State Aid and Public Procurement: The Evolution of State Aid to Banks: A Post Crisis Review
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1. Introduction

The EU framework that regulates the granting of state aid to banks has evolved significantly from the period before the 2008 financial crisis to its current status. The pre-crisis framework did not contain specific rules for financial institutions, which were treated as any other regular undertaking in financial difficulty. In light of the competitive distortions that the rescue of failing undertakings entails, those rules were quite restrictive and proved to be inadequate to deal with the unprecedented scale of the crisis that put many European banks in risk of failure, threatening the region’s financial stability. This led the European Commission to adopt a set of rules that applied specifically to financial institutions, softening its approach to rescue aid by, *inter alia*, expediting its approval. As market conditions improved, several years after the beginning of the crisis, the rules were again adapted and stricter controls to the granting of state aid were reintroduced. The current framework, in conjunction with the new resolution regime of the Banking Union, applicable since 2015, seeks to avoid state-funded bailouts of banks in all but the most exceptional circumstances. While preserving financial stability is still a fundamental objective of both regimes, substantial safeguards have also been introduced that are aimed at minimizing competitive distortions as well as protecting taxpayers by rendering the use of state resources a measure of last resort.

The purpose of this paper is to review the evolution of state aid rules applying to banks, from the pre-crisis era to the present, and critically assess the implications of the current framework in terms of safeguarding financial stability, preventing unnecessary competitive distortions, and minimising the use of public resources, which are identified as the three main objectives pursued. The paper also evaluates how the rules are in practice applied today in conjunction with the rules on bank resolution set out in the Bank Recover and Resolution Directive (the “BRRD”) and the Single Resolution Mechanism Regulation (the “SRMR”). The structure of the paper is as follows. Section 2 provides a critical overview of the applicable legal framework. After briefly explaining the general EU framework of state aid control and discussing the rationale for granting state aid to failing banks, it examines the rules that apply specifically to banks and how these rules have evolved. Their relationship with the Banking Union’s bank resolution rules is also explored. Section
3 will discuss three cases decided under the current framework, the cases of Italy’s Banca Monte dei Paschi di Siena, Spain’s Banco Popular Español S.A and Italy's Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A., and assess their different outcomes in light of the objectives identified.

2. State aid rules that apply to banks

2.1. State aid control in the EU

The substantive rules on state aid in the EU are laid down in Article 107 TFEU. According to this provision, measures which constitute state aid within the meaning of Article 107(1) are in principle prohibited, unless they fall within one of the exemptions set out in paragraphs 2 and 3. Aid that is covered by one of these exemptions is deemed to be in the common interest and is referred to as “compatible”.¹

The main rationale for controlling state aid at EU level is the prevention of distortions of cross-border competition and trade, which are indispensable for the functioning of the internal market.² When a government intervenes in the market to aid a certain undertaking, the beneficiary of that aid gains an advantage over its competitors that is not based on it being the most efficient producer or offering the best or cheaper products. This reduces incentives for unsubsidised entities to compete and may even, in certain cases, create barriers to entry. As a result of such competitive distortions, consumers in the EU may be faced with higher prices, lower quality goods and less innovation.³ Nevertheless, it is recognised that, in some occasions, it may be necessary for states to aid particular economic activities, industries or regions to advance objectives of common interest to the Union. This is reflected in the exemptions carved out in Article 107(2) and (3) TFEU, which allow for aid to be given, inter alia, to “remedy a serious disturbance in the economy of a

¹ European Commission Competition website.
² Hildebrand 2014, p. 2.
³ State Aid Action Plan, p. 3.
Member State". Since the financial crisis, this has been the legal basis for granting state aid to banks in financial difficulty.

To ensure that these rules are applied uniformly across the EU, the European Commission is in charge of ensuring that state aid granted by different member states complies with the Treaty. In particular, the Commission is given wide discretion to declare certain aid measures to be compatible with the internal market, pursuant to Article 107(3) TFEU. In order to exercise this discretion in a predictable manner, the Commission regularly issues guidelines and communications, setting out the criteria that will guide its assessment of compatibility of measures falling under Article 107(3). These instruments are not binding on members states; however, according to the ECJ in Kotnik, by adopting those guidelines, the Commission imposes a limit on the exercise of its discretion and cannot, as a general rule, depart from them. As of today, the Commission has issued seven Communications concerning state aid given to banks, which will be explored in more detail below.

### 2.2. Rationale of granting state aid to banks

During the financial crisis of 2008, a lot of banks of different European member states were experiencing tremendous difficulties, necessitating significant amounts of state aid to prevent their collapse. Normally, when an undertaking is in difficulty, it does not make sense from an economic perspective to rescue this undertaking. This is because, in a market economy, it is normal, and desirable, that less efficient undertakings exit the market, at the benefit of more efficient ones. Therefore, artificially preserving a failing undertaking in the market through state aid is highly distortive of competition. However, unlike most regular undertakings, banks are considered to be “too big to fail”, making their rescue an objective of common interest, which justifies the granting of state aid. There are two main reasons for this.

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4 Article 107(3)(b) TFEU.
5 Case C-526/14 Tadej Kotnik and Others v Državni zbor Republike Slovenije, [2016] ECLI:EU:C:2016:570, para 40.
7 Wojcik 2016, p. 93.
First, banks are essential for the economy. Allowing them to fail, and therefore be submitted to traditional bankruptcy proceedings, may mean that their critical functions, such as payment services, lending activities and maintaining the availability of deposits to depositors, are discontinued.\textsuperscript{8} This would, in turn, disrupt the normal functioning of the economy as a whole.

