Master Thesis

The Extent Of Power And Latitude Of The European Commission In The EU State Aid Policy: An Analysis Through Supranational Governance Theory

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Abstract

The present study examines the scope of the European Commission's discretion and its restraint in the field of state aid policy, specifically in the banking sector during the times of hardship which was caused by the financial crisis by applying the supranational governance theory. The research question to be answered is: **How Much Power And Latitude The European Commission Has In The EU Competition Policy's State Aid Policy?** To answer the research question, a single case study research and content analysis with reference to supranational governance theory will be enclosed, in order to provide adequate evidence to see if the expectations hold. The qualitative research method of content analysis was adopted for data collection and data analysis. The main level of analysis is the European level and the focus will be on relevant political actors, such as the EC, the MS, NCAs, MS' central and regular banks, ECB, and other related supranational organizations. Thus, it will make sense to take actor's interactions as unit of analysis to study the outcome of EC's power and willingness and the financial limitation which leads to intergovernmental politics that hinders EC's discretion in the case of the EU banking state aid policy.

Lastly, regarding the main finding of this study; although the European Commission and its DG Comp have the absolute independent powers over this policy based on the formal legal competence, its drawback in financial resources in rescuing crisis-struck banks has made the Member States -especially the powerful ones- acquired a new position over the Commission due to their financial strength. The financial limitation has turned into an intergovernmental politics that limits the EC's ability in EU banking state aid.

Keywords: State Aid, Banking Union, Lender Of Last Resort Function, Discretion, Formal Legal Competence, Financial Crisis, Intergovernmental Politics.

List Of Abbreviations

EC	European Commission
EEC Treaty	European Economic Community Treaty
DG Comp	Directorate Generale Competition
TFEU	Treaty On The Functioning Of The European Union
MS	Member States
ECB	European Central Bank
NCAs	National Competition Authorities
ECN	European Competition Network
SAAP	State Aid Action Plan
GBER	General Block Exemption Regulation
GDP	Gross Domestic Product
ESA	European Surveillance Authority

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1. Introduction and Research Question

'…As the physical and technical barriers inside the Community are removed, the Commission will see to it that a rigorous policy is pursued in regard to state aids so that public resources are not used to confer artificial advantage to some firms over others...'[1]

The abovementioned statement has paved the way for the Commission (henceforth EC) to implement the state aid policy. State aid policy is an area in which the EC has been vested with strong legal powers enshrined in the EEC treaty[2] and the Lisbon Treaty[3]. The Commission through its Competition Directorate (henceforth DG Comp) monitors the behavior of financial institutions (Zahariadis, 2010). However, the precise scope of that authority and the enforcement mechanisms available to the Commission are left ambiguous (Smith, 1997). The general assumption of article 107 TFEU is that all state aid distorts competition. However, in some cases, state aid can be compatible with the internal market when such measures pursue community objectives, such as the correction of market failures, particularly during the times of financial crisis[4]. Basically state aid in general is prohibited, nevertheless article 107 of the Treaty on the Functioning of the European Union (henceforth TFEU) points out a number of exceptions which allows governments to intervene in the market, by e.g. providing subsidies, under strict conditions[5]. Consequently, the state aid policy is politically sensitive since it can bring the EC into direct confrontation with the wishes of Member States (henceforth MS) executives (Ross, 1995; Smith, 1996; Pinder, 1995). To emphasize, there were clear risks of distortions within the banking sector, since the banks that received state aid would potentially enjoy competitive

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[1] European Commission. *Completing the Internal Market.* COM(85) 310 Final. 14 June 1985. P. 158

[2] Smith, Mitchell. P. (1997). *Autonomy By The Rules: The European Commission And The Development of State Aid Policy.* Department of Political Science, Middlebury College Centre For European Policy Studies. Available at: http://aei.pitt.edu/2732/1/002545_1.pdf

[3] European Commission. (2010). *Report From The Commission: Report On Competition Policy 2010.* Available at: http://ec.europa.eu/competition/publications/annual_report/2010/part1_en.pdf

[4] Blauberger, Michael & Kramer, Rike. U. (2009). *European Competition vs. Global Competitiveness: Transferring EU Rules on State Aid and Public Procurement Beyond Europe.* CCP Working Paper 10-10. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656961

[5] Van Cayseele, Patrick., Konings Jozef, Sergant, Ilona. (2014). *The Effects of State Aid on Total Factor Productivity Growth.* NBB Working Paper Series. Available at: http://www.nbb.be/doc/ts/publications/wp/wp264En.pdf

advantage compared to the institutions that did not require it (or choose not to take it)[6]. Also, there was also risk of distortions between the MS; banks receiving favorable treatment in one MS might enjoy competitive advantage not available to institutions in states where the assistance was less favorable (Doleys, 2010).

Given the fact, it raises some open questions such as ‘did the Commission have the discretion on the state aid policy?’, ‘does it continue to have discretion on the state aid policy?’, or ‘does it only have discretion on the policy at certain points in time?’In relation to that, this thesis is written in the hope to gain more precise understanding of the power, initiative and latitude the Commission has in the field of EU competition policy’s state aid policy which is also the main question of this research: ***How Much Power And Latitude The European Commission Has In The EU Competition Policy’s State Aid Policy?***

In that sense, the writer would like to emphasize that the goal of this thesis is to map out and also analyze the Commission’s power and discretion in the EU state aid policy. To get a clearer understanding, a few case studies of the EU banks which were struck by the crisis will be used as case study. The writer decided to focus on the state aid policy because of the duality nature of state aid –helpful on one side, yet dangerous for the competition atmosphere on the other hand- has made the EC to enforce a policy in that regards, and it is interesting to analyze the power and discretion of the EC in that policy in connection to the EU banking situation. The Commission even regarded the state aid policy as being one of the most important aspects of EU Competition Policy[7]. Thus, the writer wishes that the EC’s power over the competition policy can be seen clearly by analyzing the state aid policy.

In order to have more precise guidelines for the research and to provide the most important and useful information, I have come up with a series of sub-questions which will provide a more thorough result to answer the research question and as the basis structure for the thesis itself.

Sub-questions:

[6] Doleys, Thomas. J. (2010). *Managing State Aid In Times Of Crisis: The Role of The European Commission.* ECPR Fifth Pan-European Conference On EU Politics. Available at: http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf

[7] Slaughter and May. (2011). *An Overview Of The EU Competition Rules.* Available at: http://www.slaughterandmay.com/media/64569/an-overview-of-the-eu-competition-rules.pdf

- How strong is the EC's power as the sole implementer in the implementation of the state aid policy at the onset of the financial crisis?

The scale of the financial crisis and the speed with which it propagated through the system prompted governments to act quickly and aggressively. The Commission as the sole implementer of this policy has implemented strict rules before a member state can grant state aid to their banks. Every MS that planned to inject aid into their financial institutions must acquire the approval of the Commission since they have the exclusive powers in this area, as confirmed by the Lisbon Treaty. The failure to comply will result in force refund of the aid by the Commission. Therefore in order to measure the EC's discretion in the implementation of the state aid policy, one must look at various facets of what the EC is doing; why does the Commission applied the state aid rules? Is the EC placing any conditions on the implementation?

- How strong is the EC's discretion in pushing for exit strategy to end state aid injection permanently?

The EC has decided to enforce the EU competition policy which one out of its three branches is the state aid policy which came into force to regulate the capital injections toward EU financial institution known as state aid. Along the time the Commission also need to be responsive to the financial situations and they need to move the member states and their banks towards ending the aid in order to create the independency among the financial institutions without state aid in accordance to the EC's new banking communication (Bonin, 2013). In regards to the second sub question, the power of EC's discretion in pushing for the exit strategy can be seen and tested on the time frames: 2009, 2011, and 2013.

Given all the aforementioned explanations, the research question and the sub-questions are suitable to analyze how much power and latitude the EC has in competition policy by taking a close look at one of its branch; namely the state aid policy.

The Commission's discretion and power toward state aid policy clearly marks an opportunity for the Commission to declare itself and show that Europe has an important role to play in terms of the future economic strength[8]. State aid policy can contribute in enhancing growth and innovation by designing state aid injection in such a way to sustain competitive markets and by

[8] ERT. (2010). *Challenges In EU Competition Policy.* ERT Competition Policy Working Group. Available at: http://www.ert.eu/sites/default/files/2010-03%20COMPETITION%20POLICY%20REPORT%20FINAL.pdf

improving the functioning of some markets; it may improve on competitive dynamics and thereby inducing economic growth (Kleiner, 2005). Because the EC, through its DG Comp, are known as the strongest supranational institutions in the field of EU competition policy's state aid policy, therefore in order to understand the EC's capacity and latitude towards the policy, one must look at the supranational governance theory. Another reason to apply the supranational governance theory into this research is the resemblance principle (top-down) between the theory and the nature of state aid and its policy. Therefore, it has become the purpose of this research to analyze how much discretion and power the EC has towards the state aid policy by using the supranational governance theory and testing the hypothesis derived from the theory.

The writer has decided to divide this research into five chapters: the first chapter will consists of the introduction to the state aid policy, the motivation behind the writing of this research, and the research question and sub questions of this research. The next chapter will be about the theoretical and analytical framework, the literature review of this research, the network relationship between EC and other related actors, and the hypothesis. In regards to the topic and the problems that the writer wants to investigate, the theory that will be used is the supranational governance theory which serves to analyze the discretion that the EC have towards state aid policy in this research because cross-border transactions and communications in competition policy's state aid rules generate a social demand for EC rules and regulation, which supranational organization work to supply. Chapter three will be devoted for research methodology and operationalization of the variables in this research. Chapter four will deal with the empirical analysis of this research. Some of the state aid cases, such as *EC vs. ING* will be explained thoroughly. In this chapter, the writer will try to provide the analysis which will answer the question of how much power and latitude the Commission has in EC's competition policy state aid policy –which is the research question of this research. The final chapter will be the conclusion and the reflection of the research.

2. Theoretical Framework: Supranational Governance Theory

The theoretical frameworks which will be used for this master thesis is the supranational governance theory. Some of the main literatures and the theories will fully summarized and explained because according to Gschwend & Schimmelfennig (2007), the more fully a theory is specified, the better it can be tested and the more fully it can explain observations. What is also important according to Gerring (2012) is that theory must be translatable into specific hypotheses involving individual causal factors and an outcome.

As has been mentioned beforehand, the theory that will be used in this research is the Supranational Governance theory because, based on the formal legal competence, the EC and its DG Comp are known as the strongest supranational institutions in the field of EU competition policy's state aid policy. Therefore, in order to understand the EC's capacity and latitude towards the policy, one must look at the supranational governance theory. EC's rule making competences have expanded since 1957 and according to Sandholtz and Stone Sweet, policy-making in a number of domains has moved toward supranational governance[9]. Thus, important questions centers on whether the Commission is in fact a system of governance with some life of its own, or whether it is a passive instrument of its member states (Sandholtz & Stone Sweet, 2011). Sandholtz and Stone Sweet –who can be safely referred as the father of the supranational governance theory- admitted that supranational governance theory has important affinities with neo-functionalism. They recognized the insights of two founders of integration theory: Karl Deutsch and Ernst Haas. Deutsch and his collaborators held that '*increasing density of social exchange among individuals over prolonged periods of time would lead to the development of new communities (shared identity) and ultimately to the creation of a superstate with centralized institutions'* (Deutsch 1953; Deutsch *et al.*, 1957). They also explained that neo-functionalism theory accounts for the migration of rule-making authority from national governments to the European Commission[10]. They pointed out the EC's capacities to create, interpret, and enforce rules as supranational governance**.**

These competences have deepened by the EU's rule system which has become denser and more articulated within particular policy areas, and broadened since it covered an expanding range of substantive domains over time (Fligstein and McNichol, 1998; Fligstein and Stone Sweet, 2002; Sandholtz and Stone Sweet, 1998; Stone Sweet, Sandholtz, and Fligstein, 2001). Furthermore,

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[9] Sandholtz, W. & Stone Sweet, A. (2011). *European Integration and Supranational Governance Revisited: Rejoinder to Branch and Ohrgaard.* Journal of European Public Policy, 6:1, 144-154. Available at: http://www.tandfonline.com/doi/pdf/10.1080/135017699343847

[10] Sandholtz, W. & Stone Sweet, A. (2010). *Neofunctionalism and Supranational Governance.* Oxford Handbook of The EU. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1585123

the capacity of the EU's organs to conduct monitoring and enforcing EU law has been steadily upgraded since the 1960s (Sandholtz & Stone Sweet, 2010). The expansion of supranational governance in the European Union is one of the most remarkable political innovations in the world in the past half century and a social science puzzle of the first order[11].

Sandholtz & Stone Sweet (1997) pointed out that supranational governance serves the interests of those individuals, groups, and firms who transact across borders, and those who are advantaged by European rules and disadvantaged by national rules, in specific policy domain. Stone Sweet and Sandholtz (1997) also highlighted, in line with the supranational governance theory, that the existing supranational institutions –particularly the EC and European Central Bank (henceforth ECB)- are policy entrepreneur, since they are able to both nudge the MS toward new supranational agreements where required and prevent them from sliding back into egotistical conflict. According to Haas (1961), once supranational institutions are born, a new dynamic emerges because the creation of supranational authority leads to changes in social expectations and behavior, which feed back onto supranational policy-making, and so on. Sandholtz and Stone Sweet (1998a p.16) stated that once movement toward the supranational pole begins, European rules generate a dynamic of its own, called institutionalization, in which EC generates further rules and/or solidification of competence. Due to that, EC policy domains can become more supranational without some, or at a times a majority of, governments wanting it begin or able to reverse it (Stone Sweet and Sandholtz, 1998a p.16). Wayne Sandholtz and Alec Stone Sweet in their 1999 counter reaction to Branch and Ohrgaard, stated that supranational governance is one of the products from supranational politics; politics that goes in arenas organized at the EC level, once authority has been transferred to that level. According to Haas (1961), the establishment of supranational authority leads to changes in the expectations and behavior of social actors, who in turn shift some of their resources and policy efforts to the supranational level. Supranational authorities become the new place for a new kind of politics, triggering the formation of transnational associations and interest groups[12]. When the coordinative solutions that societal groups wants starts to be delivered by the supranational

[11] Ibid.

[12] Haas, Ernst B. (1961). *International Integration: The European and the Universal Process.* International Organization 15: 366-92. Available at: http://www.lsu.edu/faculty/lray2/teaching/7971_1s2009/haas1961.pdf

authorities, those groups increasingly seek to influence supranational rules and policies. This is just one type of feedback loop that pushes integration forward (Haas, 1961). He also noticed that some forms of feedback yielded new cycles of feedback called spillover. Basically it occurs when actors become aware that the aim of initial supranational policies cannot be achieved without extending supranational policy-making to additional, functionally related domains[13].

At any given moment in time, the question of which authorities possess the capacity to make binding rules –be it competence or jurisdictions- has varied across policy sectors[14]. In some domains, competence is organized relatively exclusive at the national level (national governance); in other domains, EC's organizations have relatively exclusive jurisdiction (Sandholtz & Stone Sweet, 1999). In this context, the state aid policy is of increasing importance in the context of European competition policy in order to maintain a fair level of activity of all enterprises participating in the European markets, regardless of the MS in which they reside. Therefore the Commission decided to govern it with the help of National Competition Authorities (henceforth NCAs)[15]. Also, because competition policy's state aid policy is crucial to the EU's internal market, the Commission's powers are far-reaching (Bannerman, 2012). The EC reviews grants of aid to institutions by national and subnational governments when those measures are reported to the Commission by the appropriate national government –as required by European Competition Policy- or by competitors who believe the aid violates single market rules[16]. The Commission applied substantial latitude in choosing which complaints to be followed up most vigorously (Smith, 2001). This choice was formed by the EC's Competition directorate independent plans for advancing the state aid agenda which needs systematic action in some sectors such as banking. The EC has long to increase the accuracy of Competition policy, including state aid policy especially in banking sector that feature prominently in more

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[13] Ibid.

[14] Sandholtz, W. & Stone Sweet, A. (2011). *European Integration and Supranational Governance Revisited: Rejoinder to Branch and Ohrgaard.* Journal of European Public Policy, 6:1, 144-154. Available at: http://www.tandfonline.com/doi/pdf/10.1080/135017699343847

[15] Caraganciu, Anatolie & Carare, Petru. (2014). *State Aid Within The Framework of Competition Policy.* Revista Economica 66:1. Available at: http://economice.ulbsibiu.ro/revista.economica/archive/66104caraganciu&carare.pdf

[16] Smith, Michael. P. (2001). *How Adaptable Is The European Commission? The Case Of State Aid Regulation.* Journal of Public Policy, 21, pp 219-238 doi:10.1017/S0143814X0100112X. Available at: http://journals.cambridge.org/abstract_S0143814X0100112X

fully integrated European markets[17]. This circumstance attract the MS to conduct close scrutiny toward the policy, and in order to guard its policy effectiveness in core sectors, the Commission must minimize confrontation with the national governments.

