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### **Abstract**

This chapter aims to understand the general nature of the current economic crisis from a socio-legal, economic, ideological and political perspective and to analyse the complexity of the multiple causes which have led to this crisis. The impact of the crisis on different areas of law is also considered, especially on banking, securities, contract, competition and corporate law. Furthermore, the article aims to criticise law in action and the management of the crisis through political decision-making (state intrusiveness), that is, the various responses and reactions to the crisis and the effectiveness of the measures implemented by policy-makers and enforcers. In particular, this article questions the constitutional legitimacy of the TBTF (Too-Big-to-Fail) theory as a predominant doctrine and criterion of state intervention in the economy. The chapter carries out a multi-layered analysis that covers aspects of economic, social, and political governance. It also draws insights from microeconomics – looking at how economic agents have affected individuals such as consumers – and from macroeconomics – looking at how state intervention in the economy has impacted upon taxpayers and considering the economic and social costs of the crisis. Finally, it approaches the crisis from the perspective of political economy by looking through the lenses of ideology and policy and by reflecting on the role of neoliberalism today.

### **I. INTRODUCTION**

The purpose of this chapter is to understand the general nature of the current crisis (banking, financial, debt, currency, constitutional, political) from a socio-legal, economic, ideological and political perspective and to analyse the complexity of the multiple causes which led to it. Interdisciplinary areas of law in which the crisis has manifested itself will be highlighted throughout this chapter, in particular financial, banking, securities, contract, competition and corporate law. Finally, the chapter aims to criticise the legal response and the management of the crisis through political decision-making (state intrusiveness), that is, the various responses and reactions to

the crisis and the effectiveness of the measures implemented by policy-makers and enforcers, and to question the constitutional legitimacy of the TBTF (Too-Big-to-Fail) theory as a predominant doctrine and criterion of state intervention in the economy.

The methodology of this chapter is interdisciplinary and encompasses law, economics, and politics. A multi-layered level of economic, social, and political governance is envisaged through insights from microeconomics, by looking at how economic agents have affected individuals such as consumers; from macroeconomics, by looking at how state intervention in the economy has impacted upon taxpayers and the economic and social costs of the crisis; and from political economy by looking through the lenses of ideology and policy and reflecting on the role of neoliberalism today.

The heavy reliance on the TBTF doctrine became an EU 'Too Big to Crash' theme amid fears of an eventual repeat of the 1929 Wall Street Crash, which to date has been avoided by all possible means of political intervention. Unfortunately, competition law could be seen as the scapegoat of this unprecedented restructuring of the banking and financial markets through the use of generous state aid to benefit inefficient financial game players. This last recognition leads us to question the adequacy of measures of profit-seeking capitalism.

The structure of this chapter is as follows. After a brief introduction, Section II questions the nature of the crisis and its origins. It explains both the micro- and the macroeconomic level of intervention in times of crisis, and it highlights the need to address the failures of both public and private economic actors. Section III digs deeper into the roots of the crisis and generally classifies the major disturbing causes playing a role in the current crisis. In turn, Section IV focuses on one particular cause of the problem, namely the behavioural exploitation of consumers by bankers and states through the use of a low interest rate stimulus. It critically engages with the EU high unemployment rate and challenges its austerity policies. Section V contrasts the existing convergence criteria for harmonious EU economic development across Member States with the current economic outlook and challenges the critical and apparent legitimacy of bailouts. The lack of democratic legitimacy of the latter is exacerbated by the social and economic costs of the EU crisis, which are the subject

of Section VI. In particular the main categories of state aid will be explored here, as well as the political and the institutional dimension of the crisis. Section VII will explain the widespread financial derivative contracts which are the object of the recent investigations conducted by the European Commission (EC). These investigations culminated with record fines, which will be discussed in greater detail in Section VIII. Finally, Section IX engages with the neoliberal ideology and challenges it as a social model of economic governance. Looking back at previous positions on social and corporate responsibility, employment, and capital mobility, the chapter is able to identify an overarching critical edge to the current scenario, in the form of the financialisation of global markets.

## II. ON THE NATURE AND ORIGIN OF THE CRISIS

The nature of the current crisis has been determined by the sectors of the economy which are most affected by economic failures. As large financial institutions such as commercial, investment or securities banks and other major corporations have experienced a large number of defaults, this has first been recognised as a banking crisis.<sup>1</sup> However, a greater risk to affect and spread the banking crisis to other financial institutions has made it systemic. Before the crisis, banks experienced longer periods of credit expansion, which had also led to a rise of real estate and equity prices, above the gross domestic product (GDP). On the negative side, the credit boom reached a peak and burst into a price 'bubble', ie house prices fell below outstanding balances on home mortgages. Thus, a sovereign debt crisis then emerged as defaults on payments of debt obligations became the rule, which called for the

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<sup>1</sup> See, eg, CM Reinhart and KS Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton NJ, Princeton University Press, 2009); J de Haan, S Oosterloo and D Schoenmaker, *Financial Markets and Institutions: A European Perspective*, 2nd edn (Cambridge, Cambridge University Press, 2012); S Valdez and P Molyneux, *An Introduction to Global Financial Markets*, 7th edn (Basingstoke, Palgrave Macmillian, 2013).

restructuring of the banking sector. This process meant offering debtors less favourable terms than the expected capital gains.

One cannot fully understand the nature of the crisis without questioning first its origins. The global crisis emerged first in the US subprime market,<sup>2</sup> which generated losses during summer 2007 to mid-2008. Hundreds of billions of dollars in bad mortgage loans initially set at bargain rates<sup>3</sup> were reset at market rates so that when housing prices started to fall, owners defaulted on their payments. This was followed by the bail-out of Bear Stearns; the nationalisation of mortgage agencies Fannie Mae and Freddie Mac; and the Lehman Brothers' bankruptcy in September 2008. Until late October of that year, a global loss of confidence created a systemic risk of collapse.

The recession manifested itself through sharp increases in budget deficits and slow economic recovery. In addition, the limits of the Stability and Growth Pact of 1997<sup>4</sup> were breached. After September 2008, European Union (EU) rescue policies focused on restoring the liquidity of banks and guarantees, while the ECB (European Central Bank) and national central banks outside the euro adjusted the provision of liquidity and cut interest rates.<sup>5</sup> The Recovery Plan provided a discretionary fiscal stimulus of €200 billion, which was used for budgetary expansion rather than to 'boost demand and stimulate confidence'.<sup>6</sup> A Financial Stabilisation Mechanism provided Member States with another €500 billion. Not until mid-March 2009, were there any signs of stabilisation.<sup>7</sup>

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<sup>2</sup> See M Jarsulic, 'The Origins of the US Financial Crisis of 2007: How a House-Price Bubble, a Credit Bubble, and Regulatory Failure Caused the Greatest Economic Disaster since the Great Depression' in MH Wolfson and GA Epstein (eds), *The Handbook of the Political Economy of Financial Crisis* (Oxford, Oxford University Press, 2013) 30; P Krugman and R Wells, *Macroeconomics*, 3rd edn (New York, Worth's Publishers, 2013) 432.