Secondly, allowing individual banks to fail is deemed to generate systemic risk and financial instability. This is because banks are interconnected, so that the failure of one could have severe knock-on effects on other banks and, by consequence, negatively affect the domestic economy and those of other countries, as the collapse of Lehman Brothers in 2008 illustrated.\textsuperscript{9}

There is, therefore, a clear public interest objective that justifies the granting of state aid to banks. As the Commission stated in its Staff Working Paper, “the social costs of a bank failure are relatively large and largely exceed the private costs”.\textsuperscript{10} On the other hand, there are also several disadvantages to granting state aid to failing banks. First of all, bank bail-outs prompt moral hazard, namely excessive risk-taking by banks in the expectation that they will be saved by their governments if they get into financial trouble. Leading up to the financial crisis, many banks in the EU engaged in risky practices, or used unsustainable business models, to gain profit, which was part of the cause of their ensuing difficulties.\textsuperscript{11} Yet, instead of letting market forces naturally lead them out of the market, states granted those banks significant amounts of aid to prevent their collapse. This is also harmful to competition as the rescue of a bank, despite its reckless behaviour, weakens incentives for unaided competitors to invest, innovate and otherwise compete on merits.\textsuperscript{12} It is, lastly, worth highlighting that bank bail-outs often entail extremely high costs, which are borne by taxpayers. For example, in the period between 2008 and 2014, Euro area governments’ total fiscal support to the financial sector amounted to 8% of the...
region’s GDP. For many, this huge amount of economic assistance that financial institutions received, in many cases to remedy their own hazardous practices, was untenable, especially at a time of general economic hardship.

It can, therefore, be concluded that, while state aid to banks is often essential to safeguard financial stability, its granting creates competitive distortions, exacerbates moral hazard, and requires large public expenditure. The following sections will examine how EU state aid rules have sought to address these concerns at different stages of their evolution.

2.3. Pre-crisis framework: The Rescue and Restructuring Guidelines

Before the crisis broke out, there was no specific framework in place to assess the compatibility of state aid to the financial sector. The rescue and restructuring of banks was handled under the Rescue and Restructuring Guidelines (the “RRGL”), which is a general framework that applies to all firms in difficulty. The RRGL distinguish between two kinds of aid; rescue and restructuring aid. Rescue aid can be given only in the form of short-term liquidity support, whose duration does not exceed six months. Its aim is to help a company overcome temporary liquidity shortage or to give the company the possibility to come up with an appropriate plan to remedy the difficulties it faces. Restructuring aid, on the other hand, has a longer duration and its purpose is to restore a firm’s long-term viability. Also, unlike rescue aid, restructuring aid can take in essence any form, including capital support. The latter, however, can be given only upon the submission and approval of a restructuring plan, which should demonstrate how the beneficiary will restore its long-term viability as soon as possible.

The RRGL are based on Article 107(3)(c) TFEU and the criteria they set out for compatible aid are based on three main principles: restoring a firm’s long-term viability,

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13 Hadjiemmanuil 2017a.
limiting state aid to the minimum necessary by requiring the beneficiary’s own contribution, and avoiding undue distortions of competition. In broad terms, the Guidelines allow rescue aid to a limited extent, but subject to few instrument-specific criteria, while they provide that firms in need of more structural support are obliged to restructure. This approach reflects the desire to avoid using state aid to artificially keep alive undertakings with unsustainable business models, as this would considerably distort competition.

The RRGL framework had been adequate, up until the crisis, to deal with the failure of banks in isolated cases. However, during the financial crisis, these Guidelines proved to be insufficient to address the systemic failure of banks across the EU. The RRGL structure was focused on assessing the compatibility of state aid granted to individual firms on a case-by-case basis, and could not be used to take market-wide measures to stabilise the economy. Moreover, as discussed, restructuring measures could not be approved immediately, as they required the prior submission and approval of a restructuring plan. These features of the RRGL were not in tune with the problems that emerged during the financial crisis.

It was, therefore, clear that the state aid framework needed some adaption to make it fit to deal with market-wide problems like the 2008 banking crisis. In the next chapter, the framework developed by the Commission during the crisis will be discussed which could be seen as an appropriate, albeit problematic, adaption.

2.4. Crisis framework: the four Crisis Communications

To deal with the systemic failure of banks at the beginning of the financial crisis, the Commission adopted four sector-specific Communications addressing the compatibility of state aid to the banking sector. These were based on Article 107(3)(b) TFEU, which was deemed to be the suitable legal basis to allow state aid to be given to banks during the

crisis as the failure of certain banks could create “a serious disturbance in the economy of a Member State”, and thereby also threaten financial stability of the EU as a whole.

Unlike the RRGL, the four Crisis Communications were adjusted to the crisis situation facing the banking sector in 2008 and this is reflected in the softer approach taken by the Commission in this new framework. For example, one of the main differences between the Crisis Communications and the RRGL was that, under the former, liquidity support could be provided for a longer period than six months without triggering the restructuring obligation. Furthermore, state recapitalisations or asset protection measures, known as structural aid, were allowed as a form of rescue aid, which was not possible under the RRGL. The Commission approved such measures by a no-objection decision, if certain criteria were met. This procedure made it possible for the Commission to speedily approve rescue measures, if certain conditions were met, while postponing the examination of the restructuring plan, as normally needed in case of restructuring aid. Another deviation from the previous rules was the authorisation of small recapitalisation (less than 2% of bank’s risk weighted assets) without an obligation to restructure. Finally, the crisis framework made it possible for member states to provide market-wide aid measures by allowing liquidity and recapitalisation schemes for large companies and not just for SMEs.

The first and main Communication adopted by the Commission during the crisis was the Banking Communication on 13 October 2008. The purpose of this Communication was to provide guidance on the compatibility of recapitalisation measures and guarantee schemes. These are both instruments to support, on the one hand, capital and, on the other hand, the liquidity of banks.