The EU's competition authority has not had the crucial tool which it needed to have a large impact in state aid policy, such as the lender of last resort function which located at the level of national governance and it places limits on what the Commission can demand given the general state of the European economy. In 2011, the ECB showed its key role by stepping in and started to become very aggressive about providing funds directly to the states and companies; whose support for government debt markets becomes crucial when investors simply refuse to refinance levels of public debt which are perceived as unsustainable in the long run[18]. Now they are making a difference with their resources by providing the funds to states and companies since the Eurogroup suggested that the ECB should fulfill its role in assuring sufficient liquidity for the financial sector and reacts with the flexibility to market circumstances[19]. Therefore, given the circumstances, what one can also take into account if they are to discuss the supranational governance theory is resources because if the Commission and other related actors, such as ECB wants to conduct its actions, they surely need resources, and therefore it matters. As a result, how far can the EC's power and latitude towards the state aid policy go with the addition of this resource factor from the supranational governance theory?.

The relaunch of the European project under the leadership of the Delors Commission marked a decisive and irreversible power shifting from the MS towards the supranational institutions, particularly the EC[20]. This scholarship emphasized the resources at the disposal of the EC, and stressed the Commission's capacity for independent action and ability to pursue its own

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[17] Smith, Michael. P. (2001). *How Adaptable Is The European Commission? The Case Of State Aid Regulation.* Journal of Public Policy, 21, pp 219-238 doi:10.1017/S0143814X0100112X. Available at: http://journals.cambridge.org/abstract_S0143814X0100112X

[18] Gros, Daniel. (2012). *On The Stability of Public Debt In A Monetary Union.* Journal of Common Market Studies Volume 50. Available at: http://onlinelibrary.wiley.com/doi/10.1111/jcms.2012.50.issue-s2/issuetoc

[19] Sutton, A., Lannoo, K., & Napoli, C. (2010). *Bank State Aid in the Financial Crisis: Fragmentation Or Level Playing Field?.* Centre for European Policy Studies. Available at: http://www.ceps.eu/book/bank-state-aid-financial-crisis-fragmentation-or-level-playing-field

[20] Kassim, H., & Menon, A. (2010). *Bringing the member states back in: the supranational orthodoxy, member state resurgence and the decline of the European Commission since the 1990s*. In Conference of Europeanists of the Council for European Studies, *Montreal, Canada* (pp. 15-17).

preferences even when these go in different directions with those of the MS (Kassim & Menon, 2010). Supranational governance theories based their expectations on four premises; one of them is the distribution of resources among key actors and their ability to mobilize them[21]. The supranational institutions are new actors with their own interests, which are likely to 'diverge from those of its creators', and they command resources that enable them to pursue these interests, including 'expertise and delegated authority' (Moe 1990:221). Governmental actors clearly have their own interests, which may include maximizing their autonomy and control over resources. According to Stone Sweet and Sandholtz (2010), the creation of supranational authority leads to changes in the expectations and behavior of social actors, who in turn shift some of their resources and policy efforts to the supranational level. In the context of supranational governance theory, the crucial tools of resources that the supranational institutions such as the Commission possess are material which is financial, and legitimacy from the non-material side[22].

The supranational governance theory tells a lot but not everything, therefore this state aid case study builds up a lot of evidences to support the claim that legal powers are not enough. The Commission tried to do what it can but there are limits placed by its ability to play. Therefore, the question remains the same: how much power, latitude, discretion that the EC has in implementing the EU competition policy's state aid policy?

Given all the aforementioned explanations from the introduction section until the supranational governance theory, the writer has managed to come up with the following hypothesis:

Hypothesis 1 (Discretion): *If Supranational Governance is applicable, the EC will practice its formal and informal (entrepreneurial) discretion in the implementation of the state aid policy toward banks in the network relationship between itself as the sole implementer at the EU level and NCAs at the national level.*

The MS had agreed on the need for supranational state aid policy, yet each of them had the motivation to deviate from this policy especially in times of economic crisis (Lavdas &

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[21] Kassim, H., & Menon, A. (2010). *Bringing the member states back in: the supranational orthodoxy, member state resurgence and the decline of the European Commission since the 1990s*. In Conference of Europeanists of the Council for European Studies, *Montreal, Canada* (pp. 15-17).

[22] Stone Sweet, Alec. & Sandholtz, Wayne. (1997). *European Integration and Supranational Governance.* Faculty Scholarship Series, paper 87. Available at: http://digitalcommons.law.yale.edu/fss_papers/87

Mendrinou, 1995; Mathijsen, 1972). At the onset of the crisis, the EC adapted state aid regulation to the needs of financial stability, rather than restricting state aid and promoting European recapitalization (Donnelly, 2013). Due to the unexpected raise of state aid and more requests for aid at the times when the crisis erupted, the Commission tried to regulate aid as of mid-2008 and therefore it has the competence to decide on the legality of state aid; given it is a required mechanism to control the competition condition in the European markets. The independent powers will create a more comprehensive state aid policy with quick respond to the report of unfair practice, for example. With the cooperation, peer reviews and exchange of good practices could be conducted between both parties. The independent variable is the legal and entrepreneur level of the Commission and the dependent variable is the implementation of banking state aid policy.

Hypothesis 2 (Financial Constraint): *Regardless of the Supranational Governance theory, there are outside factors –ultimately financial factor which leads to intergovernmental politics- that limits the EC's discretion and willingness to restrict national state aid.*

The second hypotheses will be explained thoroughly with the addition of two sub hypothesis which are the two side of the same coin. *H(2a): MS can and do actively restrict financial resources.* In order for financial stability becomes a reality, strong fiscal and regulatory resources are required at the EU level so that the single market is to remain intact with high degrees of cross-border interdependence (Donnelly, 2013). The EC does not possess the budgetary powers – their own budget is tiny- because this lies in the hand of the MS' governments which they used to constraints the EC. Prior to the Maastricht treaty, the MS had deployed only limited financial and human resources to monitors EU activity[23]. *H(2b): EC refrains from entrepreneurship and exercising of powers as a result.* Thereafter, they began to invest far greater resources in overseeing the activities of the EC, with a view to preventing or thwarting the kinds of ambitious initiatives of the EC (Kassim & Menon, 2010). Greater financial and human resources have led MS to a heightened ability to anticipate EC's initiatives and react to them, while the increasing

[23] Kassim, Husein & Menon, Anand. (2010). *Bringing The Member States Back In: The Supranational Orthodoxy, Member State Resurgence And The Decline Of The European Commission Since The 1990s.* ECPR Fifth Pan-European Conference. Available at: http://www.ies.be/files/documents/JMCdepository/Kassim.

centrality of the MS in decision making has reinforced their ability to set the policy agenda[24]. The lack of EU resources in turn requires the primacy of MS governments as guarantors of financial stability through their fiscal capacity, thus affecting the EU's capacity to recapitalize, restructure, and resolve insolvent banks[25]. The independent variable is the MS' financial resources and the dependent variable is the EC's power and discretion.

2.1. Literature Review

2.1.1. Specific Application Of The Supranational Governance Theory In The Competition Policy's State Aid Policy

In line with the supranational governance theory, the Commission as the supranational body acting as the supreme implementer of the state aid policy toward banks, has certain powers or discretions toward other related actors in this field; namely the NCAs. They serve as the EC's helping hand in the national level because sometimes violations of competition rules' state aid happened within just one country and it would be better to handle it locally[26]. Article 92 (3) EC treaty regulates that the Commission has extensive latitude to decide whether a state aid is compatible with the common market or not[27]. The Commission has devoted its powers, capacity, and resources on banking state aid policy towards the NCAs in the hope that there will be a strong relationship between the local and central actor in the implementation of the policy to the banking sector. In the field of competition policy's state aid policy, as stated by the supranational governance theory, the EC's discretion runs from upper to lower level –from the Commission level to the national/local level. This structure does not imply a one-way stream of command - since the Commission is the highest implementer of this policy, and therefore the other actors does not have any powers to help or criticize the EC-, but rather more to a dynamic and strong

[24] Kassim, Husein & Menon, Anand. (2010). *Bringing The Member States Back In: The Supranational Orthodoxy, Member State Resurgence And The Decline Of The European Commission Since The 1990s.* ECPR Fifth Pan-European Conference. Available at: http://www.ies.be/files/documents/JMCdepository/Kassim.

[25] Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

[26] European Commission. (2013). *The European Union Explained: Competition.* EC DG Com. Available at: http://europa.eu/pol/index_en.htm

[27] Schmidt, André.(2001). *Non-competition factors in the European competition policy: The necessity of institutional reforms.* CeGE Discussion Paper, No. 13. Available at: http://hdl.handle.net/10419/32016

relationship between every actor in every level; namely the EC via its DG Comp and NCAs. During the crisis, the EC's Competition Directorate published several Communications (Banking, Recapitalization, Restructuring, and Impaired Asset) to try to bring some order in the national support schemes and to push MS toward exit strategy. However, the Commission only succeeded gradually in doing this, as the crisis receded and the need to preserve the single market re-emerged as a policy priority[28].

Governance is not confined to the EU level but disseminates through involvement and procedural provisions into national and sub-national arenas[29]. If we take that statement and connect it to the theory which is being used in this research, there will be a similarity occurred. According to the supranational governance theory, the supranational bodies in this regard –the EC and DG Comp- are able to act completely independent or they could also form a relationship with the national bodies, which called the network relationship or network governance[30]. Governance has become about managing networks in both the input processes and output practices of governing networks of deliberation and delivery[31]. According to Rhodes (1997a:53), 'governance refers to self-organizing, interorganizational networks'. He goes on to argue that these networks are driven by 'the need to exchange resources and negotiate shared purposes' and that they are subject to a complex dynamic and are not directly accountable to the state but that the state may be able to 'indirectly and imperfectly steer network'.

The networks relationship in state aid policy to the EU's banking sector is a top-down 'command-and-control' relationship; from the Commission as the highest authority in implementing state aid policy, to the MS and their financial institutions as the receivers of state

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[28] Sutton, A., Lannoo, K., & Napoli, C. (2010). *Bank State Aid in the Financial Crisis: Fragmentation Or Level Playing Field?*. Centre for European Policy Studies. Available at: http://www.ceps.eu/book/bank-state-aid-financial-crisis-fragmentation-or-level-playing-field

[29] Kochler-Koch, Beate. (2002). *European Networks and Ideas: Changing National Policies?.* European Integration online Papers (EIoP) Vol. 6. Available at: http://eiop.or.at/eiop/texte/2002-006a.htm

[30] Kochler-Koch, Beate. (2002). *European Networks and Ideas: Changing National Policies?.* European Integration online Papers (EIoP) Vol. 6. Available at: http://eiop.or.at/eiop/texte/2002-006a.htm

[31] Chhotray, Vasudha. & Stoker, Gerry. (2009). *Governance Theory and Practice; A Cross-Disciplinary Approach.* Palgrave Macmillan: London. Available at: http://blog.ub.ac.id/irfan11/files/2013/02/Governance-Theory-A-Cross-Disciplinary-Approach-oleh-Vassuda-C.pdf

aid[32]. Every decision is made by the Commission with the help from its special unit in the competition policy: DG Competition and also the NCAs in the national level. The Commission has the main and sole competence to decide on the legality of state aid (Ehlermann, 1994; Blanchard, 2004). They have the rights to conduct monitoring, controlling, restricting, and recovering any forms and levels of aid and must approve aid grants before it is being implemented or granted to the banks. In implementing those rights, EC assigned its most relevant directorate; namely the DG Competition. Commission has sought to increase the strictness of competition policy, including state aid policy especially in sectors such as banking that feature undoubtedly in more fully integrated European markets[33]. According to Palmen & Trajfacki (2012), the EC wanted that the capital injections toward banks were not just simple procedures in order to prevent the funds being received by uncompetitive banks. Therefore, the Commission realized that they also needed to form the cooperation with the MS in order to ensure the implementation of the state aid policy; therefore the NCAs are given the role in the enforcement of EU Competition Policy in Member States level[34]. NCAs are allowed to enforce European and national competition laws (EPRS, 2014). European Parliamentary Research Service (henceforth EPRS) stated in its 2014 report that the EC then assigned its responsible department, namely the DG Competition together with NCAs to conduct investigation on competition cases, and afterwards the College of Commissioners will take the formal decisions. Realizing that a platform required in order for the EC and NCAs are able to cooperate in a close and complementary manner in ensuring the strict and effective implementation of state aid policy within the EU, EC established The European Competition Network (henceforth ECN) in 2002 to

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[32] Wessel, R. A., & Wouters, J. (2008). *The Phenomenon of Multilevel Regulation: interactions between global, EU and National Regulatory Spheres. International Organizations Law Review*, *4*(2), 259-291. Available at: http://doc.utwente.nl/77131/1/Wessel07phenomenon3.pdf

[33] Smith, Mitchell, P. (2001). *How Adaptable Is The European Commission? The Case of State Aid Regulation.* Journal of Public Policy, Volume 21 Issue 3 pp. 219-238. Available at: http://journals.cambridge.org/abstract_S0143814X0100112X

[34] Erbach, Gregor. (2014). *EU and US Competition Policies; Similar Objectives, Different Approaches.* European Parliamentary Research Service Briefing. Available at: http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2014/140779/LDM_BRI(2014)140779_REV1_EN.pdf

facilitate cooperation and coordination among NCAs and the Commission[35]. ECN served as a forum for discussion and cooperation of European competition authorities in cases where Articles 101 and 102 of the Treaty of the Functioning of the European Union (TFEU) are applied. It should ensure an efficient division of work and an effective and consistent application of EC competition policy's state aid policy[36].

With respect to a modernized state aid policy, national authorities (NCAs) and the EC are partners in a 'learning by doing' process in implementing the state aid policy toward banks[37]. The fact is that an improved state aid policy depends on initiatives of both the Commission and the MS was acknowledged in the State Aid Action Plan (henceforth SAAP)[38]. "While the Commission has the competence to adopt detailed state aid policy, the successful implementation of the rules and procedures depends to a large extent on Member States. [...] In this context, the Commission will examine whether independent authorities in Member States could play a role as regards facilitating the task of the Commission in terms of state aid enforcement (detection and provisional recovery of illegal aid, execution of recovery decisions)[39]. In order to further improve the cooperation between MS and the EC and other relevant actors, a network of state aid authorities should be established to facilitate the flow of information and exchange of best practices between the EC, ECB, MS, the recipient banks and also the NCAs in the field of state aid policy toward financial institutions[40].

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[35] European Commission. (2011). European Competition Network (ECN). Available at: http://europa.eu/legislation_summaries/competition/firms/l26109_en.htm

[36] European Commission (2012). The Details of ECN. Available at: ec.europa.eu/competition/ecn/more_details.html

[37] Evans, L. (2007). *Concluding remarks - 5th experts' forum on new developments in European State",* Brussels European State aid Law Institute (EStALI). Available at: http://ec.europa.eu/comm/competition/speeches/text/sp2007_03_en.pdf

[38] The State Aid Action Plan submitted by the Commission is a roadmap for the reform of state aid policy which aimed to guarantee the MS a clear and predictable framework in order for them to grant the state aid, targeted towards achieving the Lisbon Strategy objectives. Quoted from: http://europa.eu/legislation_summaries/competition/state_aid/l26115_en.htm

[39] European Commission. State Aid action plan: Less and better targeted state aid: a roadmap for state aid reform 2005 – 2009. Available at http://ec.europa.eu/comm/competition/state_aid/reform/reform.cfm, point 51.

[40] Evans, Lowri. & Nyssens, Harold. (2007). *Economics in The State Aid: Soon As Routine As Dentistry?.* Lisbon Conference on Competition Law and Economics. Available at: http://ec.europa.eu/competition/speeches/text/sp2007_14_en.pdf

2.1.2 The Financial Crisis Challenges Toward The State Aid Policy

Phillip Lowe in his article State Aid in the Context of The Financial Crisis (2009) stated that the European financial crisis, which initially occurred in the United States, has fundamentally challenged current models of regulation and oversight in every aspect of the financial sector. Lehmann Brothers bankruptcy filing caused a massive loss of confidence and an instantaneous freeze of the large-scale funding market, which became the drive for various institutions, including financial, to seek for emergency liquidity assistance to avoid massive default[41]. In times of crisis, member states governments focused on measures to keep banks afloat and they feel that those measures could be separated from competition policy which in fact it cannot be separated (Lowe, 2009). Nicolaides, Kekelekis, and Buyskes (2005) underlined the EC's main objective is to ensure that state intervention in the form of capital injection toward their own financial institutions does not interfere with the smooth functioning of the internal market or harm the competitiveness between EU undertakings, as well as to enhance structural reform.