<sup>3</sup> Interest rates were extremely low due to large capital flows from abroad to the US economy, the US Federal Reserve, and low inflation. See, eg, Jarsulic, n 2 above.

<sup>4</sup> See R Guttman and D Plihon, 'Whither the Euro? History and Crisis of Europe's Single-Currency Project' in Wolfson and Epstein, n 2 above, 368.

<sup>5</sup> See, eg, C Quigley, 'Review of the Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis' (2012) 3 *Journal of European Competition Law & Practice* 237; see generally C Quigley and AM Collins, *EC State Aid Law and Policy* (Oxford, Hart Publishing, 2003).

<sup>6</sup> *Ibid.*

<sup>7</sup> See, eg, positive signs are noted in 'Towards a Genuine Economic and Monetary Union', available at: [www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/134069.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134069.pdf).

Unique due to its geo-political architecture, the EU crisis revealed that it is not solely private economic actors who can default on their contractual obligations. Member States such as Greece failed to keep up with their borrowing costs. Furthermore, the political pursuits of monetary union and its single currency highlighted the complexity of the crisis at the microeconomic level. At the macroeconomic level, there was also a risk that Member States which maintained fixed exchange rates could also experience a currency crisis where the value of the national currency fell suddenly as a result of a loss of confidence followed by speculative attacks.<sup>8</sup>

The events in Greece led the EU to reconsider both the political and the constitutional dimension of the sovereign debts crisis. In May 2010, the EU set a precedent by granting a total of €80 billion to Greece.<sup>9</sup> In this context, the solidarity with Greece's economic failure triggered a political crisis fuelled with heated legal arguments. In particular, solidarity is pre-empted by Article 125(1) TFEU itself, which rules out state bail-outs<sup>10</sup> when it says that both the EU and its Member States shall not be liable for or assume commitments of central governments. A constitutional crisis emerged which suggested Greece's possible exit from the Eurozone. The precarious situation of sovereign debts transformed this crisis into a euro currency crisis amid speculations over Greece's economy. This was the first major test of both economic and, foremost, social European integration, which revealed the perils of free capital markets, liberalisation, and a single currency based on institutional foundations which were not capable of sharing the economic costs of major economic imbalances. In the absence of a fiscal union, the Founding Treaties proposed an Economic and Monetary Union subject to strict convergence criteria, which will be analysed in Section V.

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<sup>8</sup> In 1999 several MS attempted to stabilise their exchange rates through the Exchange Rate Mechanism, see generally P Arestis and M Sawyer, 'Can the Euro Survive after the European Crisis?' in Arestis and Sawyer (eds), *The Euro Crisis* (Basingstoke, Palgrave Macmillian, 2012).

<sup>9</sup> E Chiti and PG Teixeira, 'The Constitutional Implications of the European Responses to the Financial and Public Debt Crisis' (2013) 50 *Common Market Law Review* 686; Guttman, n 4 above, 372 reported €750 bn.

<sup>10</sup> M Ruffert, 'The European Debt Crisis and European Union Law' (2011) 48 *Common Market Law Review* 1785.

In a nutshell, the crisis has highlighted the existing economic disparities in terms of economic development across the EU. Thus, some Member States became economically and socially responsible for other Member States' inefficiency. Likewise, the financialisation of capital services worldwide has triggered the responsibility of various economic actors, institutions, and the wider society. It has raised the question of who is primarily responsible for the crisis. This is not easy to answer either before or after judging the roots of the crisis, which follows in the next section.

### III. ON THE ROOTS OF THE CRISIS: WHAT WENT WRONG?

The vast literature on the economic crisis abounds in suggestions of what went wrong before and after the crisis. Thus failures appear first as poor economic governance because the state employs ineffective means of correlating and/or correcting macroeconomic indicators which later affect individual decision-making. For example, some of the convergence criteria which Member States are required to fulfil prior to joining the Eurozone emerge first as economic indicators which went wrong, such as public deficit and spending, GDP, or interest rates. Valdez and Molyneux<sup>11</sup> have identified the following major macroeconomic imbalances: (i) large and persistent current account deficits following previous surpluses due to capital flows from emerging to rich industrial economies; (ii) a long period of low real interest rates fuelled by deflationary concerns; (iii) a credit boom for home mortgage lending which put up the housing prices before the crisis by more than 30 per cent; (iv) low interest rates that encouraged consumer spending and persuaded banks to take on more risk in various long-term contracts.

Among the leading variables indicating a financial crisis are rising defaults and government deficits, the rapid growth of credit and money supply, declining GDP etc.<sup>12</sup> This simplified picture has to be explored in greater depth to identify what went

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<sup>11</sup> See n 1 above.

<sup>12</sup> E Tymoigne, 'Financial fragility' in J Toporowski and J Michell (eds), *Handbook of Critical Issues in Finance* (Cheltenham, Edward Elgar, 2012) 102.

wrong with private and public actors, including Member States, law in action, policy-makers, and policy influencers.<sup>13</sup>

(i) *What went wrong with public economic actors?* Access to credit was easy, with too much money made available through a lax monetary policy, ie lowering interest rates. Through the transformation of investment banks into holding companies the shadow banking system acquired access to governmental funding.<sup>14</sup> Finally, banks which took high risks were bailed out and this encouraged them to indulge in more risk-taking.

(ii) *What went wrong with private economic actors?* Individual economic actors (consumers, borrowers, lenders) underestimated the economic cost and engaged in highly speculative contracts (eg variable mortgage rates, and loan insurance contracts).<sup>15</sup> In other words, consumers failed to be aware of risks to themselves and soon, complexity was mistaken for sophistication, with consumers assuming that their investments were safe. Corporate managers also failed to evaluate risks before entering into complex transactions, such as securitisation and credit default swaps, which will be detailed in Section VII.

In sum, the collective solidarity of banks had been oriented towards hazardous risk-taking,<sup>16</sup> market indiscipline, and market abuse. Managers increased returns by boosting excessive leverage, ie, the return on equity as the major indicator of a firm's performance.<sup>17</sup> In essence, the ownership of capital was financed by debts.<sup>18</sup> The net income generated to shareholders created the bonus culture, while compensation schemes encouraged short-run risk-taking.

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<sup>13</sup> For existing classifications see, eg, RM Lastra and GE Wood, 'The Crisis of 2007-2009: Nature, Causes, and Reactions' (2010) 13 *Journal of International Economic Law* 531; 537; L Garicano and R Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles' (2010) 13 *Journal of International Economic Law* 597.