The Banking Communication indicated how the Commission intended to apply the TFEU state aid rules in cases were member states individually assisted financial

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22 Geeroms et al. 2014, p. 1124.
institutions during the financial crisis.\textsuperscript{28} Whenever a state created a support scheme, this needed to be reviewed by the Commission. The scheme could be a guarantee covering the liabilities of financial institutions or the recapitalisation of financial institutions.\textsuperscript{29} The Commission used a list of criteria mentioned in the Communication to assess these support schemes. This list made it possible for the Commission to assess the schemes rapidly and, therefore, react efficiently to the crisis situation at hand.

The other three Communications adopted by the Commission during the crisis were the Recapitalisation Communication, the Impaired Assets Communication, and the Restructuring Communication. The Recapitalisation Communication provided member states detailed guidance as to whether specific forms of recapitalisation were acceptable state aid.\textsuperscript{30} The Impaired Assets Communication provided guidance on the application of state aid rules to asset relief, which is a specific measure to safeguard financial stability. Its usefulness lied on removing the uncertainty surrounding the valuation and location of impaired assets and, as such, it was seen as a possible solution for the insufficient flow of credit.\textsuperscript{31} Finally, the Restructuring Communication described the criteria used by the Commission to assess the compatibility of restructuring aid and the appropriateness of the restructuring plan accompanying such aid. The Restructuring Communication is based upon three pillars: restoration of long-term viability, burden sharing and the limitation of distortions of competition and ensuring a competitive banking sector.\textsuperscript{32}

The crisis framework was substantially updated in 2013 through another Communication adopted by the Commission that replaced the 2008 Banking Communication and specified the other three Crisis Communications. This is the 2013 Banking Communication and is discussed in the following chapter.
2.5. The current framework

2.5.1. Tightening the rules: the 2013 Banking Communication

On the basis of the four Communications described above, the Commission was able to speedily approve a large number of notified aid measures for the banking sector in the first years of the crisis.\textsuperscript{33} While this helped to stabilise markets,\textsuperscript{34} the negative side effects of those measures, and the Commission’s flexible approach, were soon felt. In many countries, the banking sector’s financial troubles, and the huge amounts of public money needed to bail them out, exacerbated the sovereign debt crisis which ensued.\textsuperscript{35} Moreover, since EU member states were not all able to support their failing banks to the same extent, due to the differing strengths of their public finances, the various rescues that were carried out contributed to the creation of an unlevel playing field among banks in the internal market.\textsuperscript{36} Banks, whose governments had become heavily indebted and could no longer guarantee their rescue, faced higher funding costs,\textsuperscript{37} which was not attributed to their qualities as financial service providers but rather the state of the economy they happened to be a part of.

It was also made clear that the Commission’s approach of allowing immediate capital injections, without requiring the submission of a restructuring plan, delayed a proper recognition of the banks’ difficulties and, therefore, resulted to more money being granted that would be appropriate in certain cases. For example, some banks which probably should have been wound down as their viability could not be restored were initially recapitalised at high cost.\textsuperscript{38} The excessive levels of capitalisation provided in some cases were also inflated by the lack of any substantial contribution by the banks’ shareholders and creditors to the rescuing costs.\textsuperscript{39}

\textsuperscript{33} Hadjiemmanuil 2017a.
\textsuperscript{34} Geeroms \textit{et al.} 2014, p. 1137.
\textsuperscript{35} Wojcik 2016, p. 93.
\textsuperscript{36} Wojcik 2016, p. 93.
\textsuperscript{37} Geeroms \textit{et al.} 2014, p. 1151.
\textsuperscript{38} Geeroms \textit{et al.} 2014, p. 1137.
\textsuperscript{39} Geeroms \textit{et al.} 2014, p. 1138.
It was in this background that the Commission decided to adopt in 2013 a new Banking Communication, replacing the 2008 Banking Communication and imposing some stricter limits to the granting of state aid to banks. Specifically, the new Communication reintroduced the requirement of the RRGL for a restructuring plan to first be submitted before any structural aid, in the form of recapitalisation or impaired asset measures, is authorised. This means that banks with capital shortfalls will be closely scrutinised to determine whether their viability can be restored, before receiving any aid by their governments. More notably, the 2013 Communication considerably expands the scope for private contribution to a bank’s restructuring process so as to decrease to the greatest possible extent the need for public support. First, the Communication provides that as soon as a capital shortfall is detected, private capital-raising measures should be undertaken by the bank to remedy this shortfall. These could include, for example, voluntary conversions of subordinated debt instruments into equity or sales of the bank’s assets and portfolios. If the identified capital shortfall remains, the Communication foresees the full contribution of the bank’s shareholders and subordinated debt-holders to covering the shortfall – the so-called “burden-sharing” – before public recapitalisations or impaired asset measures can be resorted to. Burden-sharing in practice means that shareholders’ shares are written down or transferred to creditors, while debt-holders have their debt instruments converted into equity. It is only if both capital raising and burden-sharing measures fail that the remaining capital shortfall can be covered by the injection of public money.