The financial crisis in Europe which started in 2008 has affected the financial institutions based and/or operating in the EU. Since then, the EC has pondered a sovereign obligation and budgetary emergency that examiners and financial specialists consider as the greatest current risk to the worldwide economy[42]. They are worried that some Eurozone governments could default on their obligation in a cluttered manner that vulnerabilities in the European managing an account division could trigger expansive monetary turmoil that could cost the Eurozone to enter an extended monetary subsidence, and that one or more nations could clear out the Eurozone[43]. What was once feared came to reality; the financial emergency has additionally turned into a political emergency because various national governments, such as Greece, Cyprus, Portugal, Ireland, and Spain have fallen as an issue or circuitous consequence of the emergency (Nelson *et al*, 2012).

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[41] Gerard, D. (2013). *Managing the Financial Crisis in Europe: The Role of EU State Aid Law Enforcement.* Universite Catholique de Louvain. Available at: http://www.uclouvain.be/cps/ucl/doc/ssh-cdie/documents/2013-06_D.Gerard.pdf

[42] Nelson, Rebecca M., Belkin, Paul., Mix, Derek. E., Weiss, Martin. A. (2012). *The Eurozone Crisis: Overview and Issues For Congress.* Congressional Research Service. Available at: http://fas.org/sgp/crs/row/R42377.pdf

[43] Ibid.

A widespread reaction was determined as the financial crisis hits Europe, and this reaction involved a lot of actors; from the EC and its DG Comp, ECB, and National Competition Authorities (henceforth NCAs), to Member States governments and their respective central and regular banks[44]. State aid policy came into force to regulate the capital injection which is a rather controversial in terms of its application and the effects that it brings. This aid has a high potential to be misused; as an example, member states artificially strengthen their local financial institutions which is not operating effectively anymore and protect them from the harshness of competition in order to keep the banks up and running and also to maintain employment. However, on the other side, the aid is very helpful in catapulting Europe to be in a better position to take advantage of the opportunities of globalization. Adler *et al.* (2010) described that in 2008, banks and other financial institutions experienced the turbulence of the financial crisis; assets write-downs, dried-up liquidity in wholesale funding markets, and the loss of consumer confidence were some of the consequences. The qualification of the banking industry as a special sector in the economy is a common wisdom, since the social cost of a banks' bankruptcy is larger than its private cost; the bankruptcy of one bank may generate a negative externality for all other banks through a contagion effects (CEPR, 2010).

The financial crisis has forced the Commission to prioritize the state aid granting in saving financial institutions over distortions to competition. At the beginning of the crisis, the Commission adapted state aid regulation to the needs of financial stability, rather than restricting state aid and promoting European recapitalization (Donnelly, 2013). Faced with an unexpected increase of state aid and even more requests for aid at the times when the crisis erupted, the Commission tried to regulate aid as of mid-2008 and thus give at least a semblance of legality to the granted aid[45]. The amount of aid was temporarily increased under the *de minimis* clause[46] to 500,000 EUR per institutions. Above that amount, the Commission does not interfere with

[44] Czékus, Ábel. (2012). *Responses of European competition policy to the challenges of the global economic crisis.* Published in: Crisis Aftermath: Economic policy changes in the EU and its Member States, Conference Proceedings, Szeged, University of Szeged , Vol. ISBN 9, (2012): pp. 324-336.

[45] Prokopijevic, Miroslav. (2013). *State Aid in The European Union And Serbia.* Belgrade Research Forum. Available at: http://www.emins.org/uploads/useruploads/forum-it/State-Aid-in-the-European-Union-and-in-Serbia.pdf

[46] The rule which exempt small aid amounts. It sets a ceiling below which aid is deemed not to fall within the scope of Article 107(1) TFEU and is therefore exempt from the notification requirement laid down in Article 108(3) TFEU. Quoted from: http://europa.eu/legislation_summaries/competition/state_aid/l26121_en.htm

providing aid if it had been informed about it prior to that. However, regardless of the regulation, there were several cases of granting big amounts of aid, such as the aid for some of the Europe's biggest banks: Dutch state to *ING,* Germany's aid for its *Commerzbank*, the aid that was granted to *Fortis* bank by Belgium, and the aid that Great Britain granted to large banks such as *Northern Rock* (Prokopijevic, 2013).

At the onset of the crisis, there was pressure attributed on the Commission to soften the State aid policy, in order to allow EU MS to freely implement financial sector rescue measures as they saw fit[47]. At first, because the Commission did not see the positive outcome from toning down the policy, as the highest power holder in the field of state aid, they refused it (Lowe, 2009). However, it was very quickly recognized by the Commission that there was a need to enforce common rules so as to help maintain a level playing field in the EU and avoid large scale movements of funds between MS by investors in search of the highest level of protection (Lowe, 2009). Under the EU state aid policy, mechanisms were put in place to minimize the distortions of competition that might result from the large-scale award of rescue aid, so as to avoid disrupting the European Single Market and to prepare for the return to normal market functioning. Thus, it is very important that the EC as the institution that applied and enforced EU competition laws –in which state aid control included- implemented it vigorously during the times of crisis. This will lead to the rescue of crisis-affected financial institutions and hopefully will create strong and independent financial institutions which will be able to operate without capital injection in the post crisis times and onwards. The Commission's discretion and latitude at the onset of the crisis was changed, due to the twofold of their objectives: to support financial stability and to maintain a level playing field in Europe. In relation to this matter, the financial crisis had made the current topic become more interesting.

3. Research Methodology and Operationalization

In this chapter, the first part will deal with an overview of the research design and the second part focuses on the conceptualization, operationalization and measurement of the independent and dependent variables of the hypotheses formulated previously.

[47] Lowe, Philip. (2009). *Competition Policy And The Economic Crisis.* Competition Policy International Vol. 5, No.2. available at http://ec.europa.eu/competition/speeches/text/cpi_5_2_2009_en.pdf

3.1. Research Design and Methodology

The EC's power and latitude over state aid is an interesting field of study due to the need of state aid policy enforcement in the competition atmosphere in order to keep the market open and transparent[48]. Distortions of competition across MS need to be prevented by the consistent application of the European state aid policy. Given the circumstances, it is favourable to enclose a single case study research and congruence analysis with reference to supranational governance theory, in order to provide adequate evidence to see if the expectations hold. Also, case study focuses on process-tracing in order to better understand the causal mechanisms of the relationships and phenomena of interest (Gschwend & Schimmelfennig, 2007). In regards to the time dimension, the writer aim at making observations of EC's latitude and power towards state aid policy in the banking sector in three different time-periods; 2009, 2011, and 2013. The three time period was chosen due to its relevance in measuring the Commission's power, latitude, and discretion towards state aid policy.

Almost immediately concerns were raised that EU state aid policy would impede necessary state intervention and thus lead to the collapse of financial system[49]. As a result, there were calls for a temporary suspension of state aid policy, however, the EC rightly resisted these demands and issued several communications in the time span of 2009, 2011, and 2013 that introduced greater flexibility in the application of state aid policy (Heimler & Jenny, 2010). In order to make sure that such flexibility was only temporary and exceptional, the Commission made reference to a practically never invoked clause of Article 87 paragraph 3: the existence of 'a serious disturbance in the economy' as the reason for the exempting incompatible aid[50]. In 2009, the European Union, alongside the rest of the world, has faced an exceptionally severe financial and economic crisis. It has been a challenging year for the economy, business, and policymakers. The financial crisis which started out in 2008 with the Lehmann Brothers filing its bankruptcy, and not long after that, the effect quickly made its way to the EU shore. As the threat of the financial

[48] European Round Table of Individualists. (2010). *Challenges in EU Competition Policy.* Available at http://www.ert.eu/sites/default/files/2010-03%20COMPETITION%20POLICY%20REPORT%20FINAL.pdf

[49] Heimler, Alberto & Jenny, Frederic. (2010). *The Limitations Of EC State Aid Control.* GTA Analytical Paper No. 9. Available at: www.globaltradealert.org/sites/default/files/GTA-AP9%20Heimler.pdf

[50] Ibid.

crisis reached the EU, the need to implement the state aid came into the spotlight. MS governments, central banks and financial regulators, together with the EC, have worked hard to stabilize the financial system and make sure that a crisis of this type does not occur again in the future. Policymakers have also sought to design policies to minimize the impact of the crisis on the real economy. In 2009, the Commission put in force the crisis measure to prevent the impact of Lehmann Brothers spreading in Europe, such as the General Block Exemption Regulation (henceforth GBER) to simplify the aid granting (EC, 2009). In light of the high volatility of the financial markets, coupled with uncertainty about the economic outlook, the EC decided to prolong certain measures set out in the crisis measure in 2011[51]. In 2013, there have been encouraging signs that an economic recovery is underway in Europe. Policy actions undertaken at EU level contributed to start restoring confidence and creating the basis for returning to a growth path[52].

From the short description, it can be seen that in every time period, the power and willingness of the Commission were also adapting with the current development at that time. Nevertheless, is that really happening? Because there is an indication, according to the counter-hypothesis, that EC's discretion was being limited by outside factor. Therefore, to reflect the discussion of this research, the EC's autonomous discretion and willingness over the state aid policy restriction with all the EU MS competition authorities (H(1)) could hopefully be clearly determined by discussing the counter hypothesis (H(2)) regarding the outside factor –financial which leads to intergovernmental politics- that limits the EC's powers and discretion. The details of this research design will be further discussed in the empirical analysis section.

Sampling and Data Collection

Research essentially involves the gathering or collection of data that addresses the research question and enables theory to be tested or developed. Therefore, the data from which answers to the research question are to be drawn must be appropriate in terms of its relevance and efficacy –

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[51] European Commission. (2011). *Report From The Commission: State Aid Scoreboard.* Report on State Aid Granted By The EU Member States. Available at: http://ec.europa.eu/competition/state_aid/studies_reports/archive/scoreboard_arch.htmlv

[52] European Commission. (2013). *Report On The Competition Policy.* Available at: http://ec.europa.eu/competition/publications/annual_report/2013/part1_en.pdf

‘fitness for purpose’ (Pierce, 2007). Since the main level of analysis is the European level and I am focusing on relevant political actors, such as the Commission, the MS, NCAs, MS’ central and regular banks, ECB, and other related supranational organizations, it will make sense to take actor’s interactions as unit of analysis to study the outcome of EC’s power and discretion in the case of the state aid policy. The units of observation are the power and latitude expressed by the actors in EU policy documents on state aid policy, the Commission’s report on competition policy of 2009, 2011, and 2013, pieces of legislation (COM (2012), COM (2013), etc), scientific literatures written by academic experts, interviews, speeches, statements of the actors[53].

Data Analysis

Those aforementioned data sources are the qualitative data sources. In this research study, qualitative data analysis is used because it is more useful than quantitative data, in regards that it is richer in meaning than quantified data and I am looking at verbal communication to infer actor’s power and latitude.

The writer will analyze the case studies of crisis-struck financial institutions as a research method as it will allows an in-depth study of phenomena within its real life context. According to Bennet (2004), one of the most important advantages of case studies is their ability to achieve high levels of construct validity. Thus, this is a method which has the ability to measure the indicators that best represent the theoretical concept, which the writer intends to measure. A further advantage of case studies is their potential to generate new theories, as they can identify not only new variables but also new hypothesis both through the study of deviant cases and in the field work itself (Bennett, 2004, p.35). Case studies use process tracing to examine in detail the hypothesized causal mechanisms in individual cases. Process tracing however does not allow direct assessment of causal mechanisms as there are always the dangers of measurement error or specification error. Yet, case studies are able to accommodate complex casual relations. The case study which will be presented in the analysis section of this thesis covers the EC’s application of state aid policy over a range of countries; with the example of ING in the Netherlands, and Commerzbank in Germany. ING case is chosen because there was an abuse of the EC’s

[53] The legal basis of the Scoreboard is provided in Article 6(2) of Commission Regulation (EC) 794/2004 (OJ L 140, 30.4.2004, p.1), which provides that the Commission will publish each year a state aid Synopsis containing a synthesis of the information contained in the Member States’ annual reports.

discretion and power towards ING during the financial crisis (Clifford Chance, 2012). As for Commerzbank, it is intriguing to observe EC's discretion and power towards the state aid policy of this bank because the impact of the crisis made it unable to secure the liquidity that it required to meet its obligations, and therefore would bring a massive impact to the financial system since it was the second largest private bank in Germany (Doleys, 2010).

The state aid policy is a unique feature of EU's competition policy, because it has the mechanisms for controlling the subsidies granted by their constituent parts to the financial institutions (Buelens, Garnier, Johnson, Meiklejohn, 2007). In many opportunities, state aid has been considered as a threat to the economic welfare because it will weaken the firms' incentive to improve their efficiency and also will allowed the less efficient firms to exist or even expand at the expense of the more efficient[54]. Moreover, competition between MS governments to attract investment will definitely lead to pricey subsidy race unless some supranational discipline is imposed[55]. This is the reason why the EC imposed state aid control toward EU banks, because as the main implementer of state aid policy, they have to maintain the level playing field and also the financial stability in the EU economy for longer period of time. Therefore, in connection to the research question and the hypotheses, the research design that fit best would be to look at and analyze the case study that shows how the actors involved, engaged their discretion and powers implement the state aid policy and to end the aid in order to maintain those two principles.

3.2. Operationalization and Measurement

In this section, the main issue that will be discussed is the hypothesis testing with regards to the accuracy, relevancy, and validity of the data, in order to be able to prove whether those hypotheses could be confirmed or not.

Validity is 'the extent to which a measure, indicator or method of data collection possesses the quality of being sound or true as far as can be judged.…in the social sciences generally, the relationship between indicators and measures and the underlying concepts they are taken to

[54] Buelens, C., Garnier, G., Meiklejohn, R., Johnson, M. (2007). *The Economic Analysis of State Aid: Some Open Questions.* EC: Directorate-Generale for Economic and Financial Affairs. Available at: http://ec.europa.eu/economy_finance/publications/publication9549_en.pdf

[55] Ibid.

measure is often contested' (Jary & Jary, 1995: 714)[56]. Relevancy means the connectedness between the data and the hypotheses (Jary & Jary, 1995:714). While accuracy refers to the sensitivity to change, especially of details, e.g. dates, numbers, persons, present, etc found in the data (Pierce, 2007).

The main variables of the hypotheses which will be measured for the present study are as follows:

H1 – Discretion: The EC -despite its independent supranational powers- cannot improve the operation of state aid policy without the effective support of MS and its authorities[57]. As a result of the close partnership between the two parties, better outcomes in the state aid policy, both at the national and European level could hopefully be achieved. The main concept is the network between the EC and the national level implementer, namely the NCAs. The expectation in accordance to the supranational governance theory is that the state aid policy toward banks will become more robust and stronger due to the relationship between the involved parties. However, is that really so? Is it a balanced bargaining of discretion in this network relationship, or is one party dominates the other? Has the implementation of state aid policy becomes less robust and stronger due to the network relationship? If these questions are really happening, it would definitely falsify the hypothesis.

The Commission, as the guardian of the Treaty, has the ultimate but not the sole responsibility for developing policy and safeguarding efficiency and consistency (ECN, 2012). Therefore, the instruments of the Commission on the one hand and of the NCAs on the other hand are not identical. The additional powers the Commission has been granted to fulfill its responsibilities will be exercised with the utmost regard for the cooperative nature of the network[58].

Thus, in order to test this hypothesis, the data sources that will be used are the EC's official materials, such as the communication from the Commission of the application of state aid rules in 2009, 2011, and 2013, and scientific journals regarding the network relationship between the EC and NCAs in the field of state aid. Specific attention will be paid to the joint statement of the

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[56] Jary, D. and Jary, J. (1995) *Sociology.* Glasgow: HarperCollins. p. 714.

[57] Evans, Lowri. & Nyssens, Harold. (2007). *Economics in The State Aid: Soon As Routine As Dentistry?.* Lisbon Conference on Competition Law and Economics. Available at: http://ec.europa.eu/competition/speeches/text/sp2007_14_en.pdf

[58] European Competition Network. (2012). ECN's FAQ. Available at: http://ec.europa.eu/competition/ecn/faq.html

council and the EC on the functioning of the network of competition authorities, and also to the bargaining of the responsibilities between the involved parties. Attention will also be put on the channels in which EC's DG Comp uses in the implementation of the state aid policy, such as policy standards, supervisory process, the established relationship with the NCAs, and the banking union project will be described in the empirical analysis section.

