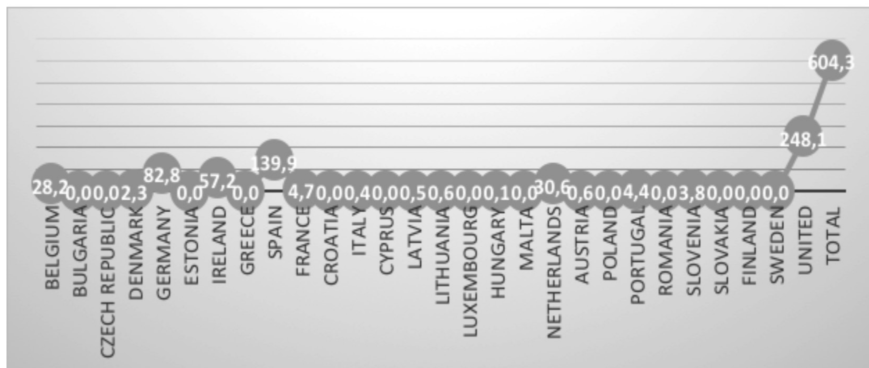
1 Prior to the international economic and financial crisis, Dexia was a major lender for local authorities in Belgium, France and Luxembourg. Under these circumstances, the long-term loans granted by the bank were refinanced by short-term loans on the interbank market. As a consequence, with the credit crunch recorded during the crisis, the bank remained without liquidities. In September 2008, Dexia received state aid from the French, Belgian and Luxembourg governments of EUR 6.4 billion. The state aid granted by Belgium, France and Luxembourg as a result of difficulties threatening the survival of the bank consisted of a capital injection. The state aid consisted from 5.2 billion approved by the European Commission as State aid and a guarantee by the Belgian, French and Luxembourg Government of the bank's debts with a maximum ceiling of EUR 150 million and a liquidity emergency aid granted by the National Bank of Belgium, guaranteed by the Belgian State.

European Union to effectively manage the situation of non-viable or in crisis bank. These instruments were particularly necessary to prevent insolvency or, if it occurs, to minimize negative consequences by maintaining the systemic functions of the institution concerned. During the crisis, these challenges were a major factor that forced Member States to save credit institutions by using taxpayers' money. Although public intervention remains a possible alternative, State aid for the financial and banking system should mainly be used as a recovery tool to catalyse the future sustainability of the European banking system. In order to achieve this, the BRRD provides a number of conditions for harmonized resolution plans, instruments and competencies, all of which represent major changes of State aid for rescue and restructuring in the banking sector regulatory framework, but also a progress towards achieving a functional Banking Union. According to BRRD, the bank in a difficult situation can choose one of the four resolution tools: selling the business to a private buyer, creating a bridge institution, separating the "good" assets of the institution in crisis from the "underperforming" assets and recapitalizing from internal sources. According to the BRRD, if the resolution tools were used to transfer the systemically important services or viable activities of an institution to a different entity (such as a private buyer or bridge institution), the residual funds must be liquidated within an appropriate period taking into account the need for the bank to provide any services or support so as to enable the buyer to carry out the activities or services acquired through the transfer. Each of the instruments proposed by BRRD brings important clarifications on how State aid for rescue and restructuring can be granted in the banking sector. Thus, the sales tool allows the authorities to sell the institution or segments of its business to one or more buyers without the consent of the shareholders. As a resolution-controlled institution, the primary role of the bridge institution is to ensure continuity in providing essential financial services to clients of the insolvent institution. The BRRD requires that the bridge institution should act as a viable entity and be brought back to the market as soon as possible or be liquidated if it is not viable.

The asset segregation tool allows authorities to transfer non-performing or toxic assets to a separate entity. As stipulated in the European Bank Resolution and Restructuring Directive, this instrument should be used in such a way as to prevent the emergence of an unjustified

competitive advantage for the institution in crisis. It should be noted that prior the BRRD adoption many State aid for impaired assets have been granted in the EU member state (see Chart 5).

Chart 5: Crisis related State Aid granted for impaired assets in the banking system during 2008 - 2016 (billion euro)



Source: Author based on State Aid Scoreboard (2017)

According to the BRRD provisions, the resolution of transnational banks must take into account two major imperatives: on the one hand, the need for procedures that take into account the urgency of the situation and allow finding efficient and fair solutions for the whole group, and on the other hand the need to protect financial stability in all the Member States in which the banking group operates. In addition, the resolution authorities must communicate the measures taken for a transnational group within the resolution process. The measures proposed by the group resolution colleges need to be prepared and discussed by the national resolution authorities. Resolution colleges have the obligation to include the views of the resolution authorities in all Member States in which the group is active in order to facilitate, whenever possible, joint and rapid decision-making.

Undoubtedly, the main argument for the BRRD adoption is that it has led to the creation of a harmonized European crisis management framework that minimizes the fiscal and systemic consequences of the collapses of EU financial and banking institutions.