The 2013 Communication’s emphasis on burden-sharing and the need to maximise private capital-raising was intended to remedy some of the problems that arose during the crisis as a result of the excessive amounts of aid given to rescue banks. The hurdles that are put in place before state aid can be authorised are meant to reduce the member states’ recourse to a bailout whenever one of their banks gets into trouble. This is expected to level the playing field between similar banks located in different member states and

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40 Banking Communication 2013, points 34 and 50.
41 Banking Communication 2013, point 32.
42 Banking Communication 2013, point 35.
43 Banking Communication 2013, point 44.
44 Banking Communication 2013, point 41.
45 Banking Communication 2013, point 49.
alleviate the burden on taxpayers, while making shareholders and creditors more responsible for their investments. The changes brought forward must also be seen in the light of the Banking Union’s single resolution regime that was being developed at the same time and which was similarly premised on putting an end to state-funded bailouts. The two main instruments of this regime, the BRRD and the SRMR, lay down common rules to manage the resolution of failing banks and, in doing so, they seek to render state aid “exceptional”, by prescribing its use only if all the other options are exhausted. There are several features of the resolution regime designed to achieve this, which are examined below. It should be noted that, since the BRRD applies to all EU member states and the SRMR essentially takes over the former’s material rules, the section below will only refer to the relevant rules in the BRRD.

2.5.2. The exceptional(?) nature of state aid under the BRRD

Under the rules of the BRRD, a failing bank is in principle faced with two options, namely to be either liquidated or resolved. Liquidation is the default option, except in cases where the relevant resolution authority determines that it is in the public interest to resolve the bank because, for example, liquidation could jeopardise financial stability. This is an important feature because, in principle, it means that banks will be allowed to fail, probably more so than ever before. Resolution under the BRRD rules aims to ensure the continuity of the bank's critical functions so as to prevent systemic failure. Once this has been controlled, and the resolution authority has separated the sustainable from the unsustainable operations of the bank, the unviable bank can be allowed to close down. Bank closure can, therefore, be expected to be a more frequent phenomenon under this system. State aid is prevented because the need for it, according to Article 32(4) of the BRRD, triggers resolution. There are only three exceptions to this rule, listed in Article 32(4)(d), the main one being the so-called “precautionary recapitalisation”.

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46 Hadjiemmanuil 2017b.
47 Nicolaides 2017.
48 Articles 32(1), (5) and 31(2) BRRD.
49 Nicolaides 2016, p. 223.
Precautionary recapitalisations are meant to apply to banks which, although in need of recapitalisation, are not deemed to be failing or likely to fail. In these cases, the need for state intervention is rather founded on the risk that the capital shortfall of such banks could quickly deteriorate as a consequence of ‘a serious disturbance in the economy’ of a member state and, thus, generate financial instability.\textsuperscript{50} To fall within this exception, the recapitalisation has to comply with a number of conditions; \textit{inter alia}, the need of capital injection has to be pointed out by the results of stress tests, the beneficiary institution has to be solvent, and the aid it receives must be of a temporary and precautionary nature and comply with rules of the state aid framework. These conditions have been argued to be highly restrictive and considerably limit the scope of this exception,\textsuperscript{51} which is confirmed by the few cases that have so far used or tried to rely on this exception. While precautionary recapitalisation was approved for two Greek banks in 2015, Piraeus Bank and National Bank of Greece, and for Italy’s Monte dei Paschi di Siena in 2017, it was not granted for Banca Popolare di Vicenza and Veneto Banca, also in Italy, as the two banks were determined to be failing or likely to fail.\textsuperscript{52} The different treatment of those banks indicates that the conditions for access to precautionary recapitalisation are meaningfully enforced by EU authorities. It is also worth pointing out that, just because aid is granted in the context of a precautionary recapitalisation, this does not mean that all the money that needs to be contributed comes from the public purse or that investors are spared. The recapitalisation will have to first be approved by the Commission on the basis of the state aid framework currently set out in the 2013 Banking Communication, which, as already discussed, requires maximum burden-sharing before a recapitalisation can be approved. Indeed, the two Greek cases referred to above illustrate that the extent to which this will take place can be quite far-reaching, as the burden-sharing that was carried out in those cases affected even the banks’ senior debt-holders.\textsuperscript{53} It, thus, went beyond the minimum level prescribed in the Communication in reducing the provision of public financing.

\textsuperscript{50} Bodellini 2017, p. 155.
\textsuperscript{52} Véron 2017, p. 7.
\textsuperscript{53} Bodellini 2017, p. 159.
Another way in which the BRRD seeks to make state aid exceptional is by placing it at the end of a line of measures that can be employed in the context of a bank’s resolution. Specifically, under the Directive, the main resolution tool to be used to resolve a bank is the bail-in. Bail-in is functionally equivalent to burden-sharing but wider in scope, as, in principle, all liabilities of a bank are subject to bail-in, including those of senior debt-holders, unless they are mandatorily or by decision excluded from it under Article 44(2) or (3) respectively. The bail-in tool can be employed to recapitalise a bank, or it can be utilised in connection with and in support of the application of other resolution tools. It is only after shareholders’ and creditors’ contributions have covered at least 8% of the bank’s liabilities that national resolution funds, established by virtue of the BRRD, can be accessed. Although these funds technically qualify as state aid within the meaning of Article 107(1) TFEU, as the control over those funds by the state renders them state resources, it is noteworthy that those funds are made up of contributions provided by the banks themselves. Their establishment, therefore, constitutes another form of removing the burden of dealing with a failing bank off taxpayers. Finally, state aid, through the use of so-called “government financial stabilization tools”, can be given only as a last resort if other methods prove to be insufficient, only in “very extraordinary situation of a systemic crisis”, and even then subject to shareholders and creditors first making a contribution amounting to 8% of the bank’s liabilities. This form of government intervention is, therefore, allowed only under strict circumstances and not as an alternative financing source to the bail-in but only as a complement to it.

Nevertheless, despite the BRRD’s explicit aim to reduce reliance on public funds, and its numerous features designed to make state aid “exceptional”, its existence has not rendered the disbursement of state aid rare in practice, as is shown by the case studies examined further below.