H2 – Financial Resources: The key reason behind the European necessity of strictly coordinating and policing MS aid injection deals with the fact that the EC controls only 1% of the European GDP while national governments manage the rest[59]. Thus, state aid coordination is necessary because many MS can use their financial resources to wage a subsidy race and create anticompetitive campaigns which will destabilize the common market[60]. This condition puts limit on the EC's discretion in the state aid policy –despite the supranational governance theory- because a key characteristics of the euro zone and the banking crisis, is the functional need for additional financial resources to compensate for shortfalls (Donnelly, 2013). In order to restore confidence in the health of banks and to exit the crisis, regulators require powers to restructure and resolve insolvent banks. However, EC only possess small amount of financial resources, while the rest is in the MS' hands[61]. This renews the position of the MS as the final guarantors or Lender of Last Resort (LLR) function of the public interest in financial markets, as the EC lacks the ability, legal or financial, to nationalize financial institutions[62].

The expectation is that due to outside factors, particularly financial which leads to intergovernmental politics, EC's discretion and powers toward state aid policy will become limited. However, if after analyzing the data and then it turned out that the EC still have the full discretion and powers over state aid policy, it would falsify the hypothesis. The data sources which will be used to confirm or falsify this hypothesis will come from the EC's official

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[59] Poli, Eleonora Francesca. (2010). *Financial Crisis Effect On The Governance In The EU: The Development Of State Aid Regulation Beyond The Oil Crisis And The Credit Crunch.* Department Of International Politics, School Of Social Science City University London. Available at: http://web.uvic.ca/jmc/events/sep2010-aug2011/2010-09-financial-crisis/pdf/Oct1,2010-Panel_B-Eleonora_Poli-Uvic-Financial_Crisis.pdf

[60] Ibid.

[61] Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

[62] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Consortium for Political Research. (384– 392). Available at: www.palgrave-journals.com/eps/1680-4333/11

materials, such as directives on state aid policy, press releases and statements, and related scientific research articles of the application of the state aid policy that contains the preferences and interests of the MS over the banking union project, as some of them are not in favour of the full discretion of the EC and its DG Comp.

4. Empirical Analysis

"The financial and economic crisis has propelled State aids to the top of the agenda of the Commission. The handling of the crisis situation is a basic test for the validity and the reasoning of the application of European State Aid rules. It tests the basic rationale, our ability to communicate and our ability for reform[63]".

4.1. Overview: The Commission Versus The Financial Crisis

This chapter is the core of this study since it will fully discussing the extent of the Commission's discretions and powers in implementing the state aid policy towards EU's banking sector particularly at the onset of the banking crisis. In the area of state aid, the EC through its DG Comp monitors the behavior of MS governments (Zahariadis, 2010). This is the form of EC's supranational powers which in accordance with the supranational governance theory; where the supranational institutions have the exclusivity in applying the policy. The EC is charged with controlling the payment of competition-distorting aid to national financial institutions and interpreting the rules to assess aid's legality[64]. Such politically contentious powers are important because the single market requires effective network co-operation of the EC and MS governments (Zahariadis, 2010). The network relation thrives on co-ordinating a multitude of actors and approximating diverse interests (Kohler-Koch, 1999). This in turn will show to what extent the EC's power and latitude in the state aid policy.

[63] Herbert Ungerer, Deputy Dir. Gen. with Special Responsibility for State Aid, Directorate Gen. Competition, Eur. Comm'n, Keynote Address at the 7th Experts' Forum on New Developments in European State Aid Law: State Aids 2008/2009— Twelve Months of Crisis Management and Reforms 20 (May 14, 2009). Available at: http://ec.europa.eu/competition/speeches/text/sp2009_05_en.pdf.
[64] Zahariadis, Nikolaos. (2010). *Discretion By The Rules: European State Aid Policy And The 1999 Procedural Regulation.* Journal Of European Public Policy 17:7. Available at: http://www.tandfonline.com/doi/abs/10.1080/13501763.2010.499224

The financial crisis that struck Europe in 2008 has affected the financial institutions based and/or operating in the EU (Ungerer, 2009). This leads to massive intervention of national authorities in the economy[65]. The counter hypothesis of this thesis stated that there are outside factors, financial ultimately, that place limits on the EC's powers and discretion regardless the supranational governance theory. Thus, the financial crisis is the real test for the EC's supranational powers and willingness in the state aid policy because according to the Larosiere report:*"the scale of the financial and economic crisis that broke out in the autumn of 2008, and the systemic risks associated with it, were such that Member States used unprecedented amounts of State aid to the financial sector"* (Larosiere, 2009, page 6). This might caused distortions of competition between the MS and therefore must be prevented by a consistent application of the state aid policy[66].

In that sense, this research sets the emphasis in providing the answer to the extent of EC's discretion on state aid policy in times of economic crisis, by testing the main concepts of the hypotheses; the network relationship and the financial resources. The state aid cases in several EU banks will be analyzed in this chapter to provide a clearer understanding of the situation and deliver the answer of this research.

4.2. The Analysis of EC's Extent Of Discretion

H(1): If Supranational Governance is applicable, the EC will practice its formal and informal (entrepreneurial) discretion in the implementation of the state aid policy toward banks in the network relationship between itself as the sole implementer at the EU level and NCAs at the national level.

Since 'good' state aid can stimulate innovation and human-capital development in the financial area, the effective support between the Commission and other related actors (e.g. NCAs, MS, aid-receiving financial institutions) is important in ensuring that the state aid policy is correctly implemented toward the financial institutions in every level, and will be able to show the clear

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65 Muşetescu, R. C. (2012). *The Economics of State Aid Control in the European Union during the Financial Crisis: the Challenge for a Post-Crisis Rhetoric*. Theoretical and Applied Economics, 6(6), 175. Available at: http://store.ectap.ro/articole/745.pdf

66 European Round Table of Individualists. (2010). *Challenges in EU Competition Policy.* Available at http://www.ert.eu/sites/default/files/2010-03%20COMPETITION%20POLICY%20REPORT%20FINAL.pdf

division of task between the related actors and the Commission[67]. The ultimate partnership in the governance activity is the formation of self-governing networks (Atkinson and Coleman, 1992; Marsh and Rhodes, 1992). The systemic co-ordination form of partnership goes a step further by establishing a level of mutual understanding and embeddedness that actors develop a shared vision and joint-working capacity that leads to the establishment of the self-governing networks (Stoker, 1998). Governance networks involve not just influencing government policy but taking over business of government[68]. Actors and institutions gain a capacity to act by blending their resources, skills, and purposes into a long-term coalition: a regime (Stoker, 1998). According to article 93 of the EC treaty, state aid policy is entrusted to the Commission and to the Commission alone[69]. The only exception is to be found in article 93(2) which allows the council, acting unanimously, to declare a state aid to be compatible ‘if such a decision is justified by exceptional circumstances’ (Ehlermann, 1994).

4.2.1. Discretion Development

The Commission has developed a strong network by acquiring a privileged access to information which is not available to MS (Smith, 1998). Hence, the DG Comp has become a valid operational centre of coordination, capable of linking the supranational interests and MS’ concerns[70]. State aid policy is not addressed to enterprises, but states (Ehlermann, 1994). They limit the freedom of governments, even of parliaments to grant financial advantages to certain sectors of their economy, in this case the banking sector (Ehlermann, 1994). Bannerman (2002) underlined that the network of EU competition authorities must be a true partnership between the EC and the MS. In the case of the state aid to the banking sector, the Commission and its DG Comp as the sole implementer of the policy in the EU, have decided to form a network relationship with other state aid-related actors, such the ECB, MS, NCAs, MS’ central and

[67] Almunia, Joaquin. (2014). *Statement On New State Aid Rules For R&D And Innovation And On The Extended Notification Exemptions Of State Aid.* Available at: http://europa.eu/rapid/press-release_SPEECH-14-402_en.htm

[68] Stoker, Gerry. (1998). *Governance As Theory: Five Propositions.* International social science journal, 50(155). 17-28. Available at: http://classwebs.spea.indiana.edu/kenricha/Oxford/Archives/Oxford

[69] Ehlermann, Claus-Dieter. (1994). *State Aid Control In The European Union: Success Or Failure?.* Fordham International Law Journal. Available at: http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1435&context=ilj

[70] Smith, M. (1998). *'Autonomy by the rules: The European Commission and the development of state aid policy'*. Journal of Common Market Study 1[03], 55-78.

national banks (European Commission, 2011). Fostering a network competition relationship at national level includes the Commission's powers to ask the MS to recover unlawful aid which has been declared incompatible[71].

State aid policy is not a static and rigid policy because it takes account of changing economic realities[72]. The combination of firm principles with flexible processes has allowed state aid to play a constructive and stabilizing role in the EU’s financial system and real economy (European Commission, 2009). Since the onset of the crisis, the network relationship between the Commission and the MS has been established in order to create good practice of the state aid policy in the banking sector (Commission, 2009).

4.2.2. Division Of Work

In order to ensure that the aids were given to the countries in line with the state aid policy, supranational supervision needs to be assisted with national level supervision (European Commission, 2013). The Commission, together with the NCAs has been closely associated with the restructuring of the financial sector to ensure that the massive support necessary to keep those institutions alive in difficult macroeconomic environment does not result in undue distortions of competition (European Commission, 2011). Work sharing between the enforcers in the network has generally been unproblematic. Five years of experience have confirmed that the flexible and pragmatic arrangements introduced by Regulation 1/2003 and the Network Notice work well (European Commission, 2008). Discussions on case allocation have come up in very few cases and have been resolved swiftly[73]. The divisions of work are as follows[74]:

- The joint statement of the Council and the Commission on the Functioning of the Network of Competition Authorities explains that as many cases as possible will be dealt by a single NCA or

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[71] European Commission. (2011). *Commission Staff Working Paper Accompanying The Report From The Commission On Competition Policy.* Available at: http://ec.europa.eu/competition/publications/annual_report/2011/part2_en.pdf

[72] European Commission. (2009). *Report On Competition Policy Including Commission Staff Working Document.* Available at: http://ec.europa.eu/competition/publications/annual_report/2009/en.pdf

[73] European Commission. (2008). *Report on Competition Policy 2007* COM 368 final. 16 June 2008.

[74] Elaborated From DG Comp’s *‘Joint Statement Of The Council And The Commission On The Functioning Of Competition Authorities.* Available at: http://ec.europa.eu/competition/ecn/joint_statement_en.pdf

the EC. Where an agreement or practice substantially affects more than one member state, members of the ECN will seek to agree who is best placed to deal with the case successfully (*paragraphs 16 and 17, Joint Statement*).

- In cases where competition is affected in more than one member state and no single member state would be able to deal with the case successfully alone, parallel action may be appropriate. An NCA may be designated as the "lead NCA" in the case, although each authority that is well placed to act may conduct its own investigation (*paragraph 18, Joint Statement*).
- The Commission will be well placed to deal with a case where competition in more than three member states is affected. The Commission may also be the most appropriate authority to deal with cases that are closely linked to other EU provisions which may be exclusively, or more effectively, applied by the Commission. Cases may also be dealt with by the Commission where European Union interest requires the adoption of a Commission decision to develop EU competition policy. This will be the position, in particular, where a case involves new competition issues (*paragraph 18, Joint Statement and paragraphs 15 and 16, Network Notice*).
- Case allocation will be completed as quickly as possible. An indicative time limit (up to 3 months) will be used within the Network. Normally, this allocation will remain definitive to the end of the proceedings provided that the facts known about the case remain substantially the same. If so, this implies that the competition authority which has notified the case to the network will normally remain the responsible competition authority if it is well placed to deal with the case and no other competition authority raises objections during the indicative time period.
- All members of the network will endeavor to make allocation a predictable process with business and other interested parties receiving guidance as to where to direct complaints.
- Members of the network will ensure that those cases which merit a detailed investigation by a competition authority are adequately allocated and assessed. This principle does not prejudice the discretion of all Network members to decide whether or not to investigate a case.

In most cases, the NCA that receives a complaint or commences an investigation will remain in charge of the case. A case will only be reallocated to another NCA or the Commission at the start of a procedure where either the NCA does not consider that it is well placed to act or where another NCA (or the Commission) considers that it is well placed to act (*paragraph 6, Network Notice*).

In deciding whether an authority is well placed to act, NCAs will take into account factors including the market or markets in which the main anti-competitive effects of the agreement or practice are felt, and the NCA's ability to gather evidence, to bring the infringement to an end, and to effectively sanction the infringement. According to the Network Notice, an NCA or the Commission will be well placed to act where the agreement or practice has substantial direct actual or foreseeable effects on competition within its territory, is implemented within, or originates from, its territory (*paragraph 8.1*), the NCA is able to bring the entire infringement to an end, and can sanction the infringement adequately (*paragraph 8.2*), the NCA can gather the evidence required to prove the infringement (*paragraph 8.3*).

As the new system is governed by rules of parallel competences, an optimal division of work is required. For an NCA to be well placed to act, there has to be a material link between the infringement and the NCA's member state. In most cases, the NCAs in countries where competition is substantially affected by an infringement will be well placed to act as long as they are capable of effectively bringing the infringement to an end. It may be, however, that the Commission will be better placed to act in such cases. It is important to point out in this context that, although the ECN provides the framework for efficient work sharing between NCAs by means of the exchange of information mechanism, it does not decide on the division of the work, nor do the Commission or the NCAs themselves. In practice, NCAs start, conduct and possibly conclude the proceedings in accordance with their own responsibility[75].

From the abovementioned explanation, the EC has the ultimate but not the sole responsibility for developing policy and safeguarding efficiency and consistency. Within the network relationship, the EC's role has tend become more of an observer. An investigating NCA has to inform the Commission without delay, and may also inform the other NCAs, when it commences its first investigative measure[76]. In most cases, an NCA also has to notify the Commission 30 days before adopting a decision, again with the possibility of notifying the other NCAs (Mataija, 2010). The EC can request all other documents necessary for the assessment of a case. The EC is

[75] Kekelekis, Mihalis. (2009). *The European Competition Network (ECN): It Does Actually Work Well.* The European Competition Network, Study Report. Available at:
aei.pitt.edu/12378/1/20090709111900_Study_Eipascoop2009_01.pdf

[76] Art 11 par 3 Regulation 1/2003.

the place to consult for the NCA; facts, evidence, and even guidance on the proper legal or economic interpretation – that an NCA might be curious about when dealing with a specific case. The Commission must share its most important findings to the NCAs. The NCAs must assist the Commission in obtaining evidence, most notably by performing the 'visit' to the state-aid-injected financial institutions. The Commission assume jurisdiction in any individual case. Not only does the initiation of a Commission investigation pre-empt NCAs from acting in the same case, but the Commission can also assume jurisdiction even if an NCA has already acted, as long as it 'consults' the NCA. This power has, however, so far not been applied by the EC although it is constantly reviewing the NCAs' investigations informally.

All state aid authorities within the network are independent from one another[77]. Cooperation between NCAs and the EC takes place on the basis of equality, respect, and solidarity, and they cooperate not only on cases but also on policy developments through various forums within the ECN (Commission, 2009). The cooperation within the network is dedicated to the effective enforcement of EC state aid policy throughout the EU.

4.2.3. EC's Discretion According To The EC's Report

As has been stated previously, the hypotheses will be tested in three points of time -2009, 2011, 2013- with the EC's report on competition policy. During 2009, the European Union, alongside the rest of the world, has faced an exceptionally severe financial and economic crisis[78]. Almost immediately concerns were raised that state aid policy would impede necessary state intervention and thus lead to the collapse of the financial system[79]. As a result, there were calls for a temporary suspension of the policy. Despite the calls, the EC rightly resisted these demands and issued several communications that introduced greater flexibility in the application of state aid policy (Heimler & Jenny, 2012). MS governments, central banks and financial regulators, together with the EC in a network, have worked hard to stabilize the financial system and make

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[77] *European Commission. (2010). Joint Statement Of The Council And The Commission On The Functioning Of The Network Of Competition Authorities.* Available at: ec.europa.eu/competition/ecn/joint_statement_en.pdf

[78] European Commission. (2009). *EC Report On Competition Policy.* P. 12. Available at: http://ec.europa.eu/competition/publications/annual_report/2009.pdf

[79] Heimler, Alberto & Jenny, Frederic. (2012). *The limitations of European Union control of state aid. Oxford Review of Economic Policy*, *28*(2), 347-367. Available at: http://oxrep.oxfordjournals.org/content/28/2/347.short

sure that a crisis of this type does not occur again in the future (Commission, 2009). According to the Commission report of the same year, since the beginning of the crisis, EC's objectives have been twofold; first, to support financial stability by giving legal certainty to rescue measures taken by the MS, and secondly, to maintain a level playing field in EU while ensuring that national measures would not export problems to other MS[80].

