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Court of Justice of the European Union Confirms Validity of the European Commission's 2013 Banking Communication on State Aid

In its judgment of 19 June 2016, the Court of Justice of the European Union confirmed that the European Commission's 2013 Banking Communication is not contrary to EU law. The Court clarified that the burden-sharing requirements do not apply automatically and that in exceptional cases the Commission could approve State aid which does not meet the conditions of the Banking Communication. The judgment also endorses the cross border recognition of regulatory measures effecting burden-sharing.

The Banking Communication

The 2013 Banking Communication (the "Banking Communication")[1] was intended as an evolution in the crisis rules for restructuring banks in difficulty. These rules adopted by the Commission provide guidance on the criteria for the compatibility of State aid with the internal market pursuant to the Treaty on the Functioning of the European Union (the "TFEU"). One of the principal aims of the Banking Communication was to start to shift losses onto creditors and shareholders so as to reduce costs to taxpayer and mitigate moral hazard in future. These rules are referred to as burden-sharing requirements.

The Facts of the Case

Only a few weeks after the adoption of the Banking Communication in August 2013, the Bank of Slovenia determined that five Slovenian banks had capital shortfalls of such a scale that the banks did not have sufficient assets to satisfy their creditors and to cover the value of deposits. In December 2013, upon request of the Slovenian authorities, the Commission authorised State aid for the banks. To meet the burden-sharing requirements of the new Banking Communication, the Bank of Slovenia made use of certain powers under the Slovenian banking law to write off the banks' equity capital as well as hybrid capital and subordinated debt. These measures were challenged before the Slovenian Constitutional Court by a number of private and public complainants. The Constitutional Court requested a preliminary ruling from the Court of Justice of the European Union ("CJEU") on the validity and interpretation of the Banking Communication.[2]

The Commission Keeps Flexibility in Exceptional Circumstances

In accordance with settled case law, the CJEU acknowledged that the Commission enjoys wide discretion when it approves State aid under the TFEU to remedy a serious disturbance in the economy of a Member State. The

1 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 (OJ 2013, C 216, p. 1).

2 Case C-526/14 Tadej Kotnik and Others v Državni zbor Republike Slovenije.

Commission published the Banking Communication both as an exercise of that discretion and to specify how it intended to use its discretion in future when assessing public support to banks.

As noted above, among the main changes introduced by the Banking Communication are the strengthened burden-sharing requirements: both shareholders and subordinated creditors must be involved in meeting the costs of restructuring a distressed bank in order to reduce its capital shortfall. As a consequence, after losses are absorbed in full by equity capital, subordinated creditors are called upon to contribute also in full either by the conversion of their claims into equity, or a write-down of the principal of those claims.

The effect of the Banking Communication is that the Commission has described in advance how it will exercise its discretion to approve State aid and cannot, as a general rule, depart from it. However, the Banking Communication does not bind Member States. They retain the right to notify the Commission of proposed State aid which does not meet the conditions of the Banking Communication. The Commission must then review the particular case and in exceptional circumstances it may approve such proposed State aid.

Indeed some wiggle room is already reflected in the Banking Communication which provides for exceptions to the burden-sharing requirements where implementing such measures “might endanger financial stability or lead to disproportionate results.”

The Burden-Sharing Requirements Are Not Contrary to EU Law

The CJEU held that it was within the Commission’s authority to generally require burden-sharing under the Banking Communication as a prerequisite for State aid approval. In support of this view, the CJEU considered the three main objectives of the Banking Communication: (1) restricting State aid in the banking sector to the minimum necessary; (2) limiting distortions of competition in the internal market; and (3) overcoming the problem of moral hazard.

The CJEU expressly dismissed various arguments which had been brought forward to call the burden-sharing requirements into question:

- **Protection of legitimate expectations**: the fact that during the early stages of the financial crisis subordinated creditors were not required to burden-share did not create a legitimate expectation that such burden-sharing would not be required in subsequent State aid cases;
- **Right to property**: due to the safeguards built into the Banking Communication (in particular the “no creditor worse off” principle), the burden-sharing requirements do not adversely affect the right to property of the investors concerned; and
- **Second Company Law Directive**[3]: the requirement to make alterations to the capital of a public limited liability company subject to a decision of the general meeting does not preclude measures to effect burden-sharing being adopted without the approval of the general meeting.

The Regulatory Measures Effecting Burden-Sharing Benefit From Mutual Recognition

The case was brought prior to the Bank Recovery and Resolution Directive[4] (the “BRRD”) entering into force. The measures implemented by the Bank of Slovenia were based on the applicable Slovenian national law. The

[3] Directive 2012/30/EU.

[4] Directive 2014/59/EU.

judgment clarifies that measures used to effect burden-sharing on the basis of national law can be deemed reorganisation measures under the Directive on the reorganisation and winding up of credit institutions (the "CIWUD").[5] This guidance is helpful even today in situations where the BRRD toolbox, and therefore EU-wide recognition under the BRRD, is not available. Both the BRRD and the CIWUD provide for the principle that certain regulatory measures taken in one Member State must be recognised automatically throughout the EU. Following this judgment it appears that, outside the scope of the BRRD, burden-sharing measures could be based on national law and then benefit from EU-wide recognition under the CIWUD.

The Practical Impact of the Judgment is Limited

The judgment is in line with the current State aid practice and affirms the Commission's strong role in the management of the financial crisis. EU Competition Commissioner Margrethe Vestager has noted that the judgment will not change pending discussions with Member States about potential State aid to their local banks.

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5 Directive 2001/24/EC.