<sup>14</sup> E Avgouleas, 'The global financial crisis, behavioural finance and financial regulation: in search of a new orthodoxy' (2009) 9 *Journal of Corporate Law Studies* 121. The US abolished the Glass-Steagall Act 1933. On information asymmetries and 'moral' hazard problems see, eg, O Kessler and B Wilhelm, 'Financialization and the Three Utopias of Shadow Banking' (2013) 17 *Comp and Change* 251; on government failure, see ME Stucke, 'Lessons from the Financial Crisis' (2011) 77 *Antitrust Law Journal* 314.

<sup>15</sup> F Möslein, 'The focus of regulatory reforms in Europe after the global financial crisis: from corporate to contract governance' in W Sun, J Stewart and D Pollard (eds), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge, Cambridge University Press, 2011) 286.

<sup>16</sup> Banks and firms were taking on extensive risk; therefore, managers were given incentives so as to generate higher returns for shareholders. On collective moral hazard see, eg, E Farhi and J Tirole, 'Collective Moral Hazard, Maturity Mismatch and Systemic Bailouts' (2012) 102 *American Economic Review* 60.

<sup>17</sup> The 2009 *Report of the OECD Steering Group on Corporate Governance* (24 February 2010) identified excessive remuneration, risk management, board practices and the exercise of shareholder rights as main problematic areas of corporate governance.

<sup>18</sup> Profits had to be paid to bond holders and other creditors plus a competitive return to equity owners see, eg, Kregel, 'Political Economy Approaches to Financial Crisis: Hyman Minsky's Financial Fragility Hypothesis' in Sun et al (eds), *Corporate Governance and the Global Financial Crisis* n 15 above, 237.

(iii) *What went wrong with policy?* Macroeconomic policy registered numerous failures through relaxed credit, followed by an industrial restructuring of banks through the application of the TBTF doctrine of state intervention in the economy. The lack of regulation in the banking sector – including investment, insurance, securities, and lending<sup>19</sup> – combined with a less interventionist approach to mergers of large financial institutions, meant that these became TBTF and ‘Too-Big-to-Supervise’.<sup>20</sup> As banks were allowed to merge, they escaped competition scrutiny<sup>21</sup> but were encouraged to compete. The latter aspect exacerbated risk-taking through improper disclosure requirements put in place to uncover banks’ speculative pursuits.<sup>22</sup> In 2012, the EC finally activated its competition policy, which helped to block a mega-merger between Deutsche Börse and the New York Stock Exchange<sup>23</sup> in the market for financial derivatives. Many believed that the unaccomplished economic, monetary, and fiscal integration of Member States was another culprit, as was the absence of a central authority dealing with the crisis.

(iv) *What went wrong with law in action?* There was inadequate regulation of special contracts in the banking, financial and securities sector; an excessive use of securitisation as a financial innovation to engineer debts ‘cleansing’; excessive sophistication of commercial contracts;<sup>24</sup> and a lack of codes of honest business practice or models of contracts in place for consumers.<sup>25</sup> As banks became increasingly sophisticated, their innovative products were not priced accurately. It was impossible to assess the hazard due to innovative securitised products. In this context, ‘soft’ law<sup>26</sup> used in the framework of state aid policy, turned competition law into a major tool for the restructuring of the banking industry.

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<sup>19</sup> See for the US JW Markham, ‘Lessons for Competition Law from the Economic Crisis: The Prospect for Antitrust Responses to the “Too-Big-to-Fail” Phenomenon’ (2011) 16 *Fordham Journal of Corporate & Financial Law* 263.

<sup>20</sup> Stucke, n 14 above, 319; on rising bank concentration see, eg, FM Scherer, ‘Financial Mergers and their Consequences’, *Harvard Kennedy School of Government Research Working Paper* 19/2013.

<sup>21</sup> See, eg, D Zimmer and L Rengier, ‘Entflechtung, Fusionskontrolle oder Sonderregulierung für systemrelevante Banken? Ansätze zur Lösung des “Too-big-to-fail” Problems’ (2010) 8 *Zeitschrift für Wettbewerbsrecht* 105, who proposed a specific merger control, including a ‘decartelisation’ of banks.

<sup>22</sup> X Vives, ‘Competition policy in banking’ (2011) *Oxford Review of Economic Policy* 27, 487.

<sup>23</sup> COMP/M6166 *Deutsche Börse/NYSE Euronext* [2011] OJ C199.

<sup>24</sup> L Buchheit, ‘We Made it Too Complicated’ (2008) 27 *International Financial Law Review* 24, who highlighted the complexity of modern financial instruments as the ‘big culprit’ of the crisis.

<sup>25</sup> C Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge, Cambridge University Press, 2012) 223.

<sup>26</sup> C Brummer, ‘Why Soft Law Dominates International Finance-And Not Trade’ (2010) 13 *Journal of International Economic Law* 623; retrospectively see, eg, AF Lowenfeld, ‘The International Monetary System: A Look Back Over Seven Decades’ (2010) 13 *Journal of International Economic Law* 575; JP Trachtman, ‘The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation’ (2010) 13 *Journal of International Economic Law* 719; G Hufbauer and DD Xie, ‘Financial Stability and Monetary Policy: Need for International Surveillance’ (2010) 13 *Journal of International Economic Law* 939.



(v) *What went wrong with EU institutions?* As regards institutional responses to the crisis, on 12 November 2008, the EC proposed tighter rules for credit rating agencies; on 29 April 2009, it presented a draft directive on hedge funds and private equity;<sup>27</sup> on 23 September 2009, the EC proposed a legislative package for EU financial macro-supervision<sup>28</sup> (Systemic Risk Board) and micro-prudential supervision (Banking Authority, Securities and Market Authority, and Insurance and Occupational Pensions Authority); in October 2010, the EC discussed a tax on financial transactions; in March 2011, it drafted rules on mortgage lending. Finally, in June 2011, the EC unveiled million-euro fines for rule-breaking bankers.

(vi) *What went wrong with influencing views?* This refers to the views of leading academic and economic experts who influenced policy-making and on whom policy-makers later relied to reshape economic and social governance and/or manage the crisis. There was a fervent reliance on faulty neo-classical economic theories<sup>29</sup> and liberal ideologies,<sup>30</sup> an over-reliance on mathematical risk models which failed to adequately predict and mitigate corporate risk,<sup>31</sup> and scientific interpretations.<sup>32</sup>

(vii) *A knock-on effect of the limits of knowledge?* This is attributed to the narrow focus of competition law<sup>33</sup> and the lack of interdisciplinary understanding, not only of law with other sciences, such as economics or sociology,<sup>34</sup> but among different areas of law like competition, contract, finance, banking and corporate law.<sup>35</sup> This led Westbrook to explain:

[D]erivatives are contracts; corporations ... are creatures of law. Economics, however, has always aspired to be a natural science, and so has considered the social as if it were natural. This fundamental ontological error has led to

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<sup>27</sup> Source: EurActiv, 'Financial Regulation: The EU's agenda', 1 April 2009, available at: <http://www.euractiv.com/euro-finance-regulation-eus-agenda-links-dossier-188497>.