2009

The EC's state aid communication of 2009 stated that between October 2008 and August 2009, EC adopted four communications indicating how it would apply the state aid rules to government measures to support the financial sector in the context of the crisis (Commission, 2009). The first one in effect was the Banking communication which contains the guidance on the application of state aid policy to state support schemes and individual assistance for financial institutions. At that time, the EC had to deal with numerous notifications of emergency aid measures by MS. They had to respond within very tight time frames, reallocating highly committed staffs and temporarily recruiting new resources (Commission, 2009). In order to face up to the crisis, EC adopted Recapitalization communication- after in-depth discussion with the ECB and MS. This second communication differentiates between banks that are fundamentally sound and the ones in distress. Both the Banking and Recapitalisation communications have made it possible to preserve financial stability and to lessen restrictions on the availability of credit whilst keeping distortions in competition to a minimum (Commission, 2009). In particular, recapitalization measures have proven to be essential for providing banks with a sufficient capital base, so that they could continue to fulfill the role as a lender to the real economy[81]. Although at the onset of the crisis national governments tended to focus on national level responses, they quickly realized that international coordination would be required[82]. The coordination was rapid between the EC, ECB and other EU national central banks (Quaglia et al., 2009).

Despite the fact that recapitalization schemes had been put in place in many MS, in early 2009 investors were not showing signs of confidence in the system (Commission, 2009). Bank

[80] Ibid.

[81] Heimler, Alberto & Jenny, Frederic. (2012). *The limitations of European Union control of state aid. Oxford Review of Economic Policy*, *28*(2), 347-367. Available at: http://oxrep.oxfordjournals.org/content/28/2/347.short

[82] Quaglia, L., Eastwood, R., Holmes, P. (2009). *The Financial Turmoil and EU Policy Co-operation in 2008*. JCMS: Journal of Common Market Studies, 47(s1), 63-87.

guarantees and recapitalizations did not translate into credits flowing to the economy; uncertainty remained about undisclosed losses on assets having lost value[83]. Therefore, after detailed discussions with the MS, the EC adopted the third communication, namely the Impaired Assets communication as a response to a growing general agreement on the need to tackle the root causes of the crisis in the form of toxic assets on banks' balance sheets (Commission, 2009). Along the time, EC started to look at the medium term and the exit strategy; at the way aid beneficiaries could start paying back the money and stand on their own feet permanently (Commission, 2009). For that reason, they adopted the last piece of the communication: the Restructuring communication. It reflects the EC's thinking for a future beyond the crisis with a viable banking sector. By means of this communication, the EC sets out its discretion on the principles applicable to those beneficiaries that were not only in need of short-term rescue aid, but required aid to implement structural changes to their business models (Communication, 2009).

Another evidence of EC's power in granting state aid with condition in 2009 was when they approved the application of the GBER in order to accelerate and simplify the injection of the aid to the crisis-affected banking institutions (Commission, 2010). This framework exempted the notification procedure that the MS required to do before they could grant the aid[84]. However it does not meant that the EC losing its discretion because the network relationship plays an important role here; MS will still have to provide the reports to the EC after the aid has been granted (European Commission, 2009).

The EU view on aid to the financial sector has been phrased as follows (open letter of the DG Comp to the Financial Times, April 22, 2009): "We are applying the tried and tested code of good economic governance that the EC Treaty's state aid rules represent to ensure four things: 1) that banks receive sufficient support to avoid financial meltdown; 2) that Member States' cures for their own banks do not put those banks in an artificially advantageous competitive position that would kill off banks in other Member States; 3) that banks are restructured to ensure their

[83] European Commission. (2009). *EC Report On Competition Policy.* P. 12. Available at: http://ec.europa.eu/competition/publications/annual_report/2009.pdf

[84] *European Commission. (2010). Joint Statement Of The Council And The Commission On The Functioning Of The Network Of Competition Authorities.* Available at: ec.europa.eu/competition/ecn/joint_statement_en.pdf

future long-term viability so that the mistakes of the past are not repeated, that taxpayers' money does not disappear down a black hole and that lending to the real economy is secured; 4) that the Single Market is preserved, with no discriminatory conditions attached to aid and no barriers to entry for cross-border banking. This is because the Single Market is crucial to ensuring Europe's economic recovery".

2011

2011 was a year of turbulence. The financial crisis turned into a sovereign debt crisis in parts of the euro area, threatening the banking sector and the fiscal sustainability of many MS governments (Commission, 2011). The prevailing uncertainties in financial markets required prolongation of the extraordinary state aid crisis policy. In regards to that, the EC has decided to prolong the special rules applicable to financial institutions at the early December of 2011 (Commission, 2011). By means of those rules, state aid policy has continued to become a consistent policy response to the financial crisis throughout the EU, and contributed significantly in limiting distortions of competition between aid beneficiaries financial institution within the single market (Commission, 2011).

The EC confirmed its approach to failing banks in a number of important decisions throughout the year[85]. According to EC's 2009 communication on the application of state aid, financial institutions which have no realistic prospect of returning to viability must exit the market and not be kept artificially afloat by repeated state support.

In 2011, further progress was made to ensure that the recovery decisions are enforced effectively and immediately. By 31 December 2011, the amount of illegal and incompatible aid recovered had increased from EUR 2.3 billion in December 2004 to EUR 12.3 billion (resulting in a decrease from 75% to around 13.6% of the percentage of illegal and incompatible aid still to be recovered as of 31 December 2011)[86]. The example of this network relationship can be seen by the fact that both the Commission and the Member States have contributed to ensuring well-functioning markets through the enforcement of European and national competition law

[85] European Commission. (2011). *EC Report On Competition Policy.* P. 3. Available at: http://ec.europa.eu/competition/publications/annual_report/2011.pdf

[86] European Commission. (2011). *Commission Staff Working Paper Accompanying The Report From The Commission On Competition Policy.* Available at: http://ec.europa.eu/competition/publications/annual_report/2011/part2_en.pdf

(European Commission, 2011). All 27 Member States have functioning competition agencies or NCAs, with which the Commission has coordinated its actions in numerous cases. In 2011, no fewer than 88 cases were submitted by the Member States to the Commission for consultation, increasing the total number of cases brought since May 2004 to 555 (European Commission, 2011).

2013

The EC stated in its 2013 report in state aid, that there have been encouraging signs that an economic recovery is underway. Policy actions undertaken at EU level contributed to start restoring confidence and creating the basis for returning to a growth path, however, this does not mean that all the restructuring efforts should be relaxed (Commission, 2013). If the EU wants to leave the legacy of the crisis behind and re-launch the European economy, it needs to go further with underpinning those positive signs by further measures to ensure sustainability[87]. What Europe needs are structural adjustments, an efficient allocation of resources, and productivity growth (Commission, 2013). Smart, sustainable and inclusive growth remains at the core of Europe's policy agenda for the decade. Boosting competitiveness across the EU is paramount for reaching that objective (Competition, 2013). In regards to that, in 2013, the EC has adopted a new communication on the application of EU state aid policy to support measures in favour of banks in the context of the financial crisis (the Banking communication)[88]. The new communication replaces the 2008 banking communication and contains the updated rules for crisis-related aid to the financial sector, and supplements the other communications for the financial sector (crisis communications[89]). EC hopes that the new rules will enable a more

[87] European Commission. (2013). *Report From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions on Competition Policy: Accompanying Document.* Available at: http://ec.europa.eu/competition/publications/annual_report/2013/part1_en.pdf

[88] Von Bonin, Andreas. (2013). *New Rules On State Aid To Banks.* Freshfields Bruckhaus Deringer LP. Available at: http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/36418.pdf

[89] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('2008 Banking Communication'); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication'); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication'); Communication on the return to viability and the assessment of restructuring measures in the

efficient restructuring of banks and the minimization of state aid (Von Bonin, 2013). In addition, the rules are intended to prepare a smooth transition to a banking union by providing more clarity to markets. To achieve these objectives, the EC has further tightened its rules towards the beneficiary banks, and limited the ability of MS to grant aid in the financial sector (Von Bonin, 2013).

State aid policy was an important tool to help to ensure that banks revert to their economic function as lenders to the real economy, through conditionality in restructuring decisions[90]. Together with the ECB and the International Monetary Fund (henceforth IMF), they kept providing financial assistance to MS that had requested it, such as Ireland, Greece, Portugal, and Cyprus, since the restructuring of the banking sectors, including extensive financial-sector conditionality, was one of the main policy requirements addressed to those countries (Commission, 2013).

A viable, transparent, and competitive banking system providing finance to the real economy is a necessary precondition to restore sustainable growth[91]. The current financial and economic crisis has its origins in the financial sector and any exit strategy necessarily requires addressing the root causes of the crisis.

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financial sector in the current crisis under the State aid rules (‘Restructuring Communication’); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis (‘2010 Prolongation Communication’), and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis (‘2011 Prolongation Communication’). Elaborated from the Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (‘Banking Communication’). Available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730%2801%29#ntr1-C_2013216EN.01000101-E0001

[90] European Commission. *(2013). Report On Competition Policy.* Available at: http://ec.europa.eu/competition/publications/annual_report/2013/part1_en.pdf

[91] European Commission. (2012). *Report On Competition Policy.* Available at: eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52013DC0257

Table 1: Overview of temporary State aid communications in response to crisis

Date published in EU Official Journal	Title	Expiry date
25 October 2008	Application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (banking communication)	No specific expiry
15 January 2009	Recapitalisation of financial institutions in the current financial crisis (recapitalisation communication)	No specific expiry
22 January 2009 (consolidated April 2009, amended October and December 2009)	Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis (general sector support)	31 December 2010
26 March 2009	Treatment of impaired assets in the Community banking sector (impaired assets communication)	No specific expiry
19 August 2009	Return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (restructuring communication)	31 December 2010
7 December 2010	On the application, from 1 January 2011, of the State aid rules to support measures in favour of banks in the context of the financial crisis	31 December 2011
11 January 2011	Temporary Union Framework for State aid measures to support access to finance in the current financial and economic crisis	31 December 2011

Source: European Commission (2008), (2009a), (2009b), (2009c), (2009d), (2010b) and (2011).

4.2.4. Empirical Case Study Example: EC vs. ING Case And EC vs. Commerzbank

At the onset of the crisis, Commerzbank was the second largest private bank in Germany with €1.1 trillion in assets (Doleys, 2010). In the wake of Lehman and the contraction of interbank lending, the bank was unable to secure the liquidity it required to meet its obligations. It asked for state aid injection and was granted an €18 billion recapitalization package[92]. Under the terms of the *Recapitalization Communication*, on which basis the Commission approved the capital injection, Commerzbank was asked to submit to the Commission a restructuring plan.

Negotiations with Commission over elements of the package were protracted (Doleys, 2010). The Commission insisted that restructuring address what it regarded as the fundamental problems with its business model. The final package, approved by the Commission on 7 May 2009, was noteworthy for both its scale and scope (Doleys, 2010). Commerzbank committed to refocusing operations on its retail and corporate banking operations. To do this, it would divest

[92] Doleys, Thomas. J. (2010). *Managing State Aid In Times Of Crisis: The Role of The European Commission.* ECPR Fifth Pan-European Conference On EU Politics. Available at: http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf

itself of investment banking and its commercial real estate holdings (Gerard, 2013). It was also committed to a number of behavioral constraints, including a ban on paying dividends, a three year ban on the acquisitions of competitor and prohibition on acting as a price leader[93]. When completed, the Commission-mandated "cost" of Commerzbank"s €18 billion bail-out will be a 45 percent (c. €500 billion) reduction in its balance sheet from pre-crisis levels[94]. The Commission concluded that the business plan presented is likely to restore the bank's long-term viability (Commission, 2009).

In the case of EC vs. ING, it was via article 87(3)(b) EC Treaty that the Commission issued its approval of rescue packages towards EU banks, which one of them was the Dutch bail-out package for ING[95]. According to Clifford Chance's Client Briefing which was published on 2012, the General Court in Luxembourg (henceforth the "Court") on 2 March 2012 handed down its judgment in relation to the classification of State aid provided to ING by the Dutch State in the context of the financial crisis. Proceedings were brought by the Dutch State and ING against the European Commission (the "Commission"), disputing the level of aid received and (as far as ING's appeal was concerned) the restructuring measures required from ING to class the aid as compatible with the common market. The Dutch Central Bank ("DNB") acted as intervener in ING's appeal. The important chronologies of the case are as follows[96]: In the context of the systemic financial crisis, ING – like numerous other banks – required financial support from the State. For ING, the bail-out consisted, in particular, of two distinct measures: On November 11th 2008, ING Group received a capital injection of €10 billion from the Dutch state via the creation of one billion ING securities at a price of €10 each. Under the terms agreed between ING and the state, the securities were, on ING's initiative, either to be repurchased at €15 (50% premium), or,

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[93] Gerard, D. (2013). *Managing the Financial Crisis in Europe: The Role of EU State Aid Law Enforcement.* Universite Catholique de Louvain. Available at: http://www.uclouvain.be/cps/ucl/doc/ssh-cdie/documents/2013-06_D.Gerard.pdf

[94] Doleys, Thomas. J. (2010). *Managing State Aid In Times Of Crisis: The Role of The European Commission.* ECPR Fifth Pan-European Conference On EU Politics. Available at: http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf

[95] European Commission. (2012). *Memorandum From Mr. Almunia To The Commission Regarding ING Case.* Available at: http://ec.europa.eu/competition/state_aid/cases/244692/244692_1348558_30_2.pdf

[96] Oxera. (2012). *Passing Judgment on Crisis State Aid Control: The ING MEIP Case.* Available at: http://www.oxera.com/Oxera/media/Oxera/downloads/Agenda/The-ING-MEIP-state-aid-case.pdf?ext=.pdf

after three years, to be converted into ordinary shares[97]. The second measure was on October 24th 2009, where the state and ING amended their deal. The new terms provided that ING could now repurchase up to half of the securities at the issue price €10, rather than €15. If it exercised this option, ING would have to pay accrued interest plus an early-redemption penalty of up to €705m (Clifford Chance, 2012). On November 18th 2009, the Commission adopted a Decision which said that the amendment itself constituted additional state aid on top of the capital injection, and that this new aid could be valued at €2 billion (Oxera, 2012). On December 21st 2009, ING exercised the option available under the amended deal, repaying half of the capital injection by redeeming half of the state's securities at a price of €10, plus the interest and early-redemption premium (Oxera, 2012). The state had earned approximately a 15% internal rate of return on its investment in one year. On January 28th 2010, ING and the Dutch government appealed the Commission Decision, saying that the amendment to repayment terms did not result in an additional €2 billion of aid, and that, on this basis, the Decision should be annulled (Oxera, 2012). On March 2nd 2012, the General Court ruled in favour of ING and the Dutch government (Oxera, 2012).

The general court's judgment was a victory for ING and Dutch state as it annuls part of the Commission's state aid decision (Clifford Chance, 2012). The general court ruled that the EC had overstated the state aid received by ING during the financial crisis by up to EUR 2 billion and as the result of the victory; ING may be relieved from certain remedies imposed by the EC[98]. The judgment creates a set-back for the Commission powers and latitude as it states that the restructuring requirements placed on ING are closely linked to the amount of aid received by it from the Dutch State, indicating that remedies in State aid cases must be proportionate to the level of aid provided[99]. From the case review in the European Law Blog[100], the Court of Justice

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[97] Oxera. (2012). *Passing Judgment On Crisis State Aid Control: The ING MEIP Case.* Agenda: Advancing Economics In Business. Available at: http://www.oxera.com/Oxera/media/Oxera/downloads/Agenda/The-ING-MEIP-state-aid-case.pdf?ext=.pdf

[98] Clifford Chance. (2012). *ING's Landmark Victory Brightens The Outlook For State Aid Recipients.* Available at: https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrIGReI2crGqLnALtlyZe8m8PS4S4a9fNN6Jk%2FYL0Zjp%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaeIf&attachmentsize=127790

[99] Ibid.

[100] http://europeanlawblog.eu/?p=2453

of The European Union (CJEU) confirmed the General Court's judgment of 2 March 2012 in the State aid dispute between the EC and the Kingdom of the Netherlands, ING Groep NV and the Dutch Central Bank (De Nederlandsche Bank NV).

4.2.5. European Banking Union

The European Council meeting in 2012 marked the starting point of an ambitious project to create a European banking union as part of a collective European effort to resolve the current crisis and build a more resilient policy infrastructure for Europe's financial system (European Council, 2012). A solid and federal banking union is the most important basis for a stable Eurozone (Geeroms & Karbownik, 2013). The banking union also aimed to break the vicious circle between sovereign debt and national banking crises that threatened the Union's financial stability and the very survival of the Euro[101]. That includes four successive steps, the first three of which are explicitly framed in the European Council Conclusions, and the fourth kept deliberately implicit[102].