Another positive aspect is that, as mentioned earlier in our analysis, the adoption of the BRRD was aimed at preventing "moral hazard" for the aids granted to banks in difficulty, while ensuring that the financial public contribution is not granted without taking into account the "bail-in" procedure (rescue with internal resources) by the subordinated shareholders and creditors according to national normal insolvency proceedings. Thus, under the BRRD regulations, the senior secure debt instrument, as well as unsecured bank deposits, can be internally cleared, while the deposit guarantee fund will be used for deposits that have been secured.

Regarding the impact of adopting BRRD, an analysis of the return to viability of the European banking sector (Adamczyk, Windisch, 2015) shows that since the onset of the crisis until present almost 25% of the European banking sector has been restructured under state aid rules.

In this context, the question is legitimate: are the BRRD regulations sufficiently flexible so as not to hinder the restructuring and rescue of a bank in difficulty? According to a recent review (Micossi et al., 2016), the BRRD provisions on burden sharing and rescue tools imposed on competition authorities and resolution authorities directly affect risk capital instruments of the banking system and, if not properly applied, can become a source of systemic instability. Basically, a correct application of what BRRD stipulates requires a distinction – not always easy to put into practice - between a crisis of confidence or a liquidity that affects a single bank and one that is likely to reverberate across the national or European banking system. The second type of crisis may lead to endemic consequences not only at national level but even across the EU. If that be the case starting from the premise that a solution to the difficulties of the financial and banking system in the EU can only be achieved through higher security capital requirements is a wrong approach. This is all the more evident presently, nine years after the crisis, while the EU banking system remains exposed to vulnerabilities, and as a result of this, State aid for rescue and restructuring is still needed.

Perhaps the most relevant case is that of Italian banks, whose insolvency procedures have come under the auspices of BRRD. While one-third of the Italian banks' liabilities are held by families, the BRRD bail-out provisions made senior stakeholders, while secondary bondholders have incurred losses of 4 euro billion. Moreover, in the case of Italian banks, a significant part of the bonds were sold to retail investors.

In order to limit the bail-in procedure to a minimum and minimize the state's contribution, a resolution fund of 3.6 euro billion was involved. Against this background, Merler and Minena (2016) are showing that the Italian banks' bond sales explosion is a tangible proof of their lack of confidence in their viability and the failure of the Italian authorities to manage the crisis under the new regulatory framework offered by BRRD. Despite the potential vulnerabilities of BRRD's enforcement the European authorities remain optimistic that its implementation will produce positive effects on long-term. Thus, in a European Commission report on competition policy (published in 2016), it appears that far from hampering the granting of State aid to the banking sector, BRRD sets the necessary framework to preserve the stability of that sector while allowing to banks and financial institutions to draw up recovery plans and to update them on a regular basis, setting out the measures to be taken to restore their viability.

It should be noted that BRRD introduced the default option for failing banks to go into normal insolvency proceedings. Only if the resolution authority decides that it is in the public interest to do so, can a bank be resolved in line with the Bank Resolution and Recovery Directive. The Bank Resolution and Recovery Directive also required that State aid to failing banks (notified to the Commission after 1 January 2015) may be granted only if the bank is put into resolution. The only exception is a so-called "precautionary recapitalisation", allowing State aid outside of resolution in narrowly defined circumstances (see Figure 1).

Figure 1: Conditions of "precautionary recapitalisation" under BRRD provisions

The European Central Bank needs to declare that the bank is solvent	The State support shall not be used to offset losses that the institution has incurred or is likely to incur in the future
The State support is temporary (the State should be able to recover the aid in the short to medium term)	The State support has received final approval under EU State aid rules.

Source: Author on studied literature

Note: The existing State aid rules refers to 2013 Banking Communication requiring that the use of taxpayer money to be limited through appropriate burden-sharing measures (shareholders and subordinated debt holders contribute), while depositors and senior creditors are not required to contribute under State aid rules, but a credible and effective restructuring plan to ensure the bank is viable in the long-term is needed.

As some authors (Magnus, Mesnard, 2016) show while precautionary recapitalizations are meant for solvent institutions, BRRD also enable the public recapitalization for the ones that are failing or likely to fail. The public recapitalization requires a resolution scenario and needs the mandatory participation from the shareholders and creditors.

Recently (in 2017), a precautionary recapitalization was applied to the Italian bank Monte dei Paschi di Siena that stood out as the worst performer among all 51 banks which were scrutinized during the EBA's 2016 EU-wide stress test (European Parliament (EP), 2017). In the evaluation concluded by the European Parliament regarding precautionary recapitalizations under the Bank Recovery and Resolution Directive (EP, 2017) it was stated that a long negotiation between the Italian authorities and the Commission was necessary before the precautionary recapitalization was approved on 4 July 2017, because, initially, the Monte dei Paschi di Siena failed to raise the amount of capital required from private investors (EUR 5 billion). After receiving a total capital of EUR 8.1 billion (that included the conversion of junior bondholders for EUR 4.3 billion, and a capital injection of EUR 3.9 billion by Italy), the bank was saved. From the capital received EUR 5.4 billion was approved as precautionary recapitalization by the Commission, meaning the bank was not deemed failing or likely to fail under Article 32 BRRD.