<sup>28</sup> Critically on the Basel Committee's 'Core Principles for Effective Banking Supervision', see Brummer, n 26 above, 225.

<sup>29</sup> ME Stucke, 'Teaching Antitrust After the Financial Crisis' (2013) 8 *Journal of Business & Technology Law* 209, suggesting that behavioural economics is now 'mainstream'; J Crotty, 'The Realism of Assumptions does Matter: Why Keynes-Minsky Theory Must Replace Efficient Market Theory as the Guide to Financial Regulation Policy' in Wolfson and Epstein (eds), n 2 above, 134.

<sup>30</sup> See RA Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Cambridge MA, Harvard University Press, 2009) 235. Posner identified one of the causes of the crisis as laissez-faire liberalism.

<sup>31</sup> F Akinbami, 'Is meta-regulation all it's cracked up to be? The case of UK financial regulation' (2013) 14 *Journal of Banking Regulation* 16, 20.

<sup>32</sup> Especially trust in the superiority of mathematics, game theory and modelling over rigorous disciplines such as law, political science, psychology, sociology and history.

<sup>33</sup> Markham, n 19 above, 265.

<sup>34</sup> See the insightful contributions of I Lianos, 'Judging' Economists: Economic Expertise in Competition Law Litigation: A European View' in I Kokkoris and I Lianos (eds), *The Reform of EC Competition Law: New Challenges* (Kluwer Law International, 2010) 185; I Lianos and C Genakos, 'Econometric Evidence in EU Competition Law: An Empirical and Theoretical Analysis' CLES Research Paper 06/2012.

<sup>35</sup> See, eg, T Cottier, 'Challenges Ahead in International Economic Law' (2009) 12 *Journal of International Economic Law* 3, on the failures of a 'strictly disciplinary tradition' of fragmentation and specialisation.

fanciful pricing models, as if we could model the movements of legal instruments like we model the movements of the stars.<sup>36</sup>

In other words, the practical inability of macroeconomics to test its predictions empirically has played a major role in this crisis.<sup>37</sup> Statistics and the reliance on macroeconomic models by central banks have proven to be useful. For example, econometrics has demonstrated how a series of macroeconomic measures, specifically those targeting active employment policies, impact upon individuals. Nevertheless, these tools remain limited and have proven to be grossly inadequate in practice.<sup>38</sup>

What conclusions can be drawn from the above? It is necessary to identify both the plethora of causes which have contributed to this crisis and the means of correcting the resulting negative effects. A preliminary balance of these causes would include the institutional problems of leading public authorities – which ought to have prevented and managed the crisis (eg governments, regulators) – the legal problems regarding the economics of special contracts which imply a speculative risk and the application of non-interventionist competition supervision at a microeconomic level. Furthermore, an inadequate macro-supervision of shadow banking, and the influence of schools of economics/economists on crisis management also played an important role. Given the complexity of this crisis, it is difficult to identify *one* major root of the crisis; rather, multiple causes have led to major negative events.

As it is possible that a certain cause is the effect and vice versa, the first scenario is pitched at a microeconomic level. The next section aims to investigate what has happened in the subprime mortgage lending market and then goes on to question the perceived influence of certain schools of economics/economists to verify their plausibility if applied to the current crisis. The following problem–question scenario builds upon all of the above insights into the roots of the crisis.

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<sup>36</sup> D Westbrook, *Out of Crisis: Rethinking our Financial Markets* (Boulder CO, Paradigm Publishing, 2009).

<sup>37</sup> G Kirchgässner, 'Die Krise der Wirtschaft: Auch eine Krise der Wirtschaftswissenschaften?' (2009) 10 *Perspektiven der Wirtschaftspolitik* 447, 452: '*Dies ist ein Preis, den wir dafür zahlen müssen, dass wir zumindest im Bereich der Makroökonomik – keine experimentelle Wissenschaft sind: makroökonomische Experimente sind nie kontrolliert and sollten auch sehr zurückhaltend eingesetzt werden, da sie dann, wenn sie schief gehen, enorme gesellschaftliche Kosten haben können*'. Thus one can disagree with the last paragraph since macroeconomic policies have always been tested on mankind and citizens have paid the social and economic costs of policy failure.

<sup>38</sup> *Ibid.*

#### IV. ON THE INTERPLAY OF MICRO- WITH MACROECONOMICS IN THE SUBPRIME<sup>39</sup> MORTGAGE LENDING MARKET

At a microeconomic level, consumers borrowed more on terms which were favourable in the short term, but the long-term effect was building up a bubble due to a lack of economic foresight and human irrationality. A variable interest rate inducement coupled with myopia over any eventual job loss reveals an unconscionable moral hazard. It is believed that banks intentionally exploited consumers by taking advantage of their well-known decision-making biases,<sup>40</sup> namely, a tendency to ignore the long-term costs of complex transactions, while opting for a variable interest rate, or a limited experience with commercial transactions.<sup>41</sup> The relevance of consumer law here is the potential to find the behavioural exploitation of consumers as a form of deceptive conduct, such as a lender's omission of terms and conditions. It is a well-established principle that offering incomplete information to consumers about the costs of their transaction, through false statements or omissions, will give rise to contractual misrepresentation, which, in turn, if it is based on intentional behaviour, becomes fraudulent.<sup>42</sup>

Unfortunately, the existing consumer protection and available remedies have not been adequate tools for antitrust intervention due to an artificial separation of the consumer from competition laws.<sup>43</sup> The drawback is therefore leaving behavioural economics to consumer protection laws which address information asymmetries for borrowers who are being misled through lenders' business marketing strategies. Reliable credit information is believed<sup>44</sup> to correct information asymmetries through an effective credit reporting mechanism. Recently, the hypothesis that lenders are

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<sup>39</sup> Posner, n 30 above, 23 suggested 'subprime' as a euphemism for mortgage loans to people at high risk of default.

<sup>40</sup> See also F Akinbami, 'Retail Products and the Global Financial Crisis', available on SSRN.

<sup>41</sup> M Huffman and D Heidtke, 'Behavioural Exploitation Antitrust in Consumer Subprime Mortgage Lending' (2012) 3 *William & Mary Policy Review* 77, available on SSRN.

<sup>42</sup> For a disposition to fraud, see MR Darby and E Karni, 'Free competition and the optimal amount of fraud' (1973) 16 *Journal of Law and Economics* 67; F Akinbami, 'Financial services and consumer protection after the crisis' (2011) 29 *International Journal of Bank Marketing* 134, 137.