The First Step

The first step was the creation of the Single Supervisory Mechanism (SSM), now being finalized following an agreement at the Economic and Financial Affairs Council meeting of 13 December 2012 (ECOFIN, 2012). Its initial phase has already started at the ECB with the cooperation of national supervisors (ECOFIN, 2012). In addition to the adoption of the Council regulation establishing the SSM (SSM Regulation; Council, 2012), are the adoption of the regulation reforming the European Banking Authority (EBA Regulation) to adapt it to the new situation created by the advent of the SSM, as well as the adoption of the Capital Requirements Regulation (CRR) and its complement; the fourth Capital Requirements Directive (CRD IV), in order the SSM can implement a harmonized supervisory 'rulebook' based on the Basel III

[101] Micossi, Stefano., Bruzzone, Ginevra., Carmassi, Jacopo. (2013). *The New European Framework For Managing Bank Crises.* Centre For European Policy Studies: Brussels. Available at: www.ceps.eu

[102] Veron, Nicolas & Wolff, Guntram. B. (2013). *From Supervision To Resolution: Next Steps On The Road To European Banking Union.* Bruegel Policy Contribution. Available at: http://www.bruegel.org/download/parent/771-from-supervision-to-resolution-next-steps-on-the-road-to-european-banking-union/file/1646-from-supervision-to-resolution-next-steps-on-the-road-to-european-banking-union/

accord, instead of the currently applicable (and often divergent) national regulations (Veron & Wolff, 2013).

An SSM offers many potential advantages[103]: It would facilitate a more systemic approach to track the buildup of risk concentrations, and contribute to achieving a comprehensive macroprudential oversight of the euro area; It would coordinate supervisory actions across countries, and ensure consistent application of prudential norms; It would foster convergence of best practices across members, partly alleviate concerns of regulatory capture at the local level, and promote integration of the single market for financial services. In concrete terms, higher standards of supervision in place before the crisis might have meant a swifter identification of an unsustainable build-up of risk (e.g., in Ireland or Spain) and a more timely and effective intervention to diffuse such risk (e.g., by applying higher capital buffers or restricting excessive concentrations) (Goyal et al., 2013).

Central banks are probably the most trusted institutions in the financial economic world, even more so after the financial crisis of 2007-2008[104]. Therefore, the ECB was made responsible for the SSM. Because the supervision of around 6000 banks in the Eurozone is a huge task for an institution without any experience in prudential supervision, and because national authorities prefer keeping an eye on their own banks, the supervision is based on the principle of subsidiarity by the ECB assisted by the NCAs (Geeroms & Karbownik, 2013). The SSM is the ultimate responsible authority for all banks in the Eurozone. However, the actual conduct of supervision is delegated to the NCAs, depending on the size of the banks (Geeroms & Karbownik, 2013). The EC argued that even smaller banks can pose systemic risks due to interlinkages and thus destabilize countries and regions; Spanish Caja's are used as an example (Garicano, 2012). Thus, the ECB is responsible for an extensive set of tasks ranging from the authorization of credit institutions to carrying out early interventions in the case of financial distress of a credit institution (ECB, 2013).

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[103] Goyal, Rishi., Brooks, Petra Koeva., Pradhan, Mahmood., Tressel, Thierry., Dell' Ariccia, Giovanni., Leckow, Ross., Pazarbasioglu, Ceyla. (2013). *A Banking Union For The Euro Area.* International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

[104] Geeroms, Hans & Karbownik, Pawel. (2013). *How To Complete The EU's Banking Union.* WMCES Research 2013-2014. Service Public Federal Finances: Belgium.

The Second Step

According to Geeroms & Karbownik (2013), beyond supervision, there were two initiatives that the EC wants to be completed:

• First, an *"operational framework"* for the direct recapitalization of banks by the ESM, the euro area crisis-management fund created in 2012, which is mentioned in connection with the *"imperative to break the vicious circle between banks and sovereigns"*. In the language of the Council conclusions, this document, which is currently under negotiation between MS, should *"include the definition of legacy assets" and "be agreed as soon as possible in the first semester 2013"*;

• Second, the adoption of two pieces of legislation that were proposed before the June 2012 Council decision to create a banking union: the proposed Bank Recovery and Resolution (BRR) Directive (COM, 2012), adopted by the EC in the early June 2012, which would create or reform national bank resolution regimes in a harmonized way in compliance with the Financial Stability Board's recommendations (FSB, 2011), including a provision for the 'bail-in' of unsecured bank debt; and the proposed recast of the Deposit Guarantee Schemes (DGS) Directive (COM 2010), adopted by the Commission in July 2010, which would further harmonize national deposit guarantee systems.

The Third Step: Single Resolution Mechanism (SRM)

The December 2012 EC Conclusions stated that *"the [European] Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM, to be examined by the co-legislators as a matter of priority with the intention of adopting it during the current parliamentary cycle"* (Veron & Wolff, 2013). The SRM should *"safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises"*, and should be based on *"contributions by the financial sector itself and include appropriate and effective backstop arrangements"*[105]. Resolution is an administrative procedure to manage bank crises out of court

[105] Veron, Nicolas & Wolff, Guntram. B. (2013). *From Supervision To Resolution: Next Steps On The Road To European Banking Union.* Bruegel Policy Contribution. Available at: http://www.bruegel.org/download/parent/771-from-supervision-to-resolution-next-steps-on-the-road-to-

so as to protect financial stability, preserve vital systemic functions and protect depositors, while minimizing any adverse impact on taxpayers (Micossi et al., 2013). It normally entails the resolution authority taking full control of the failing bank's assets, liabilities and operations, with all the means and tools to reorganize it or wind it down[106]. Key principles in the European legislation under discussion are that no creditor should find they worse off than under a normal insolvency procedure; and that all decisions taken by resolution authorities should be subject to judicial review (Micossi et al., 2013). These principles guarantee that the Union procedure will not infringe fundamental rights under national and European law[107].

A single authority, as presumptive receiver of failed banks, can facilitate timely resolution, including of banks that operate across borders[108]. It provides a mechanism to internalize home-host concerns and reach agreement on resolution and burden sharing. It can thus help to avoid the protracted and costly resolutions that occurred (Goyal et al., 2013). A single authority is also necessary to align incentives for least cost resolution—since a common backstop in the context of a decentralized mechanism would provide mal-incentives to shift residual losses from national taxpayers to those in the euro area (Veron & Wolff, 2013). Pooling bank resolution capacity in a single body would achieve economies of scale, avoid incoherence and duplication, and accumulate expertise that would prepare and implement recovery and resolution plans, in particular for systemic institutions (Goyal et al., 2013).

The documents from the Commission and the Council suggest that the SRM proposal will be published only after the adoption of the BRR and DGS Directives (Van Rompuy, 2012). The reference to 'co-legislators' in the European Council conclusions is a hint that the SRM may take

european-banking-union/file/1646-from-supervision-to-resolution-next-steps-on-the-road-to-european-banking-union/

[106] Micossi, Stefano., Bruzzone, Ginevra., Carmassi, Jacopo. (2013). *The New European Framework For Managing Bank Crises.* Centre For European Policy Studies: Brussels. Available at: www.ceps.eu

[107] Ibid.

[108] Goyal, Rishi., Brooks, Petra Koeva., Pradhan, Mahmood., Tressel, Thierry., Dell' Ariccia, Giovanni., Leckow, Ross., Pazarbasioglu, Ceyla. (2013). *A Banking Union For The Euro Area.* International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

the form of a directive and/or regulation of the European Parliament and the Council, but with no indication of the underlying Treaty base[109].

The Fourth Step

The European Council Conclusions of December 2012 leaves the implicit need for further initiatives beyond the SRM. However, the banking union would remain incomplete and arguably unstable without further integration, particularly in the areas of insolvency, resolution and deposit insurance (Pisani-Ferry et al., 2012). The need for steps beyond the SRM has been obliquely acknowledged by European policymakers, including the acknowledgement by ECB executive board members that further integration of deposit guarantee schemes beyond the DGS Directive will be needed but is not urgent (Constancio, 2012 and 2013). The EC has also referred to the desirability of future Treaty changes to perfect the design of the SSM (European Commission, 2012)

4.2.6. Conclusion Hypothesis 1

The banking cases of Commerzbank and ING have created an authoritative example that any parties deals with the Commission must be given appropriate opportunities and amount of time to make their views known. The Commerzbank case was an example of a smooth implementation of EC's discretion of the banking state aid policy. While on the other hand, from the court ruling over the case, EC's power and latitude was definitely not a superior power which only work one way; as the financial institutions are able to stand up against the EC if they feel that the Commission is abusing or conducting mistakes in the application of its powers as in the ING case. Doley (2010) strengthen the previous statement by stating that a government which believes the Commission has acted beyond its authority can ask the ECJ to annul its actions on the grounds of 'lack of competence' or 'misuse of powers'.

A banking union-a single supervisory-regulatory framework, resolution mechanism, and safety net-for the Euro area is both immediate and longer term[110]. Moving responsibility for potential

[109] Veron, Nicolas & Wolff, Guntram. B. (2013). *From Supervision To Resolution: Next Steps On The Road To European Banking Union.* Bruegel Policy Contribution. Available at: http://www.bruegel.org/download/parent/771-from-supervision-to-resolution-next-steps-on-the-road-to-european-banking-union/file/1646-from-supervision-to-resolution-next-steps-on-the-road-to-european-banking-union/

financial support and bank supervision to a shared level can reduce fragmentation of financial markets, stem deposit flight, and weaken the vicious loop of rising sovereign and bank borrowing costs (Goyal et al., 2013). In steady state, a single framework should bring a uniformly high standard of confidence and oversight, reduce national distortions, and mitigate the buildup of concentrated risk that compromises systemic stability (Goyal et al., 2013). Progress is required on all elements; a single supervisory mechanism (SSM) must ultimately supervise all banks, with clarity on duties, powers and accountability, and adequate resources[111]. But without common resolution and safety nets and credible backstops, an SSM alone will do little to weaken vicious sovereign-bank links; they are also necessary to limit conflicts of interest between national authorities and the SSM[112]. A single resolution authority, with clear ex ante burden-sharing mechanisms, must have strong powers to close or restructure banks and be required to intervene well ahead of insolvency (Goyal et al., 2013).

From the aforementioned explanations and in relation to the supranational governance theory used in this research, it can be confirmed that the implementation of state aid policy has become more solid and robust because of the EC's independent powers and also because of the network relationship between the EC and the NCAs under the umbrella of ECN. The EC's initiative to issued four crisis communications, then revised one of them, and the banking union project are the evidence that the EC does indeed have the discretion and powers as the supreme implementer in the state aid policy. Although they suffered a minor setback in the ING case, it does not mean as a falsification of the hypothesis, as there were no proofs found that and therefore the first hypothesis can be safely confirmed.

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[110] Goyal, Rishi., Brooks, Petra Koeva., Pradhan, Mahmood., Tressel, Thierry., Dell' Ariccia, Giovanni., Leckow, Ross., Pazarbasioglu, Ceyla. (2013). *A Banking Union For The Euro Area.* International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

[111] Ibid.

[112] Goyal, Rishi., Brooks, Petra Koeva., Pradhan, Mahmood., Tressel, Thierry., Dell' Ariccia, Giovanni., Leckow, Ross., Pazarbasioglu, Ceyla. (2013). *A Banking Union For The Euro Area.* International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

4.3. The Analysis Of EC's Limitation Of Discretion At The Exit Strategy

Hypothesis 2 (Financial Constraint): *Regardless of the Supranational Governance theory, there are outside factors –ultimately financial factor which leads to intergovernmental politics- that limits the EC's discretion and willingness to restrict national state aid.*

At the onset of the crisis, banks and other financial institutions experienced an extreme combination of write-downs on their assets, dried-up liquidity in wholesale funding markets, and the loss of consumer confidence[113]. This has led to increased demand for state intervention in the economy in the name of systemic stability, predominantly but not exclusively at the national level[114]. MS have used a number of measures to ensure systemic stability of their national economies: capital injections, expanded deposit guarantees (state aid), engineering bank takeovers (generating dominant market positions) and nationalization, which transferred bank debt into the public sector (Donnelly, 2011).

State aid plays a role when a bank is nationalized, and it was commenced with EC's approval when no viable buyer could be found to support an insolvent or illiquid bank[115]. The EC expected these to be emergency measures in order to prevent the collapse of the financial sector (Donnelly, 2011). State intervention was seen as indispensable, but outside the EU's rule structure, leading the commission to approve of rule breaking by necessity at the same time as it is bound to defend rules by insisting that these deviations be temporary (Donnelly, 2011). The crisis also showed that MS governments became more important than EC and its DG Comp in saving the financial system and their demands more important than the restrictions of EU rules because EC's own budget is very small[116].

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[113] Adler, Emily., Kavanagh, James., Ugryumov, Alexander. (2009). *State Aid To Banks In The Financial Crisis: The Past And The Future.* Economist's Note. Available at: http://jeclap.oxfordjournals.org/

[114] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Political Science: 384-392. Available at: http://www.palgrave-journals.com/eps/journal/v10/n3/abs/eps201121a.html

[115] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Political Science: 384-392. Available at: http://www.palgrave-journals.com/eps/journal/v10/n3/abs/eps201121a.html

[116] Ibid.

4.3.1. The Hesitation Toward Banking Union

On 26 June 2012 the President of the European Council, Herman Van Rompuy, published the report "Towards a genuine Economic and Monetary Union". This was elaborated together with the Presidents of the Commission, the Eurogroup and the ECB. It proposed a stronger EMU architecture supporting the idea of integrated frameworks for budgetary matters, economic policy and for the financial sector (European Council, 2012). The European resolution scheme proposed in the report aimed at orderly winding-down troubled institutions and is primarily funded by contributions of banks to protect taxpayers. Moreover, the report proposed the creation of a common resolution authority in charge of the deposit insurance scheme and the resolution fund. Also, the report said the ESM could perform as the fiscal backstop (European Council, 2012).

The financial crisis has revealed the inadequacy of Euro area's institutional framework. Pre-crisis institutions promoted excessive (cross-border) risk-taking by the private sector but did not provide for regulatory mechanisms to enable sharing of risks that materialized[117]. In June 2012, at the height of the crisis, political leaders of the Euro area declared that "it is imperative to break the vicious circle between banks and sovereigns", thereby marking the starting point of the Banking Union (Veron & Wolff, 2013). Since 2012, the three pillars of the Banking Union have been spelled out further: the SSM as the most advanced pillar will become operational in November 2014; harmonized rules and centralized competencies in bank resolution have been agreed upon in SRM; and basic conditions for a common financing mechanism for bank resolution have been clarified in the Single Rulebook (Buch et al., 2014).

The agreement on the SSM and the SRM is a fundamental step away from the original concept of the Single Market where supervision is executed by national authorities (*home country control*), following harmonized rules (*minimum harmonization*) and *mutual recognition* of supervisory decisions (Buch et al., 2014). In short, it is a fundamental step towards enhanced financial integration. Before assuming responsibility for banking supervision, the European Central Bank (ECB) is conducting an examination of banks' balance sheets and risk profiles

[117] Buch, Claudia.M., Korner, Tobias., Weigert, Benjamin. (2014). Towards Deeper Financial Integration In Europe: What The Banking Union Can Contribute. German Council Of Economic Experts. Available at: http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_02_2013.pdf

(comprehensive assessment) (de Grauwe, 2013). However, the banking union side of financial stability has been hampered by the hesitation of the MS to delegate authority to the EU (Donnelly, 2013). An EU-level banking supervision without a corresponding degree of supranational financial resources creates a misalignment between the levels on which financial institutions are supervised and resolved[118].

The low degree of fiscal integration was caused by the unwillingness of the MS; which despite the fact that central banks can help markets or individual institutions to overcome liquidity problems, still reluctant whether to bail out insolvent financial firms using taxpayers' money or wind them down (weighted from both economic and political points of view) (Skuodis, 2014). James (2012:19) also confirmed that this was the logic behind the argument against a Europe-wide supervisory system during the negotiations on Maastricht Treaty. Spendzharova (2012: 318-319) described two main explanations why MS rejected the urges for bigger supranationalism in banking supervision, which means not transferring their financial resources to the EU level. First, many EU new MS, whose domestic financial markets are dominated by foreign institutions, raised serious doubts that giving the newly created European Supervisory Authorities (ESA) 'the power to issue binding decisions' could result in their footing the bill for bail-outs of foreign branches and subsidiaries operating in their jurisdiction. Second, the UK and other home states stressed that ESA will not be held accountable for the fiscal consequences of their binding decisions (Spendzharova, 2012). The deliberately unwillingness of the MS to transfer the financial to the EU level has made the EU neither created a pan-European supervision to match the pan-European banks, nor agreed on an EU-wide financial burden sharing mechanism to support falling cross-border institutions (Skuodis, 2014). This result in the failure of the ECB, which had been awarded supervision of EU banks, in receiving many of the powers that it had said in advance was necessary[119].