54 Article 43(2) BRRD.
55 Article 44(5) BRRD.
57 Nicolaides 2016, p. 224.
58 Articles 37(10) and 56-58 BRRD.
59 Article 56(3) BRRD.
60 Article 37(10) BRRD.
61 Article 37(10)(a) BRRD.
62 Article 31(2)(c) BRRD.
2.5.3. The shift from bail-out to bail-in: an appraisal

It is clear that the key characteristic of the current system for dealing with banks in difficulty is the shift of preference from bail-out to bail-in, and its equivalent burden-sharing, the introduction of which were meant to end the excessive reliance on state aid by the banking sector. However, it has been doubted whether such heavy emphasis on bail-in is appropriate in light of the other key objective identified above, which is the preservation of financial stability. As previously explained, preserving financial stability was the key rationale behind the granting of state aid to banks, and bail-in has been designed to replace this in a way that avoids excessive public spending. However, bail-in, and the general anti-bailout logic of the current regime, have been criticised for being inappropriate to safeguard financial stability in all occasions. In particular, it has been argued that, in certain situations of systemic crisis, bail-in may actually aggravate the situation rather than improve it.\(^63\) This is due to two main reasons.

First, the application of the bail-in tool may create contagion.\(^64\) As has been mentioned previously, banks are interconnected and their debt instruments are often held by other banks. Thus, the write down or conversion of a bank’s liabilities, which are other banks’ assets, may have a domino effect on those other banks and jeopardise financial stability.

Secondly, the possibility of a bail-in taking place may make it more difficult for banks to obtain funding.\(^65\) Knowing that their debt instruments may be subjected to a write down or a conversion, creditors may be more reluctant to invest in a bank, or demand a higher interest rate to reflect the higher risk of their investment. As a result, the refinancing costs of banks may increase, potentially to prohibitive levels. This could be particularly harmful during a system-wide banking crisis, as it is precisely at such a point when banks will be striving to draw funding through the issuance of capital or debt instruments.\(^66\)

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\(^{63}\) Bodellini 2017, p. 144; Hadjiemmanuil 2017a.

\(^{64}\) Bodellini 2017, p. 150.

\(^{65}\) Van Lambalgen 2018, p. 102.

\(^{66}\) Hadjiemmanuil 2017a.
It can therefore be argued that, while bail-in is useful in terms of alleviating the recourse to taxpayers’ money, its application may not always be desirable from the perspective of financial stability. However, it is important to note that, at least in principle, both the Banking Communication and the BRRD contain safeguards for such negative effects on financial stability to be avoided through exceptions to the application of burden-sharing and bail-in respectively in certain occasions. Specifically, both point 45 of the 2013 Banking Communication and Article 44(3)(c) of the BRRD provide that burden-sharing or bail-in should not be applied in cases where this could generate financial instability. This is very likely to be the case when, for example, a significant portion of the liabilities of a bank is held by other banks or other financial institutions. The extent to which the Commission or the relevant resolution authorities will be willing to rely on this flexibility has, nonetheless, been questioned. For example, Hadjiemmanuil cites the case of Italy’s Monte dei Paschi bank – discussed in more detail below – as an example of the Commission’s insistence on burden-sharing by creditors, even in the face of a simmering crisis such as that affecting the Italian banking sector.\(^\text{67}\)

3. Case studies: state aid in practice under the current framework

Following the examination of the substance of the current state aid framework and its interaction with the resolution regime of the Banking Union, this chapter will now focus on how the new rules have been applied in practice. In the next sections, three different cases decided under the current framework, but which resulted in considerably different outcomes, will be discussed to illustrate the effects of the new rules and their exceptions. The three cases concern Banca Monte dei Paschi di Siena (“MPS”),\(^\text{68}\) Banco Popular Español S.A (“BPE”),\(^\text{69}\) and Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A. (the “Veneto Banks”).\(^\text{70}\) MPS underwent restructuring and benefited from a precautionary recapitalisation, BPE underwent resolution, and the Veneto Banks were liquidated, which

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\(^{67}\) Hadjiemmanuil 2017b.  
\(^{68}\) New aid and amended restructuring plan of Banca Monte dei Paschi di Siena 2017.  
\(^{69}\) Decision to take resolution action in respect of Banco Popular Español, S.A. 2017.  
\(^{70}\) Decision concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza SpA 2017; Decision concerning the assessment of the conditions for resolution in respect of Veneto Banca SpA 2017.
is regulated under national insolvency law. After explaining the factual and legal circumstances of each case, the final section of this chapter critically assesses their different outcomes and the conclusions that can be drawn from them.

3.1. Banca Monte dei Paschi di Siena

MPS is the fourth largest Italian bank with a total balance sheet of €153 billion, risk-weighted assets of €65.5 billion, 25,566 employees and 2,032 branches. Therefore, the bank is essential for the Italian economy and allowing it to fail would definitely have caused disruption of the normal functioning of the economy. In 2016, it had been revealed, through results of the 2016 EU-wide stress test, that although MPS had sufficient capital in the normal scenario, it experienced a capital shortfall in the adverse scenario. Consequently, MPS attempted to raise new private capital but stated in its press release that it had not been successful to complete the required €5 billion capital strengthening transaction, and thus turned to the state. On 23 December 2016, the Italian authorities approved Law-Decree 237/2016 setting out the legal framework for precautionary recapitalisations and liquidity aid. Seven days later, MPS applied for extraordinary public support in the form of precautionary recapitalisation in order to address its capital shortfall, for which the ECB gave provisional approval at the end of 2016. The Commission approved the recapitalisation in decision SA.47677 after the ECB confirmed that MPS was solvent. On the 28th of June 2017, the Italian authorities notified a recapitalisation of up to €5.4 billion. After the voluntary burden-sharing-related conversion of subordinated debt into equity, eligible retail sub-ordinated debt holders had the right to accept a settlement agreement with MPS to exchange their shares, resulting from the conversion, into a senior bond. According to the figures of MPS and taking into account the total state aid budget of €5.4 billion, the maximum possible take up of the settlement was €1.5 billion. In conclusion, the state recapitalised MPS as follows: i.) by subscribing

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72 Nicolaides 2017.
74 New aid and amended restructuring plan of Banca Monte dei Paschi di Siena 2017, p 5.
75 Nicolaides 2017.
to €3.9 billion newly issued shares; ii.) by purchasing up to €1.5 billion in existing shares.\textsuperscript{76} This aid was permissible; as explained above, if the conditions for precautionary recapitalisation are met, public funds can be used without triggering resolution and the associated 8% bail-in requirement. Nevertheless, burden-sharing of equity and junior debt still applied, as required under the 2013 Banking Communication.