<sup>43</sup> See especially NW Averitt and R Lande, 'Using the "Consumer Choice" Approach to Antitrust Law' (2007) 74 *Antitrust Law Journal* 175; A Albers-Llorens, 'Competition and Consumer Law in the EU: Evolution and Convergence' (2014) 33 *Yearbook of European Law* 1.

<sup>44</sup> A Padilla and M Pagano, 'Sharing default information as a borrower discipline device' (2000) 44 *European Economic Review* 1951–80.

more likely to share credit information when entry barriers are high and the threat of competition is low has been rejected empirically due to burdensome administrative costs.<sup>45</sup> Banks with larger market shares earn higher monopoly rents on their borrower information than do banks with a smaller market share. Furthermore, higher entry barriers are associated with lower transparency in credit reporting.<sup>46</sup>

The above picture needs to further explore the macroeconomic level. Hayek's theory of trade cycle is worth highlighting. He argued that interest rates below the 'natural' rate lead banks to expand their lending in a manner which is unsustainable.<sup>47</sup> This, in turn, leads inevitably to a crisis, since businesses are misled into believing that more resources are available than is really the case.<sup>48</sup> According to his theory, it is then government action or misinformation by the central bank which 'awakes' the crisis through the banking system. In essence, the past reaction to such governmental stimulus was an impulsive entrepreneurial spirit towards excessive lending with dramatic effects on the real economy. Banks were attracted to subprime mortgage lending by higher interest rates of 2 per cent above fixed prime lending.<sup>49</sup> For consumers, mortgage financing became attractive; for example, a buyer could pay £350,000 with a 90 per cent mortgage, and three years later, the house price had increased to £500,000.

A serious analysis of the cause–effect–result phenomenon shows that but for the low interest rates, consumers would not have mortgaged, bankers would not have assumed risky lending, and everybody would have been happy. The shortcoming of the cause–effect platitude is that it is precisely the inherent risk and its hazardous multiplication that is the real cause which has resulted in the default bubble. Since the maintenance of a low interest rate is a macroeconomic state policy, one could argue that it was the widespread reliance on this policy which created this mess. The

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<sup>45</sup> M Bruhn, S Farazi and M Kanz, 'Bank Competition, Concentration, and Credit Reporting', The World Bank Development Research Group, Finance and Private Sector Development Team, *Policy Research Working Paper* 64422/2013, 5.

<sup>46</sup> *Ibid*, 16.

<sup>47</sup> FA Hayek, *Prices and Production* (London, Routledge, 1931).

<sup>48</sup> RCB Miller, 'The Austrians and the Crisis' (2009) 29 *Economic Affairs* 27, 28.

<sup>49</sup> On the existing link between the use of aggressive mortgage lending and house price volatility see, eg, A Pavlov and S Wachter, 'Subprime Lending and House Price Volatility', *University of Pennsylvania Institute for Law and Economics Research Paper* no 08/2008.

interest-rate-effect in macroeconomics postulates that a rising price level pushes up the interest rate, which in turn, lowers consumption and new investments in plant and equipment.<sup>50</sup>

In conclusion, it would be naive to assume that a mortgage multiplier could eventually create a crisis of such proportions. There are other trading exchanges which operated much in the same way or even worse and which will be explained in Section VII. In contrast, others have argued that under the influence of neoliberalism, the economy 'benefited' from an explosion of public and private credit.<sup>51</sup>

Another belief is that a recession is able to destructively correct the errors of a boom. In other words, bad businesses will collapse, which explains the rescue mechanisms put in place by the EC. In contrast to the previous credit boom period, interest rates have to be higher to collect through deposit savings the monies needed for the liquidity of banks which are due to collapse. This view has been contradicted more recently, because the liquidity problems were created 'by the unexpected decline in the value of financial assets and by the consequent reduction of inter-bank lending'.<sup>52</sup>

The level of interest rates is said to depend upon the depth of the recession.<sup>53</sup> Anecdotal evidence of the promised triple-dip recession proves how interest rates for savings have not been tripled, much to our own economic loss. In contrast, Member States were able to borrow at historically low interest rates.<sup>54</sup> Following the Austrian School of Economics' advice, Member States failed to raise interest rates significantly.<sup>55</sup> Rather, the EU simulated a destructive recession and restructured banks through recapitalisation, the difference this time being that the resources which allowed this to happen have flown directly from EU taxpayers to hazardous risk-takers. Nevertheless, irrespective of whether the process of restructuring itself

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<sup>50</sup> SL Slavin, *Macroeconomics*, 9th edn (Boston MA, McGraw-Hill, 2009) 257.

<sup>51</sup> J O'Connor, 'Marxism and the Three Movements of Neoliberalism' (2010) 36 *Critical Sociology* 704.

<sup>52</sup> A Heimler and F Jenny, 'The limitations of European Union control of state aid' (2012) 28 *Oxford Review of Economic Policy* 347, 363.

<sup>53</sup> *Ibid.*, 31.

<sup>54</sup> G Grahl, 'The Subordination of European Finance' (2011) 15 *Comp and Change* 31, 43 noting in particular Japan (0.96%), Germany (2.40%), US (2.56%), France (2.86%), UK (3%).

<sup>55</sup> *Ibid.*

should not have been implemented effectively, the real worry turns on whether this sacrifice is actually worth anything?

Furthermore, the reverse of not encouraging government spending for fear of any taxation mismatch or of a pervasive inflationist course seems equally odd, as it results in austerity, which promotes job cuts and raises unemployment levels. Unfortunately, the austerity obsession has delivered economic failure, social poverty, migration and unprecedented levels of unemployment. This will be documented in Section V. Now, to return to Hayek's prescription of 'flexible' wages, ie, cutting wages to minimise unemployment and combat inflation, the latter being currently low at 1.7 per cent, it is worth revealing that global population<sup>56</sup> is more than three times higher than 1.8 billion, as it was in the 1920s. This makes one particularly circumspect of creative ideas of 'full' employment in real terms<sup>57</sup> as applied to a different historical level in society's development. In the EU, the last total population revealed by Eurostat in 2012 was 503.7 million, not counting 4.2 million Croatians. As nearly 26.2 million unemployed citizens account for 10.8 per cent of the active work force, it means that we have an active population of 235.8 million but only 212.22 million employed citizens.

In conclusion, the EU has just 41.7 per cent of its total population in full employment. This dramatic unemployment situation comes just after what we could call a Failed Financialisation of Big Banks, and proves that what Stiglitz has already suggested about macroeconomic multipliers is true,<sup>58</sup> namely that, assessed retrospectively, the process of EU restructuring of banks, with its overly generous stimulus package, has failed to generate either jobs or any extra GDP.<sup>59</sup> Fortunately, the EU unemployment rate does not exceed the 200 million estimate of the International Labour Organization as a global crisis unemployment figure.<sup>60</sup> Finally,

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<sup>56</sup> Currently estimated at approximately 7 billion.