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[118] Skuodis, M. (2014). *The Political Economy of the European Banking Union: What Union for Which Member States?.* ECPR Joint Sessions Of Workshops. Available at: http://ecpr.eu/filestore/paperproposal/9dac1c1a-72d7-4840-a7ae-32c398d20179.pdf

[119] Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

4.3.2. The Emergency Exit: Backstop Arrangements

From a crisis management perspective, a well-designed Banking Union could provide a credible and stabilizing framework for handling failures of an individual financial institution or even several financial institutions at the same time[120]. However, the Banking Union in and of itself cannot be expected to deal with a systemic crisis, which, by definition, affects large parts of the financial system (Buch et al., 2014). In their 2014 writing, *'Towards Deeper Financial Integration In Europe: What The Banking Union Can Contribute',* Buch, Korner, and Weigert stated that taking the emergency exit in such a situation will, ultimately, require the mobilization of fiscal resources, in which the EC is lack of. Dealing with insolvent financial institutions falls under the responsibility of the resolution authority which, in turn, needs fiscal backing to implement appropriate crisis management measures (Veron & Wolff, 2013). The governments or the central banks may act as lender of last resort for the merely illiquid parts of the banking system (Minsky, 1985; Kindleberger, 2005). Yet, fiscal backstop arrangements are the least developed area of negotiations between policy makers at the European level. EC and its DG Comp may act as effective facilitator in ordinary times; however, their influence is likely to be limited when MS' interests are subject to severe shocks that lead to distributive conflicts[121]. During times of economic shocks, the role of MS as the contributors or recipients of financial assistance is more likely to determine the design of novel EU institutions than the preferences of supranational actors such as EC and its DG Comp (Hennesy, 2014).

4.3.3. Member States' Preferences And Interests

In the area of transferring national authority over bank supervision to the EU institutions, the chosen scope of supranational decision making has been influenced by member states' preferences on three main issues: (1) scope of the SSM; (2) scope of the SRM; and (3)

[120] Buch, Claudia.M., Korner, Tobias., Weigert, Benjamin. (2014). Towards Deeper Financial Integration In Europe: What The Banking Union Can Contribute. German Council Of Economic Experts. Available at: http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_02_2013.pdf

[121] Hennessy, A. (2014). *Redesigning financial supervision in the European Union (2009–2013). Journal of European Public Policy*, *21*(2), 151-168.

governance of the SRM[122]. In the draft regulation on the SSM, the EC proposed that the ECB would be "responsible for carrying out key supervisory tasks for all credit institutions established in participating MS, regardless of their business model or size" (European Commission, 2012:4). However, the final agreement between the EU MS and the European Parliament (EP) reduced the proposed scope of supranational supervision to only most significant banks that meet at least one of the three main criteria: the total value of their assets exceeds EUR 30 billion or/and 20% of the participating member state's GDP or/and a national supervisor considers them to be important for the domestic economy[123]. Notwithstanding these criteria, it was also agreed that the ECB will directly supervise three most significant banks in each participating member state, those banks that will receive direct financial assistance from the ESM as well as those that the ECB may consider significant on its own initiative due to their cross border activities (Council Regulation (EU) No 1024/2013: Article 6). As a result, with the exception of around 130 systemically important banks that meets the aforementioned criteria, the majority of over 6000 euro area credit institutions were exempted from direct ECB's oversight[124].

Arguing that the ECB could not be able to supervise all euro area banks, Germany wanted the single supervisor to focus only on the largest financial institutions[125]. In other words, it advocated for a two-tier European supervisory system: one for large banks and one for small. In contrast to the German view, the France-led group of countries, including Spain, Italy and UK among others, found such fragmentation unacceptable (Skuodis, 2014). Although the German arguments were valid, the country's position was criticized on at least two grounds. It was obvious that a two-tier supervisory system could easily distort a level playing field in the single market. Second, as it has been noted by many commentators, the recent history of, for instance, Spanish *cajas* well illustrate that banking crises do not only originate with big financial

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[122] Skuodis, M. (2014). *The Political Economy of the European Banking Union: What Union for Which Member States?.* ECPR Joint Sessions Of Workshops. Available at: http://ecpr.eu/filestore/paperproposal/9dac1c1a-72d7-4840-a7ae-32c398d20179.pdf

[123] Ibid.

[124] Skuodis, M. (2014). *The Political Economy of the European Banking Union: What Union for Which Member States?.* ECPR Joint Sessions Of Workshops. Available at: http://ecpr.eu/filestore/paperproposal/9dac1c1a-72d7-4840-a7ae-32c398d20179.pdf

[125] Alexander, K. (2013). *Bank resolution and recovery in the EU: enhancing banking union?*. In *ERA Forum* (Vol. 14, No. 1, pp. 81-93). Springer-Verlag.

institutions, but also with much smaller, fast-expanding financial firms (Münchau, 2012). Behind the public arguments, the German-France divide was strongly influenced by national political economy considerations. Germany's small, locally-oriented savings banks, known as Spaarkasen, and regional Landesbanken – public banks that comprise around one third of the German banking system (Hüfner 2010:8)– have been ardent opponents of any supranational supervision. Being subject to different regulatory requirements than their much bigger commercial competitors, Germany's public banks argued that single supervision applied to all sizes of European banks would result in disproportionate administrative burden on them (Wilson, Wiesman and Barker, 2012). The Germany's insistence on the ECB to focus only on the most significant banks therefore meant that its small, but politically influential public banking sector would be exempted from the ECB's authority. Germany demanded for bigger MS' discretion in both the new pan-European bank supervisory and resolution frameworks (Skuodis, 2014). Meanwhile, most of the French banking system would automatically become inside the new supervisory framework due to the dominance of several large banks (Barker, 2012). France and southern MS agreed on a much bigger transfer of sovereignty, effectively accepting bigger constraints. Although Germany opposed not only to the French and other biggest MS' preferences, but also those of the EC and the ECB (Steen, 2012), it finally agreed with a compromise on a clearly differentiated system: the ECB will be responsible for the functioning of the new supervisory system as a whole, but direct supervision will automatically effect only the largest European credit institutions (Steen, 2012).

To conclude, certain countries of Northern Europe such as Sweden, the Netherlands and Finland expressed their concerns about the Commission's proposal due to its potential influence and powers on European banking resolution. For example, the Swedish Finance Minister, Anders Borg, argued that there may be conflict of interests since the Commission is in charge of making decisions in two fields: state aids and resolution (El País, 2013). Also the Swedish Prime Minister argued that, even though Sweden will not participate in the EBU, it joins the UK and Germany in opposing the Commission's proposal (El País, 2013).

4.3.4. National Governments As The Lender Of Last Resort

Economic growth requires a functioning financial sector that channels funds to their most effective uses and provides firms with the capital they need[126]. Preventing financial panics from turning into fully fledged financial crises and ending liquidity crises once they have developed, requires access to sufficient amount of liquidity. To take on this responsibility, a lender of last resort needs access to substantial financial resources (Zanker, 2007). Looking at the circumstances created by the crisis, the EC and its DG Comp agreed to the capital injections performed by the MS toward their financial institutions with strict exceptions, in order to prevent the collapse of those institutions which might create a greater risk to EU's financial stability[127]. Financial stability refers to the on-going capacity of banks to meet the demands of their depositors and other creditors (Donnelly, 2013). Financial stability requires strong supranational financial resources backed by a fiscal union and regulatory powers that cover supervision, restructuring, resolution, and deposit insurance[128]. In many jurisdictions, the central banks remain responsible for, or involved in, financial stability (Masciandro & Quintyn, 2007). To preserve financial stability in the Euro area, most researchers suggest the establishment of a European LLR (Lender of Last Resort)[129]. The Maastricht treaty created the European System of Central Banks (ESCB) and the ECB to head this system (Kahn, 2002). The Treaty entrusted this institution with the responsibility for monetary policy, but it did not give the ECB supervisory powers or an explicit mandate for providing emergency liquidity support to individual banks, because national authorities remained responsible for financial stability (Kahn, 2002). According to Goyal *et al* (2013), banks can place deposits and refinance eligible assets with the Eurosystem and, if collateral constraints bind, resort to emergency liquidity assistance (ELA) from their national central banks. While the ECB's Governing Council has the authority to ensure that

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[126] Zanker, Benedikt. (2007). *On The Viability Of An International Lender Of Last Resort.* Baden-Baden: Nomos-Verlag-Ges.

[127] European Commission. (2011). *The Eu's Comprehensive Policy Response To The Big Crisis.* Quarterly Report On The Euro Area. Available at: http://ec.europa.eu/economy_finance/publications/qr_euro_area/2011/pdf/qrea1_focus_1_en.pdf

[128] Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

[129] Kahn, Charles. M. (2002). *Allocating Lending of Last Resort And Supervision In The Euro Area.* Department Of Finance: University Of Illinois. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=310542

LOLR activities by national central banks do not interfere with common monetary policy, losses arising on ELA remain the responsibility of the national central banks, which exacerbate sovereign-bank linkages[130]. LOLR support to banks is granted to illiquid but solvent financial institutions only, but in principle provided without conditionality[131]. Instead, the borrower from the LOLR is supposed to provide good collateral, or rather, collateral that would be good under orderly market conditions (Buiter & Rahbari, 2012).

Financial crisis management in the single financial market of the European Union (EU) is a subject attracting increased attention. As one of the key objectives of the political, economic, monetary, and legal integration of the EU's MS, the single financial market is becoming a reality with the progressive expansion of cross-border financial services and the increased integration of national financial systems[132]. While EU market liquidity and efficiency are no doubt improving, financial disturbances are now more likely to affect more than one MS (Schinasi & Teixeira, 2006). Moreover, while European national financial systems are becoming systemically integrated, the EU's financial-stability architecture is still based primarily on the exercise of national responsibilities (Schinasi & Teixeira, 2006).

The MS reacted to the crisis by introducing a number of emergency measures ranging from State guarantee schemes to nationalization provisions[133]. The guarantee schemes are aimed at ensuring the supply of liquidity to the financial system and increasing the level of guarantees for bank deposits (or temporarily providing guarantees for all deposits) in order to prevent 'bank runs' (Petrovic & Tutsch, 2009). The recapitalization measures were introduced to strengthen the capital base of fundamentally sound financial institutions, improve the functioning and stability

[130] Goyal, Rishi., Brooks, Petra Koeva., Pradhan, Mahmood., Tressel, Thierry., Dell' Ariccia, Giovanni., Leckow, Ross., Pazarbasioglu, Ceyla. (2013). *A Banking Union For The Euro Area.* International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

[131] Buiter, Willem & Rahbari, Ebrahim. (2012). *The European Central Banks As Lender Of Last Resort For Sovereigns In The Eurozone.* JCMS Volume 50 Annual Review pp. 6-35. Citigroup: London. Available at: http://onlinelibrary.wiley.com/doi/10.1111/j.1468-5965.2012.02275.x/pdf

[132] Schinasi, Garry. J. & Teixeira, Pedro. G. (2006). *The Lender Of Last Resort In The European Single Financial Market.* Working Paper Series No. 43. Available at: frankfurt.de/opus4/frontdoor/deliver/index/docId/2834/file/ILF_WP_043.pdf

[133] Petrovic, Anna. & Tutsch, Ralf. (2009). *National Rescue Measures In Response To The Current Financial Crisis.* European Central Bank Legal Paper Working Series No. 8. Available at: http://www.ecb.europa.eu/pub/pdf/scplps/ecblwp8.pdf

of the banking system as a whole and ensure proper financing to the wider economy[134]. In addition, liquidity positions of these financial institutions have been enhanced through the provision of loans. A number of Member States have introduced measures aimed at relieving financial institutions of impaired assets, whereby the State directly takes over the risks inherent in the assets or transfers them to 'bad banks' (Petrovic & Tutsch, 2009). Finally, a number of Member States have resorted to nationalization of distressed financial institutions, with a view to restructuring and re-entry into the market[135].

As part of the state aid injection approval, the EC requires that the financial institutions provides solid restructuring plan (exit strategy) in return for the capital injections[136]. This was meant to gradually end the state aid injection in order to establish financial independency among EU banks (European Commission, 2008). Preparing exit strategies for government support for the financial sector will enhance the effectiveness of these measures in the short term, as this depends upon clarity regarding the pace with which such measures will be withdrawn[137]. As the recovery was the result of a joint effort between MS, central banks, and also EC and its DG Comp, the exit strategy should also be carefully planned among these actors[138]. The banking crisis has demonstrated the importance of a coordinated framework for crisis management and prevention, which one of the frameworks is the crisis resolution (European Commission, 2009). Crisis resolution was meant to bring crisis to a lasting close, and at the lowest possible cost for the taxpayer while containing systemic risk, securing consumer protection and minimizing

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[134] International Monetary Fund. Monetary, Capital Markets Department, & International Monetary Fund Staff. (2010). *Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity*. International Monetary Fund.

[135] Petrovic, Anna. & Tutsch, Ralf. (2009). *National Rescue Measures In Response To The Current Financial Crisis.* European Central Bank Legal Paper Working Series No. 8. Available at: http://www.ecb.europa.eu/pub/pdf/scplps/ecblwp8.pdf

[136] European Commission. (2009). *Communication from the Commission — The Recapitalisation Of Financial Institutions In The Current Financial Crisis: Limitation Of Aid To The Minimum Necessary And Safeguards Against Undue Distortions Of Competition.* Official Journal Of The European Union. Available at: ec.europa.eu/competition/state_aid/.../d_31_07_13_en.pdf

[137] European Commission. (2009). *Economic Crisis In Europe: Causes, Consequences, and Responses.* European Economy 7. Available at: http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf

[138] Sutton. A., Lannoo, Karel., Napoli, Chris. (2010). *Bank State Aid In The Financial Crisis: Fragmentation Or Level Playing Field?.* A CEPS Task Report: Brussels. Available at: http://www.ceps.eu/book/bank-state-aid-financial-crisis-fragmentation-or-level-playing-field

competitive distortions in the internal market[139]. It is important that state aid for financial institutions or other severely affected banks does not persist longer than necessary in view of its implications for competition and the functioning of the EU Single Market[140]. This in part requires reversing temporary support measures as well action to restore economies to sustainable growth and fiscal paths (European Commission, 2009). Inter alia, this includes policies to restore banks' balance sheets, the restructuring of the sector and an orderly policy 'exit' because an orderly exit strategy from expansionary macroeconomic policies is also an essential part of crisis resolution[141]. Blundell-Wignall, Atkinson, and Se-Hoon (2009) agreed that crisis measures should be consistent with a sensible approach to ‘exit’ and with the sustainable long-term strategies. Governments gave massive support to banks, either through guarantees, recapitalization or through "cleaning" of balance sheets from impaired assets; other sectors of the economy were supported under the temporary, and exceptional, framework for State aid (European Commission, 2010). Although the EC and its DG Comp have published guidelines on how and when the MS authorities should use resolution tools, MS will have ultimate discretion to decide whether or not to adopt these tools in their legal and regulatory frameworks[142].

4.3.5. Conclusion Hypotheses 2

The crucial priority in the field of EU financial sector at the moment is to restore a solid, stable, and healthy financial sector able to finance the real economy. Given remaining uncertainties about the economic outlook and fragilities in the financial sector, support measures should only be withdrawn once the economic recovery can be regarded as self-sustaining and once financial stability has been restored[143]. The withdrawal of temporary crisis-related measures should be

[139] European Commission. (2009). *Economic Crisis In Europe: Causes, Consequences, and Responses.* European Economy 7. Available at: http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf
[140] European Commission. (2009). *Economic Crisis In Europe: Causes, Consequences, and Responses.* European Economy 7. Available at: http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf
[141] Ibid.
[142] Alexander, K. (2013). *Bank resolution and recovery in the EU: enhancing banking union?*. In *ERA Forum* (Vol. 14, No. 1, pp. 81-93). Springer-Verlag.
[143] European Council conclusions of 10/11 December 2009.

coordinated and take account of possible negative spill-over effects both across MS as well as of interactions between different policy instruments[144].

The precise timing of exit strategies will depend on the strength of the recovery, the exposure of MS to the crisis and prevailing internal and external imbalances[145]. However, the EC and its DG Comp's financial limitation have hindered their discretion and power in ending the aid injection permanently, because with limited financial resources, stronger MS' will successfully upload their preferences at the expense of other national preferences (Brummer, 2012; Donnelly, 2012). International agreements on banking regulation and financial stability underline the principle of home country control rather than collective or supranational supervision (Kapstein, 1994). Thus, it is very possible that strong MS governments use institutions to intimidate others or impose their will on them[146].