It was argued by several European officials that the approval of this recapitalisation would undermine the BRRD’s credibility.\textsuperscript{77} Even though this was argued, recapitalisations of this kind are not unlawful. As discussed in the previous chapter, flexibility was introduced in the BRRD by the legislators through three specific forms of extraordinary public support, stated in Article 32(4)(d) BRRD, which can be given by the state without triggering resolution. One of these is aid given in the form of a precautionary recapitalisation to a solvent bank subject to strict conditions, laid down in Article 32(4)(d)(iii) of the BRRD. The Commission confirmed that the proposed aid to MPS complied with all these conditions, by its Decision “C (2017) 4690 final”, for the following reasons.

Firstly, according to the Commission, the aid was compatible with Art. 107(3)(b) TFEU since it was “granted to remedy a serious disturbance in the Italian economy and to preserve financial stability in the Italian banking sector”.\textsuperscript{78} The Commission further noted that the measure did not confer an undue advantage to MPS as the latter committed to comply with a restructuring plan drawn up and approved by the Commission. The aid measures were confined to a solvent institution. The aid was conditional on final approval under the EU state aid framework since recapitalisation would only occur after the Commission approved it and no funds were injected before this. The aid was of a precautionary nature since raising capital to cover the capital shortfall identified by the ECB resulted in the creation of prudential buffers in MPS. The measure was also temporary since Italian authorities committed to divest all their shares in the bank by a predefined date. The measures were also proportionate to the objective of remedying a serious disturbance in the Italian economy since the burden-sharing of equity and junior

\textsuperscript{76} New aid and amended restructuring plan of Banca Monte dei Paschi di Siena 2017, p 7.
\textsuperscript{77} Lubben and Wilmarth, Jr. 2016, p. 1238.
\textsuperscript{78} New aid and amended restructuring plan of Banca Monte dei Paschi di Siena 2017, p 25.
debt holders that took place limited the amount of aid granted to the minimum necessary and MPS’ restructuring plan contained sufficient safeguards to avoid undue distortions of competition. Private means available at MPS covered the whole amount of €4.4 billion of likely losses. Therefore, the Commission concluded that the measure was not used to offset losses that MPS has incurred or were likely to incur in the future. Under the adverse scenario of the 2016 stress test, the measure was limited to the injection necessary to cover the capital shortfall. Finally, the last condition was fulfilled as well since all Additional Tier 1 and Tier 2 of Art. 59(3) BRRD instruments held by MPS would be subject to conversion into ordinary shares, thereby fully contributing to covering the capital needs of the bank before state aid was injected. Taking into account all the above-mentioned criteria, the Commission concluded that the aid measures were in compliance with Art. 32(4)(d) BRRD and the recapitalisation was granted.

3.2. Banco Popular Español S.A

The second case that will be discussed to illustrate the practical outcome of the new framework concerns Banco Popular Español S.A., a Spanish bank with significant market shares in loans and deposits, ranked 6th by total assets in the country. Starting from October 2016, the liquidity situation of BPE deteriorated significantly, which occurred due to the material cash outflow across all customer segments. This led to BPE having insufficient options to restore its liquidity position in order to ensure that it would regain a stable position and meet its liabilities when they fell due. The Banking Group of which BPE was part attempted to address these liquidity problems of the bank by taking various measures, such as initiating a private sales process to a strong competitor to restore its financial situation, but failed.

On the 6th of June 2017, the ECB reached the conclusion, after consultation with the Single Resolution Board (“SRB”), that BPE was “failing or likely to fail”, in line with the criterion, stipulated in Articles 32(4)(c) BRRD and 18(4)(c) SRMR, of being unable to pay

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79 Saldias and Petkov 2017, p. 5.
80 Decision of the Single Resolution Board concerning the adaptation of a resolution scheme in respect of Banco Popular Español, S.A. 2017, p. 6.
its debts and other liabilities in the near future. Consequently, on the 7th of June, the SRB decided that the bank should go into resolution as this was in the public interest, in line with Articles 18(5) and 14 SRMR, in order to ensure the continuity of BPE’s critical functions and to avoid adverse effects on financial stability.\textsuperscript{81} As the bank was failing and since there were no alternative private actions that could prevent this failure, the rest of the conditions for BPE’s resolution were met.\textsuperscript{82} The resolution plan drawn up by the SRB entailed the transfer of shares and capital instruments of BPE to Banco Santander, for which the latter paid a mere €1. The effect of this transaction was that BPE could continue to operate under normal business conditions as a solvent and liquid member of the Santander Group.\textsuperscript{83} The sale was accompanied by the bail-in of shareholders through the write-down and conversion of their equity.\textsuperscript{84}

BPE’s resolution was the first successful application of the Banking Union’s resolution regime. Notably, it fulfilled both the objective of preserving financial stability, by ensuring the continuation of BPE’s critical functions, and the protection of taxpayer money, as the bail-in of shareholders removed the need for any state aid to be given by Spain, or even, as a matter of fact, for the SRF to be accessed.\textsuperscript{85}