<sup>57</sup> On the rejection of 'full' employment see L von Mises, *Human Action* (New Haven CT, Yale University Press, 1949).

<sup>58</sup> J Stiglitz, 'The global crisis, social protection and jobs' (2009) 148 *International Labour Review* 4.

<sup>59</sup> See, eg, J Bivens and H Shierholz, 'The Great Recession's Impact on Jobs, Wages, and Incomes' in Wolfson and Epstein (eds), n 2 above, 61.

<sup>60</sup> T Clarke, 'Corporate governance causes of the global financial crisis' in Sun et al (eds), *Corporate Governance and the Global Financial Crisis* n 15 above, 43.

macroeconomics suggests that only an unemployment rate of 20 per cent triggers a depression.<sup>61</sup>

Another cause of the fragile growth lies in the more restrictive and austere macroeconomic policies that are necessary to achieve the economic and monetary union.<sup>62</sup> Nevertheless, Austrian economics offer one excellent tip: if undertaken, bank recapitalisation and state control is most likely to be unsuccessful. This is true in the EU when one confronts the bleak industry predictions available so far and the high unemployment rate.

It is argued here that Stiglitz's assertion that the rejection of the Keynesian theory of employment<sup>63</sup> – which promoted rigid wages –<sup>64</sup> formed the basis of the many post-Keynesian doctrines and undermined job protection and labour rights<sup>65</sup> was accurate. In macroeconomics, a 5 per cent unemployment rate means that the economy attains full employment.<sup>66</sup> The misconstruction of employment theory, with a strong emphasis on its 'utopian' vision of full employment, can be justified by the distrust of wage competition, which even if it could achieve labour flexibility, does so at the expense of worsening workers' conditions. According to Keynes, lowering wages would lower workers' incomes and reduce further spending on goods.<sup>67</sup> This makes Keynesian theory socially human. Thus Keynes believed that capitalism has a natural tendency to cut employment<sup>68</sup> but falling interest rates, prices, and wages are insufficient to stimulate investment and consumption<sup>69</sup> as a way out of the

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<sup>61</sup> Slavin, n 50 above, 218.

<sup>62</sup> See, eg, Grahl, n 54 above, 34; J Stiglitz, 'Towards a Better Measure of Well-being' in *Financial Times*, 13 September 2009.

<sup>63</sup> See Keynes' letter to TS Elliot in DE Moggridge (eds), *The Collected Writings of John Maynard Keynes: Activities 1940-1946. Shaping the Post-War World: Employment and Commodities* vol 27 (London, Macmillan, 1980) 384: 'the full employment policy by means of investment is only one particular application of an intellectual theorem. You can produce the result just as well as by consuming more or working less ... How you mix up the three ingredients of a cure is a matter of taste and experience, ie of morals and knowledge'.

<sup>64</sup> See JM Keynes, 'The General Theory of Employment' (1937) 51 *Quarterly Journal of Economics*, 209; Keynes, *The General Theory of Employment, Interest and Money* (London, Macmillan, 1973), also available at: [www.isn.ethz.ch](http://www.isn.ethz.ch).

<sup>65</sup> *Ibid*, 9.

<sup>66</sup> Slavin, n 50 above, 258.

<sup>67</sup> *Ibid*, 262.

<sup>68</sup> Kirchgässner, n 37 above, 462.

<sup>69</sup> On government spending, Keynes argued: 'quantity is more relevant than quality. Even if the government employed some people to dig holes and others to fill up those holes' see, eg, Slavin, n 55 above, 368.

recession.<sup>70</sup> In other words, without government intervention, the economy does not move toward full employment.

Unfortunately many Keynesian policies implemented in the 1950s and 1960s were inappropriately addressing deflation after it had ceased to represent a major threat.<sup>71</sup> Therefore, Minsky's financial fragility theory postulated that the trade cycle reacts to endogenous shocks, such as a change in monetary policy by the central bank (eg increasing interest rates to slow the economy for fear of inflation, or a supra-production crisis where markets are saturated with cars, electronics etc)<sup>72</sup> and that a deficient aggregate demand triggers a stagnant unemployment situation, which could eventually attain Keynesian full employment through monetary and fiscal policy.<sup>73</sup> If nothing else works, another option suggested by Austrian economics is to promote competition in currency exchange. Obviously, this did not work well for the Eurozone countries, which could not devalue their national currencies.<sup>74</sup>

Finally, as a last resort, tax is viewed with much scepticism.<sup>75</sup> Granting temporary facilities to individuals contributes to raising the level of savings deposits, which, in turn, actively stimulates consumption. However, direct tax helps little if it targets only those consumer goods that are to be produced in the long run and imports. Since 50 per cent of the lower taxed goods account for only 2.8 per cent of revenues, while the upper 5 per cent account for 63.5 per cent, and because the marginal consumption rate falls as earnings increase, then adjusting the private consumption deficit through direct taxation is thus possible for the category of lower income taxation. As government spending was feared to become inflationary,<sup>76</sup> spending has remained static, whereas taxation has served to increase reliance on

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<sup>70</sup> Ibid, 268.

<sup>71</sup> Tymoigne, n 12 above, 100.

<sup>72</sup> Macroeconomics describes the saturation of markets through the innovation theory where economic downturn continues until a new innovation takes hold. Another endogenous theory focuses on psychological factors whereas optimism triggers investments in plants, more jobs and consumer spending.

<sup>73</sup> Kregel, n 18 above, 237.

<sup>74</sup> Another suggestion has been to create a mechanism by which Member States with a current account deficit could devalue in real terms and other Member States with a surplus could revalue.

<sup>75</sup> Kirchgässner, n 37 above, 462.

<sup>76</sup> Karl Otto Pohl, former president of the German Bundesbank once said: 'Inflation is like toothpaste. Once it is out of the tube, it is hard to get it back again'. Hyperinflation happened in Germany after World War I when prices rose 10% an hour: see, eg, Slavin, n 50 above, 240.



consumption taxes, such as VAT and payroll taxes, and to diminish corporate tax.<sup>77</sup> In conclusion, trying to fix a crisis through taxation is nothing but a vicious circle.

In conclusion, all these insights reveal how unhelpful economic policies or economists' predictions<sup>78</sup> are; how the crisis has destroyed them one after another, thereby shaking our society in the search for social justice, the rule of law, and a new order; and how this crisis managed to exacerbate its social and economic costs instead of fixing the economy.