If the precautionary recapitalization was a success for the Monte dei Paschi di Siena bank, it was not the case for others two Italian banks: Banca Popolare di Vicenza and Veneto Banca. Both were rescued by the Atlante fund in 2016. The Atlante fund aimed to recapitalize weak Italian lenders and purchase portfolios of NPLs after the two capital raising exercises of Banca Popolare di Vicenza and Veneto Banca, which had been fully underwritten by Itensa San Paolo and Unicredit respectively, failed. According the data from the EP (2017) the fund injected EUR 2.5 billion of capital in the two lenders in 2016 and a further EUR 0.9 billion in January 2017 in advance of the future capital increase. However, after evaluation of the European Central Bank, it was concluded (in June 2017) that they were failing or likely to fail, hence the resolution of those banks

was not warranted on the ground of public interest. As a consequence the banks were liquidated under Italian insolvency laws. This case shows that under BRRD provision it is extremely important to correctly assess the conditions for requesting a precautionary recapitalization.

Conclusions

According to the latest Scoreboard of State Aid granted in EU in 2016, the level of State aid for the banking sector, both approved and used, was the lowest since the beginning of the crisis. In 2016 for the first time since the beginning of the financial crisis no recapitalization aid was used for any bank. Although the latest State Aid Scoreboard shows that the European banking sector is relying less and less on government guarantees for liquidity support, as it is able to find the necessary liquidity on the market, at the beginning of crisis State aid was an essential tool since numerous European banks were contaminated by the lack of liquidity, the widespread of depreciated assets, and even the bankruptcy risk. In addition to specific issues, especially related to mortgage credit and mortgage-backed assets, or to the losses generated by the adoption of risky strategies by various banks, the European banking sector has experienced a general erosion of confidence.

Under the circumstances of the global financial crisis and especially in the post-crisis period, it was necessary to grant State aid not only though the traditional measures for firms in difficulty, but also in the form of guarantees, capital injections and guarantee for depreciated assets, in order to respond to the exceptional systemic risks generated by the crisis in the European banking sector, but those aids had also direct implications for the financial freedom in the banking systems across the EU.

In this context, the European Bank Resolution and Restructuring Directive (BRRD) has provided a comprehensive regulatory framework that includes specific solutions for the European banks confronted with crisis situation. The BRRD also established regulations on rescue and restructuring plans of large cross-border banking institutions that already benefited from a number of state aid schemes and measures, increasing the level of coordination between those aids. However, some BRRD restrictive regulations may have a negative impact on national banking systems and on the population (see the case of Italian banks). In this case, the post-notification assessment conducted by the European Commission

should analyse the bank's situation as well as whether the denial of external bailing can trigger an endemic crisis in the national banking system.

Other vulnerabilities of BRRD are related to the fact that the use of resolution tools may affect the rights of shareholders and creditors, hence created negative spillover effects for all the citizens from EU. Thus, the power of the authorities to transfer some shares of or all assets of an institution to a private buyer, may create negative spillover effects. In addition, the power to decide which debts of an institution in difficulty are to be transferred in line with the objective of ensuring continuity of services and avoiding adverse effects on financial stability could affect the equal treatment of creditors. Resolution measures should therefore be taken only when this is necessary in the public interest. Moreover in such situations where creditors of a transnational bank of the same category are treated differently in the context of a resolution measure, such distinctions should be proportionate with the risks addressed and not discriminatory on the basis of nationality.

Looking on the crisis related State Aid data we may conclude that EU banking system was rescued thanks to coordinated efforts from government and the European Commission. The recovery of some banks was in many cases a common effort between Member States (see the Dexia case), but as the data on approved aids show, some states have been more aware of the new state aid framework opportunities, hence a more uneven distribution of such aids after than before the crisis.

Moreover there are analyses showing that more reforms are needed in order to better assure the preservation of property rights for those who are keeping their money in the banks subjected to state aid and recapitalisation, because human dignity and human security are indisputable linked with financial security which cannot be achieved without better guaranteeing bank accounts security for the population even in cases of insolvency or restructuring procedure according with the state aid law.

While BRRD provide a comprehensive regulatory framework for state aid in the banking sector, the power of the authorities to transfer some shares of or all assets of a bank to a private buyer, without the consent of the shareholders, may adversely affect their ownership rights and even their human dignity.[2]

2 Ioan-Gheorghe Rotaru, "Plea for Human Dignity", in *Scientia Moralitas. Human Dignity - A Contemporary Perspectives*, The Scientia Moralitas Research Institute, Beltsville, MD, United States of America, 2016, Volume 1, pp. 29-43.

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