The next case, regarding two smaller Italian banks, was decided one week after the previous case and illustrates the politically sensitive nature of aid measures relating to the banking sector. The case concerns Veneto Banca ("VB") and Banca Populare di Vicenza ("BPV"): two medium sized banks with market shares in terms of deposits of around 1.0% and ranked 17th and 20th, by total assets in Italy.\textsuperscript{86} Both banks were dealt with at the same time since they underwent the same procedure and their cases were decided on the same date. Both banks had been loss-making for a number of years, had a very high amount of

\textsuperscript{81} Notice summarising the effects of the resolution action taken in respect of Banco Popular Español pursuant to Article 29(5) SRMR, p. 1.
\textsuperscript{82} Article 18(1)(1) SRMR.
\textsuperscript{83} Nicolaides 2017.
\textsuperscript{84} Nicolaides 2017.
\textsuperscript{85} Nicolaides 2017.
\textsuperscript{86} Saldias and Petkov 2017, p 6.
non-performing loans (37% compared to 18% of the Italian average) and due to this they faced liquidity outflows from customers between August 2015 and September 2016.\(^{87}\)

Their liquidity position deteriorated even further in March 2017 and they notified the ECB of their intention to apply for precautionary recapitalisation. On the 23\(^{rd}\) of June 2017, the ECB reached the conclusion that the banks were deemed to be failing in the near future, which meant that their applications for precautionary recapitalisation were rejected. Consequently, the SRB decided the banks could not be placed under resolution because the condition of public interest had not been met.\(^{88}\) This conclusion was based, firstly, on the ground that the functions performed by the banks were not critical, since they were provided to a limited number of third parties and could be adequately replaced within a reasonable timeframe.\(^{89}\) Secondly, the failure of the banks was not deemed likely to result in significant adverse effects on financial stability, especially given the two banks' low financial and operational interconnections with other financial institutions.\(^{90}\) Finally, it was considered that normal Italian insolvency proceedings would achieve the resolution objectives to the same extent as resolution, by offering comparable degree of protection for depositors, investors, other customers, clients' funds and assets.\(^{91}\)

As a consequence, the winding-up of the Veneto banks had to happen under normal Italian insolvency proceedings.\(^{92}\) In this context, Italy considered public support necessary to mitigate the effects of a bank's market exit. Therefore, EU state aid rules applied, in particular the 2013 Banking Communication, requiring burden-sharing. However, senior bondholders did not have to contribute and depositors remained fully protected in line with EU rules. The Italian government asserted that the liquidation would destroy the value of

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\(^{87}\) Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Veneto Banca S.p.A. 2017, p. 5-6; Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Banca Popolare di Vicenza S.p.A. 2017, p. 6.

\(^{88}\) Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Veneto Banca S.p.A. 2017, p. 10; Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Banca Popolare di Vicenza S.p.A. 2017, p. 10.

\(^{89}\) Notice summarising the effects of the decision taken in respect of Veneto Banca S.p.A. 2017; Notice summarising the effects of the decision taken in respect of Banca Popolare di Vicenza S.p.A. 2017.

\(^{90}\) Notice summarising the effects of the decision taken in respect of Veneto Banca S.p.A. 2017; Notice summarising the effects of the decision taken in respect of Banca Popolare di Vicenza S.p.A. 2017.

\(^{91}\) Notice summarising the effects of the decision taken in respect of Veneto Banca S.p.A. 2017; Notice summarising the effects of the decision taken in respect of Banca Popolare di Vicenza S.p.A. 2017.

\(^{92}\) Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Veneto Banca S.p.A. 2017, p. 5-6; Decision of the Single Resolution Board concerning the assessment of the conditions for the resolution in respect of Banca Popolare di Vicenza S.p.A. 2017, p. 11.
the banks and bring the economic stability of the Veneto region in jeopardy.\textsuperscript{93} With this statement, the government adopted a law decree that allowed for a liquidation procedure of the banks with a transfer of performing assets and some liabilities to Intesa Sanpaolo (“ISP”) for the price of €1,--. The Commission approved this aid measure together with two other measures of state aid by Italy to facilitate the liquidation of the banks, which were: (i) cash injections of €4.785 billion; and (ii) state guarantees of a maximum of about €12 billion, related \textit{inter alia} to the financing of the liquidation procedure by ISP.\textsuperscript{94} Distortion of competition arising from this aid was limited due to the winding-up and exiting the market of the banks and transferred activities being restructured and significantly downsized by ISP. Furthermore, the Commission confirmed that the measures do not constitute aid to ISP, because it was selected after a fair, open and transparent sales process, fully managed by Italian authorities, ensuring that the activities were sold at the best offer available.

\section*{3.4. Analysis}

The difference in treatment of each of the banks featuring in the three cases described above is remarkable. All the banks discussed had poor fundamentals, significant asset quality issues, low or negative profitability and were, therefore, in financial difficulties. However, each of the cases was solved in a different manner; MPS received precautionary recapitalisation, BPE underwent resolution, in accordance with Art. 18 of the SRMR; and the two Veneto banks underwent liquidation under national insolvency rules. How is this possible? The conditions laid down in the new legislation play an important role. MPS fulfilled the conditions for precautionary recapitalisation as it was not seen as a bank which was “failing or likely to fail”. BPE was seen as a bank which was “failing or likely to fail”, but was resolved under SRMR rules because its resolution was deemed to be in the public interest. The Veneto banks were also determined to be likely to fail and could, therefore, not receive precautionary recapitalisation. However, unlike BPE, the Veneto banks’ resolution was not considered to be in the public interest by the

\textsuperscript{93} Saldias and Petkov 2017, p. 6.
\textsuperscript{94} Mesnard \textit{et al.} 2017, p 1.
SRB, which led to their liquidation, regulated under national insolvency law. The Italian government stated that state aid was necessary to avoid a market disturbance in the Veneto region, and transferred the banks to ISP, which was allowed by the Commission in order to facilitate the liquidation process and mitigate regional economic effects.