## V. ON THE MACROECONOMICS OF THE EURO CRISIS

Before looking to the current economic outlook, it is useful to re-call the macroeconomic legal framework which has been instrumental for setting out the overall performance criteria in the EU. Article 119(2) TFEU refers to a single currency, namely the euro, monetary policy, and exchange-rate policy. Its primary objective is to maintain price stability and to support the general economic policies in the Union, in accordance with the 'principle of an open market economy with free competition'. This principle means that at a microeconomic level, free competition will be complemented by macroeconomic policy. The primary objective of price stability is also mentioned under Article 105 of the Protocol on the European System of Central Banks (ESCB). According to Article 119(3), macroeconomic policy shall comply with the following guiding principles: stable prices, sound public finances and monetary conditions, and a sustainable balance of payments. Article 140(1) TFEU sets out the Maastricht convergence criteria for the accession of Member States to the single currency. Unfortunately, these nominal terms are tight. They mandate that the EC and the ECB report to the Council on the progress made by the Member States regarding the achievement of economic and monetary union, with a view to the achievement of a high degree of sustainable convergence. The economic criteria refer respectively to the 'achievement, sustainability, observance and durability' of:

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<sup>77</sup> OECD 1998, *Economic Outlook*, Paris, June 1998 which shows how corporate tax rate fell by 10.3% compared to 12.4% which corresponds to the fall of the average top marginal income.

<sup>78</sup> LJ Peter, *Peter's Quotations*: 'An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today'.

- (i) a high degree of price stability, by looking at the inflation rate of the three best performing Member States;<sup>79</sup>
- (ii) the sustainability of the government financial position, by looking at the public deficit;
- (iii) normal fluctuation margins provided for by the exchange-rate mechanism without devaluing against the euro;
- (iv) convergence achieved by the Member States with derogation and its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

In conclusion, the above criteria refer to various nominal values, such as an inflation lower than 1.5 per cent; exchange rates within the range of 15 per cent; long-term interest rates no more than 2 per cent higher than the arithmetic coverage of the similar 10-year government bond yields in the three Member States with the lowest HICP inflation; a budgetary deficit lower than 3 per cent GDP; and a government public debt criterion lower than 60 per cent. While these criteria aim to establish financial responsibility, they fail to include unemployment targets. Only in the last paragraph of Article 140 TFEU, is it spelled out that the monitoring reports ‘shall also take account of ... an examination of the development of unit labour costs and other price indices’.

#### Current Economic Outlook

 EU Real GDP Growth	-4.2% (2009)	0.1% (2013)
 EU Unemployment	9.6% (2010)	10.8% (12% euro area) (2014)
 EU Government debt	78.7% (2009)	86.8% (92.7% euro area) (2014)
highest in Greece 171.8%, Italy 132.9% and Portugal 128.7%		

Source: Eurostat<sup>80</sup>

The current economic situation reveals interesting insights into the state of the economy. Inflation has generally been higher than 2 per cent. According to the

<sup>79</sup> It will be inferred from a rate of inflation which is close to that of the three best performing Member State.

<sup>80</sup> Source: EU Commission, Towards More Responsibility and Competitiveness in the European Financial Sector, 2012.

latest Eurostat figures,<sup>81</sup> the annual *inflation* rate in the Eurozone area was 1.6 per cent in July 2013 compared to 2.4 per cent a year earlier. The annual inflation rate in the EU was 1.7 per cent in July 2013.<sup>82</sup> Therefore, a country with a relatively low (high) inflation rate has a relatively high (low) real interest rate. However, monetary policy has been operated in a perverse manner, with low real rates being applied where inflation is relatively high. This contradicts the presumption that high inflation is met by high real rates of interest to dampen demand. Many economists agree that compared with the Bank of England and the US Federal Reserve, which have reduced aggressive interest rates, the ECB has adopted a stricter approach. In April 2011, interest rates reached 1.25 per cent. Apart from the existing large current account imbalances between the EMU Member States, there are also substantial differences in terms of changes in unit labour costs.

Again, unemployment rose to 26.2 million in January 2013, which accounts for 10.8 per cent of the active population<sup>83</sup> and 11.9 per cent of the active population in the euro area (19 million). Furthermore, long-term unemployment reached another historical high<sup>84</sup> in the third quarter at 11.2 million, which is 86 per cent higher than four years earlier. Another aspect worth highlighting is that youth unemployment reached its peak in January 2013 with 23.6 per cent of active youths.<sup>85</sup> Immigration was 20.7 million in January 2012 and migration was 13.6 million.<sup>86</sup> In addition, 25.7 per cent of people aged between 55 and 64 were living in poverty and social exclusion,<sup>87</sup> while the lowest average monthly salary was just 393 euros (Bulgaria).<sup>88</sup> In 24 Member States, the likelihood of finding a job was lower in the third quarter of 2012 than four years before.<sup>89</sup> And this is not all. Major planned cuts in the industry

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<sup>81</sup> Eurostat, euro indicators, press release 123/2013, 16 August 2013.

<sup>82</sup> The largest increase to the euro area ('Eurozone') annual inflation is said to come from fruit, vegetables and tobacco.

<sup>83</sup> European Commission, 'EU Employment and Social Situation' (2013) *Quarterly Review* 5. Other high unemployment rates were recorded in Bulgaria (-4.9%), Cyprus (-4.8%) and Spain (-4.5%).

<sup>84</sup> *Ibid*, 6.

<sup>85</sup> The youth unemployment rate ranges from 15% or more in Austria, Denmark, Germany and the Netherlands to 55% or more in Greece and Spain. Highest unemployment rates were registered in Greece (-6.5%) and Portugal (-4.3%).

<sup>86</sup> *Ibid*, 15.

<sup>87</sup> *Ibid*, 24.

<sup>88</sup> *Ibid*, 28.

<sup>89</sup> *Ibid*, 30.

sectors cast rather a bleak shadow over the overall economy. For example, in the banking sector, Commerzbank is implementing a global restructuring plan targeting between 4000 and 6000 job losses by 2016; in the airline sector, Iberia is cutting 19 per cent of its entire workforce (3807 employees) and Air Berlin another 900 by 2014,<sup>90</sup> while the manufacturing sector lost 36,964 jobs last year, and financial intermediation 19,585. The worst prognosis is in the construction industry, and wholesale and retail trade as a result of significant reductions in terms of output, added value, and employment.<sup>91</sup>

#### A. The 'Efficiency' Justification against Bail-outs of Inefficient Banks or States

So how was it then legally possible to instrument the bail-outs of banks? Article 119 TFEU makes it clear that the adoption of an economic policy which is based on the 'close coordination' of Member States' economic policies has to be in accordance with the principle of an open market economy with free competition. It must be added that competition law rarely accepts a failing-firm-defence on the grounds of its poor economic performance, that is, inefficiency. In this respect Article 120 TFEU mandates that economic policies ought to follow the same principle, 'favouring an efficient allocation of resources'. Furthermore, Article 123(1) TFEU contains an imperative prohibition of

[o]verdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States ... in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States,

as well as 'the purchase directly from them by the European Central Bank or national central banks of debt instruments'. One cannot possibly comment more on the legally binding hierarchy and 'constitutional' ranking of the above provisions, which clearly eliminate the possibility of granting bailouts on the basis of inefficiency, be it at state or TBTF level, without basically undermining the rule of law and transforming the spirit of free competition into coercive freedom, the meaning of which will be revealed in the end Section IX.