4.4. Corroboration Of The Hypotheses

H(1): If Supranational Governance is applicable, the EC will practice its formal and informal (entrepreneurial) discretion in the implementation of the state aid policy toward banks in the network relationship between the Commission as the sole implementer and NCAs in the national level.	**Confirmed**

With regards to H(1), the EC has developed a strong network by acquiring a privileged access to information which is not available to MS (Smith, 1998). Thus, the DG Comp has become a valid operational centre of coordination, capable of linking the supranational interests and MS'

144 European Commission. (2010). *Communication From The Commission: Europe 2020, A Strategy For Smart Sustainable And Inclusive Growth.* Available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52010DC2020

145 European Commission. (2009). *Economic Crisis In Europe: Causes, Consequences, and Responses.* European Economy 7. Available at: http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf

146 Krasner, S. (1999) *Sovereignty: Organized Hypocrisy*. Princeton: Princeton University Press. Quoted in Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

concerns[147]. Bannerman (2002) emphasized that the relationship of EU competition authorities must be a true partnership between the EC and the MS. In the case of the state aid to the banking sector, the Commission and its DG Comp as the sole implementer of the policy in the EU, have implemented its formal and informal discretion with other state aid-related actors, such as the ECB, MS, NCAs, MS' central and national banks (European Commission, 2011). Since the onset of the crisis, the relationship between the Commission and the MS has been established in order to create good practice of the state aid policy in the banking sector (Commission, 2009).

The Commission, together with the NCAs has been closely associated with the restructuring of the financial sector to ensure that the massive support necessary to keep those institutions alive in difficult macroeconomic environment does not result in undue distortions of competition (European Commission, 2011). Cooperation between NCAs and the EC takes place on the basis of equality, respect, and solidarity, and they cooperate not only on cases but also on policy developments through various forums within the ECN (Commission, 2009). The cooperation within the network is dedicated to the effective enforcement of EC state aid policy throughout the EU.

During 2009, the European Union, alongside the rest of the world, has faced an exceptionally severe financial and economic crisis[148]. Almost immediately concerns were raised that state aid policy would impede necessary state intervention and thus lead to the collapse of the financial system[149]. As a result, there were calls for a temporary suspension of the policy. Despite the calls, the EC rightly resisted these demands and issued several communications (Banking, Recapitalization, Impaired Assets, and Restructuring) that introduced greater flexibility in the application of state aid policy (Heimler & Jenny, 2012). The crisis worsens in 2011 by threatening the banking sector and the fiscal sustainability of many MS governments. In regards to that, the EC has decided to prolong the special rules applicable to financial institutions at the early December of 2011 (Commission, 2011). By means of those rules, state aid policy has

[147] Smith, M. (1998). *'Autonomy by the rules: The European Commission and the development of state aid policy'*. Journal of Common Market Study 1[03], 55-78.
[148] European Commission. (2009). *EC Report On Competition Policy.* P. 12. Available at: http://ec.europa.eu/competition/publications/annual_report/2009.pdf
[149] Heimler, Alberto & Jenny, Frederic. (2012). *The limitations of European Union control of state aid. Oxford Review of Economic Policy*, *28*(2), 347-367. Available at: http://oxrep.oxfordjournals.org/content/28/2/347.short

continued to become a consistent policy response to the financial crisis throughout the EU, and contributed significantly in limiting distortions of competition between aid beneficiaries financial institution within the single market (Commission, 2011). In its 2013 report in state aid, the EC stated that there have been encouraging signs that an economic recovery is underway. Policy actions undertaken at EU level contributed to start restoring confidence and creating the basis for returning to a growth path, however, this does not mean that all the restructuring efforts should be relaxed (Commission, 2013). What Europe needs are structural adjustments, an efficient allocation of resources, and productivity growth (Commission, 2013). Smart, sustainable and inclusive growth remains at the core of Europe's policy agenda for the decade. Boosting competitiveness across the EU is paramount for reaching that objective (Competition, 2013). In regards to that, in 2013, the EC has adopted a new communication on the application of EU state aid policy to support measures in favour of banks in the context of the financial crisis (the Banking communication)[150].

As another case in point to show the network relationship between the EC and NCAs, the European Council meeting in 2012 marked the starting point of an ambitious project to create a European banking union, which rests on three pillars: SRM, SSM, and single rulebook, aimed to break the vicious circle between sovereign debt and national banking crises that threatened the Union's financial stability and the very survival of the Euro[151]. A solid and federal banking union is the most important basis for a stable Eurozone (Geeroms & Karbownik, 2013). Banking union is a collective European effort -from supranational to national level regulators- to resolve the current crisis and build a more resilient policy infrastructure for Europe's financial system (European Council, 2012).

All of the aforementioned explanations have provided the arguments that the network relationship between the EC and its DG Comp with the NCAs –in accordance to the supranational governance theory- has solidify the implementation of state aid policy in the EU financial sector.

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[150] Von Bonin, Andreas. (2013). *New Rules On State Aid To Banks.* Freshfields Bruckhaus Deringer LP. Available at: http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/36418.pdf

[151] Micossi, Stefano., Bruzzone, Ginevra., Carmassi, Jacopo. (2013). *The New European Framework For Managing Bank Crises.* Centre For European Policy Studies: Brussels. Available at: www.ceps.eu

Hypothesis 2 (Financial Constraint): ***Regardless of the Supranational Governance theory, there are outside factors –ultimately financial factor which leads to intergovernmental politics- that limits the EC's discretion and willingness to restrict national state aid.***	**Confirmed**

In regards to H(2), at the start of the EU financial crisis, banks and other financial institutions experienced an extreme turbulence[152] which has led to increased demand for state intervention in the economy in the name of systemic stability, predominantly but not exclusively at the national level[153]. State aid plays the role when a bank is nationalized, and it was conducted with EC's approval when no viable buyer could be found to support an insolvent or illiquid bank[154]. The crisis has showed that MS governments became more important than EC and its DG Comp in saving the financial system and their demands more important than the restrictions of EU rules because EC's own budget is very small[155].

At the height of the crisis, the Euro area leaders declared that "it is imperative to break the vicious circle between banks and sovereigns", which marked the starting point of the Banking Union (Veron & Wolff, 2013). Since 2012, the three pillars of the Banking Union have been spelled out further: the SSM as the most advanced pillar will become operational in November 2014; harmonized rules and centralized competencies in bank resolution have been agreed upon in SRM; and basic conditions for a common financing mechanism for bank resolution have been clarified in the Single Rulebook (Buch et al., 2014). However, the banking union side of

[152] Adler, Emily., Kavanagh, James., Ugryumov, Alexander. (2009). *State Aid To Banks In The Financial Crisis: The Past And The Future.* Economist's Note. Available at: http://jeclap.oxfordjournals.org/

[153] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Political Science: 384-392. Available at: http://www.palgrave-journals.com/eps/journal/v10/n3/abs/eps201121a.html

[154] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Political Science: 384-392. Available at: http://www.palgrave-journals.com/eps/journal/v10/n3/abs/eps201121a.html

[155] Ibid.

financial stability has been hampered by the hesitation of the MS to delegate authority to the EU (Donnelly, 2013). The transfer of regulatory powers from the national level to EU regulatory agencies rarely proceeds smoothly and without objections from important participants in the European policy process[156]. An EU-level banking supervision without a corresponding degree of supranational financial resources creates a misalignment between the levels on which financial institutions are supervised and resolved[157]. This result in the failure of the ECB, which had been awarded supervision of EU banks, in receiving many of the powers that it had said in advance was necessary[158].

A well-designed Banking Union could provide a credible and stabilizing framework for handling failures of an individual financial institution or even several financial institutions at the same time[159]. However, the Banking Union in and of itself cannot be expected to deal with a systemic crisis, which by definition, affects large parts of the financial system (Buch et al., 2014). During times of economic shocks, the role of MS as the contributors or recipients of financial assistance is more likely to determine the design of novel EU institutions than the preferences of supranational actors such as EC and its DG Comp (Hennesy, 2014).

In the area of transferring national authority over bank supervision to the EU institutions, the chosen scope of supranational decision making has been influenced by member states' preferences on three main issues: scope of the SSM; scope of the SRM; and governance of the

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[156] Spendzharova, Aneta. B. (2013). *Review of International Political Economy: Banking Union Under Construction: The Impact Of Foreign Ownership And Domestic Bank Internationalization On European Union Member-States' Regulatory Preferences In Banking Supervision*. Review of International Political Economy. Available at: http://www.tandfonline.com/doi/abs/10.1080/09692290.2013.828648

[157] Skuodis, M. (2014). *The Political Economy of the European Banking Union: What Union for Which Member States?.* ECPR Joint Sessions Of Workshops. Available at: http://ecpr.eu/filestore/paperproposal/9dac1c1a-72d7-4840-a7ae-32c398d20179.pdf

[158] Donnelly, Shawn. (2013). *Power Politics and the Undersupply of Financial Stability in Europe.* Review of International Political Economy. Available at: http://dx.doi.org/10.1080/09692290.2013.801021

[159] Buch, Claudia.M., Korner, Tobias., Weigert, Benjamin. (2014). Towards Deeper Financial Integration In Europe: What The Banking Union Can Contribute. German Council Of Economic Experts. Available at: http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_02_2013.pdf

SRM[160]. Some MS voiced concerns about possible fiscal burdens and loss of sovereignty when decisions with important national repercussions are taken at the European level (Spendzharova, 2012). Arguing that the ECB would not be able to supervise all euro area banks, Germany wanted the single supervisor to focus only on the largest financial institutions[161]. In contrast to the German view, the France-led group of countries, including Spain and Italy, found such fragmentation unacceptable (Skuodis, 2014). Germany demanded for bigger MS' discretion in both the new pan-European bank supervisory and resolution frameworks (Skuodis, 2014). Meanwhile, most of the French banking system would automatically become inside the new supervisory framework due to the dominance of several large banks (Barker, 2012). Certain countries of Northern Europe such as Sweden, the Netherlands and Finland expressed their concerns about the Commission's proposal due to its potential influence and powers on European banking resolution. For example, the Swedish Finance Minister, Anders Borg, argued that there may be conflict of interests since the Commission is in charge of making decisions in two fields: state aids and resolution (El País, 2013). The Swedish Prime Minister also argued that, even though Sweden will not participate in the EBU, it joins the UK and Germany in opposing the Commission's proposal (El País, 2013).

Economic growth requires a functioning financial sector that channels funds to their most effective uses and provides firms with the capital they need. To take on this responsibility, a lender of last resort needs access to substantial financial resources (Zanker, 2007). Looking at the circumstances created by the crisis, the EC and its DG Comp agreed to the capital injections performed by the MS toward their financial institutions with strict exceptions, in order to prevent the collapse of those institutions which might create a greater risk to EU's financial stability. The Maastricht treaty created the European System of Central Banks (ESCB) and the ECB to head this system (Kahn, 2002). The Treaty entrusted this institution with the responsibility for monetary policy, but it did not give the ECB supervisory powers or an explicit mandate for providing emergency liquidity support to individual banks, because national authorities remained

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[160] Skuodis, M. (2014). *The Political Economy of the European Banking Union: What Union for Which Member States?.* ECPR Joint Sessions Of Workshops. Available at: http://ecpr.eu/filestore/paperproposal/9dac1c1a-72d7-4840-a7ae-32c398d20179.pdf

[161] Alexander, K. (2013). *Bank resolution and recovery in the EU: enhancing banking union?*. In *ERA Forum* (Vol. 14, No. 1, pp. 81-93). Springer-Verlag.

responsible for financial stability (Kahn, 2002). As part of the state aid injection approval, the EC requires that the financial institutions provides solid restructuring plan (exit strategy) in return for the capital injections. As the recovery was the result of a joint effort between MS, central banks, and also EC and its DG Comp, the exit strategy should also be carefully planned among these actors. However, the lack of EU resources affects its capacity to recapitalize, restructure, and resolve insolvent banks. Thus, although the EC and its DG Comp have published guidelines on how and when the MS authorities should use resolution tools, MS will have ultimate discretion to decide whether or not to adopt these tools in their legal and regulatory frameworks[162].

The aforementioned explanations in this section have also delivered the evidences that despite the theory of supranational governance, EC and its DG Comp encountered financial constraints and it affected their discretion and willingness in the implementation of EU state aid policy. This leads to intergovernmental politics because their financial limitations made powerful MS impose their influence toward the EC and its DG Comp and the weaker MS in order to steer the policy towards their interests.

5. Conclusion

This research is conducted in order to provide the answers to the extent of discretion and latitude of the EC and its DG Comp in implementing state aid policy. In doing so, the EC and its DG Comp relation with other related actors were being reviewed. The obstacles, such as financial factors, were also put into consideration. The EC and DG Comp, in their role as the EU's competition authority, must continue to play a significant role in crisis resolution by exercising its state aid policy powers towards European banks. The state aid policy powers will limit moral hazard and prevent distortions in the single market. Despite its independent supranational powers, the EC and DG Comp cannot improve the state aid policy and its operation without the effective support of MS and its authorities. As a result of the close partnership between the two parties, better outcomes in the state aid policy, both at the national and European level could hopefully be achieved. In this regard, to ensure that the aids were given to the financial

[162] Alexander, K. (2013). *Bank resolution and recovery in the EU: enhancing banking union?*. In *ERA Forum* (Vol. 14, No. 1, pp. 81-93). Springer-Verlag.

institutions in line with the state aid policy, supranational supervision needs to be assisted with national level supervision (European Commission, 2013). The Commission and its DG Comp, together with the NCAs has been closely related with the restructuring of the financial sector to ensure that the massive support necessary to keep those institutions alive in difficult macroeconomic environment does not result in undue distortions of competition (European Commission, 2011).

Although it seems that the implementation of the state aid policy has been a smooth sailing, apparently there are some outside factors –particularly financial factors which lead to intergovernmental politics- that have created limitations for the supranational institutions in implementing the policy and permanently put it to an end. When the crisis hits, banks and other financial institutions experienced the hard blow at the start of the crisis and led to the increased demand for state intervention in the economy in the name of systemic stability, predominantly but not exclusively at the national level[163]. MS have used a number of measures to ensure systemic stability of their national economies: capital injections, expanded deposit guarantees (state aid), engineering bank takeovers (generating dominant market positions) and nationalization, which transferred bank debt into the public sector (Donnelly, 2011). The EC tried to implement a well-designed Banking Union which could provide a credible and stabilizing framework for handling failures of an individual financial institution or even several financial institutions at the same time[164]. However, the Banking Union in and of itself cannot be expected to deal with a systemic crisis, which by definition, affects large parts of the financial system (Buch et al., 2014). The emergency exit measures in such circumstances will require the mobilization of fiscal resources, in which the EC is lack of. EC and its DG Comp may act as effective facilitator in ordinary times; however, their influence is likely to be limited when MS'

[163] Donnelly, Shawn. (2011). *The Public Interest And The Economy In Europe In The Wake Of The Financial Crisis.* European Political Science: 384-392. Available at: http://www.palgrave-journals.com/eps/journal/v10/n3/abs/eps201121a.html

[164] Buch, Claudia.M., Korner, Tobias., Weigert, Benjamin. (2014). Towards Deeper Financial Integration In Europe: What The Banking Union Can Contribute. German Council Of Economic Experts. Available at: http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_02_2013.pdf

interests are subject to severe shocks that lead to distributive conflicts[165]. At times of economic shocks, the role of MS as the contributors or recipients of financial assistance is more likely to determine the design of novel EU institutions than the preferences of supranational actors such as EC and its DG Comp.

Arguing that the ECB would not be able to supervise all euro area banks, powerful MS such as Germany wanted the single supervisor to focus only on the largest financial institutions. The Germany's insistence on the ECB to focus only on the most significant banks therefore meant that its small, but politically influential public banking sector would be exempted from the ECB's authority. Germany demanded for bigger MS' discretion in both the new pan-European bank supervisory and resolution frameworks (Skuodis, 2014). Certain MS such as Sweden, the Netherlands and Finland expressed their concerns about the Commission's proposal due to its potential influence and powers on European banking resolution. Even though Sweden will not participate in the EBU, it joins the UK and Germany in opposing the Commission's proposal. This crisis showed that MS governments became more important than EC and its DG Comp in saving the financial system and their demands more important than the restrictions of EU rules because EC's own budget is very small (Donnelly, 2011). This also made clear that the EMU's hold on national finances and structrural adjustments are decided by powerful MS rather than EU rules and institutions (Donnelly, 2011).

[165] Hennessy, A. (2014). *Redesigning financial supervision in the European Union (2009–2013). Journal of European Public Policy*, *21*(2), 151-168.

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