These cases indicate some successes in terms of the objectives pursued by the current state aid framework for banks, in conjunction with the bank resolution regime. As already stated, BPE was resolved fully in compliance with the BRRD rules and the application of bail-in to its shareholders dispensed with the need for the Spanish government to give state aid. Thus, financial stability was preserved while taxpayer money was protected at the same time. On a different note, the MPS case, although it ultimately escaped the application of the bail-in requirements of the BRRD since the bank was not resolved, illustrated that EU authorities will rigorously apply the conditions for access to precautionary recapitalisation, ensuring that this option stays truly exceptional. This is somewhat confirmed by the cases of the Veneto banks, which were refused the benefit of this exception because they did not meet the condition of being solvent.

Nevertheless, the interesting development in the Veneto cases is that both banks ended up receiving large amounts of state aid to assist their liquidation and the background of this outcome reveals an unharmonious application of the rules by the SRB, on the one hand, and the Commission, on the other, as well as questionable interpretations by both authorities of the applicable provisions. Specifically, while the SRB determined that the Veneto banks were not of systemic significance, and thus their resolution was not in the public interest, the Commission, in a somewhat contradicting manner, considered that their liquidation without public support would cause a serious economic disturbance in the Veneto region. Both positions can be questioned. With respect to the SRB’s decision, it can be viewed as surprising that the SRB did not deem the simultaneous insolvency of the Veneto banks serious enough, even though these banks were significant enough to be under the direct supervision of the ECB, they operated in the most productive region of the third national economy of the Eurozone and were among the largest and most important lenders in Italy. On the other hand, the

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95 Messore 2017.
Commission’s approval of the aid given to the Veneto banks on the basis of Article 107(3)(b) TFEU can also be argued to be problematic. This provision allows for state aid to be granted to remedy a “serious disturbance in the economy of a Member State” (emphasis added) and in case law, this has been interpreted as referring to a disturbance that affects the whole economy, not just a region thereof.⁹⁶ This could signal the Commission taking a deferential approach towards the Italian government wanting to rescue its banking system and, indeed, the negotiations that occurred at the EU level before the two Veneto banks were liquidated indicate that this was very likely the case.⁹⁷ Similarly, allowing the two banks to escape the bail-in of senior creditors may have factored in the SRB’s decision to not resolve the two banks under the BRRD/SRMR rules, especially since many creditors of Italian banks, like the Veneto banks, were families and small investors, whom Italy wanted to spare from a bail-in.⁹⁸ In the context of the Italian banking crisis, the EU authorities’ actions may be commended, however, their unorthodox approach could come at the expense of legal certainty and fair competition.

Moreover, the Veneto cases raise the question of whether the current framework has the effect that smaller, non-systemic banks, if it is assumed that the Veneto banks were so, are in fact able to receive state aid under more favourable conditions than systemic banks. Most importantly, as the two cases illustrate, the former category may be granted aid without having to bail-in senior liabilities, which are subject to bail-in under the BRRD/SRMR framework but not under the Banking Communication. As discussed previously, the whole philosophy of the BRRD/SRMR is that state aid should be given as a solution of last resort to prevent systemically significant institutions from failing. However, the Veneto cases seem to show that state aid can be granted under more lenient conditions for less important banks. This may give an unfair advantage to non-systemic banks, which could potentially benefit from an implicit state guarantee on their senior liabilities in the form of reduced funding costs,⁹⁹ and thereby have an impact on competition.

⁹⁷ Messore 2017.
⁹⁸ Van Lambalgen 2018, p. 115.
⁹⁹ Messore 2017.
A possible assessment of the Veneto cases is that those banks were too small to be resolved but too big to be liquidated without any public support. On the one hand, it is positive that the applicable rules, and the authorities applying them, provided for enough flexibility to address such less than clear-cut cases. On the other hand, however, this approach may generate legal uncertainty and, consequently, also competitive distortions in the internal market, which is a fundamental objective of the state aid framework to prevent.

4. Conclusion

In light of the above, it can be concluded that the current rules affecting the granting of state aid to the banking sector draw, at least substantively, a rather adequate balance between the different, and often opposing, objectives of financial stability, undistorted competition and the protection of state resources. While state aid to banks is still grounded on remedying serious economic disturbances, unlike what had been the case in the pre-crisis era, new elements have been introduced to address some of the problems that emerged during the crisis as a result of the excessive amounts of aid given to assist failing banks. Perhaps most important among these are the strengthening of burden-sharing principles and the introduction of the bail-in tool in the context of the EU’s single bank resolution regime. Both of these tools ensure that shareholders and creditors contribute to the maximum extent in absorbing a bank’s losses before other sources of financing, including state aid, can be used to assist the bank. Nevertheless, although burden-sharing and bail-in may help to alleviate the burden on taxpayers, as well as minimise competitive distortions that naturally result from government bailouts, their appropriateness in terms of financial stability has been questioned.

In practice, the few cases that have so far been settled under the current framework disclose mixed results. In the first place, they make clear that state aid is still given to banks in substantial amounts and has not become exceptional, despite the EU authorities’ clear intention to make it so. Moreover, the cases examined, and their highly divergent outcomes, show that the rules are working but, at the same time, room for flexibility also
exists in their application in difficult cases. While this may be praiseworthy in individual instances, further inconsistency in decision-making is harmful for legal certainty and competition, making it desirable for it to be avoided.
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