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<sup>90</sup> Ibid, 66.

<sup>91</sup> Ibid, 58.

Another critical argument is that competition intervention in favour of TBTF banks has been implemented through substantial crisis communication in the form of soft law. It has been argued elsewhere that state aid communications bear no legally binding force.<sup>92</sup> Thus, they are administrative provisions which offer guidance on how to deal with the restructuring or capitalisation of banks. Therefore, a higher hierarchical and constitutionally accepted rescue provision is Article 107(3)(b) TFEU on state aid to 'remedy a serious disturbance in the economy of a Member State'. This has closed the academic debate over the primacy of 'hard' over 'soft' law.<sup>93</sup> The latter could be called an administrative measure which has binding force. No legal act or decision whatsoever would otherwise be enacted if it were to be disregarded. Furthermore, if it were legally valid that soft law communications are not binding on EU courts, this would be instrumental, on the one hand, for states to claim disgorgement of profits for cashed bail-outs of banks engaged in fraudulent pursuits and, on the other hand, for EU citizens to claim fair compensation through taxation. It would be legitimate for them to pay lower taxes until the almost 40 per cent of the GDP in bail-outs was credited on their payroll accounts.

In conclusion, the apparent legitimacy of state bail-outs is in the treaty; the implementation of banks bailouts is in administrative law communications.

## VI. ON THE SOCIAL COSTS OF THE CRISIS

After the apparent legitimacy has just been discussed above, it is worth checking the actual economic cost involved in bail-outs. This begs the following question: how much state aid was really needed and why? Insights into how state aid gradually progressed reveal that between 2002 and 2007, the amount of state aid decreased by 2 per cent annually and ranged within 0.5 per cent of the GDP,<sup>94</sup> followed in 2008 by a

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<sup>92</sup> See, eg, T Doleys, 'Managing State Aid in a Time of Crisis: Commission Crisis Communications and the Financial Sector Bailout' (2012) 34 *Journal of European Integration* 549.

<sup>93</sup> See the insightful contributions on soft law of O Stefan, *Soft law in court: competition law, state aid and the Court of Justice of the European Union* (Kluwer Law International, 2013); 'Hybridity before the court: a hard look at soft law in the EU competition and state aid case law' (2012) 37 *European Law Review* 49.

<sup>94</sup> P Nicolaidis, 'State aid' in I Kokkoris and R Olivares-Caminal (eds), *Antitrust Law amidst Financial Crisis* (Cambridge, Cambridge University Press, 2010).

nearly four-fold increase to 2.2 per cent of the GDP. Between 2008 and 2009, the figure of €3.632 billion, the equivalent of 29 per cent GDP, signalled an alarming shift of perspective when everybody started to see red. Even ad hoc state aid in favour of individual financial institutions amounted to €587 billion (9 per cent GDP).<sup>95</sup> Germany, the UK and France, which make up 60 per cent of the EU banking sector, received 60 per cent of the total amount of state aid granted.<sup>96</sup> A total of 215 financial institutions received some form of aid, but 114 received toxic asset support relief.<sup>97</sup> Between 2008 and 2011, the EC approved a shocking €4.5 trillion of state aid, that is, nearly 36.7 per cent of the GDP.<sup>98</sup> This makes the entire GDP worth €12.26 trillion.<sup>99</sup> Minus the bail-outs, the remaining €7.76 trillion was nearly approaching another Great Depression as macroeconomics suggests that at extremely low levels of real GDP, when output is €3 trillion, the economy is in a depression.<sup>100</sup>

The economic costs estimated for the UK economy post-intervention amount to nearly £40 billion of lost output.<sup>101</sup> Other macroeconomic crisis mechanisms, such as the Stabilisation Mechanism, allow the EC to raise up to €60 billion as financial assistance to Member States experiencing financial difficulties. The Financial Stability Facility has been set up to issue debt securities guarantees of up to €444 billion.<sup>102</sup> Therefore it does not make us feel any better to know that in 2009, the US bail-out amounted to US\$8 trillion,<sup>103</sup> that is \$30,000 per citizen, \$650 billion of GDP income,

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<sup>95</sup> B Lyons and M Zhu, 'Compensating Competitors or Restoring Competition? EU Regulation of State Aid for Banks during the Financial Crisis' (2013) 13 *Journal of Industrial Competition & Trade* 47.

<sup>96</sup> Quigley, n 5 above, 240.

<sup>97</sup> *Ibid.*

<sup>98</sup> Source: DG COMP at: [ec.europa.com/competition/recovery/financial\\_sector.html](http://ec.europa.com/competition/recovery/financial_sector.html). See, eg, J Pisani-Ferry and A Sapir, 'EU banking policies' (2010) *Economic Policy* 358, who reported that by the end of August 2009 state aid measures amounted to 44% GDP.

<sup>99</sup> See [epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/](http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/).

<sup>100</sup> Slavin, n 50 above, 262.

<sup>101</sup> Several economists argued that countries facing insolvency should default as quickly as possible to allow a substantial debt restructuring aimed at restoring sustainable debt levels. The UK government spent \$856 billion to support the crisis in 2008 see, eg, Clarke, n 60 above, 44.

<sup>102</sup> Source: European Commission, MEMO/12/413, Brussels 6 June 2012.

<sup>103</sup> Thus Moseley reported US\$700 billion for US banks bailouts see, eg, F Moseley, 'The Bailout of the 'Too-Big-to-Fail' Banks: Never Again' in Wolfson and Epstein (eds), n 2 above, 645.

5.5 million jobs etc.<sup>104</sup> Recent figures contradict a 2009 estimate by the International Monetary Fund of US\$11.9 trillion as the total cost of the global crisis.<sup>105</sup>

It is by no means controversial to say that banks were being favoured before the current crisis hit. Banks were immune from competition intervention and allowed to merge, which is another fact that is statistically documented. Between 1997 and 2007, the number of EU banks declined by 29 per cent compared to 22 per cent in the US.<sup>106</sup> Bank concentration levels remain relatively high post-crisis, while recent research contradicts the economic assumption that concentration levels should necessarily translate into high market shares.<sup>107</sup> Against the shortcoming of immunity to competition agency scrutiny,<sup>108</sup> it does not follow that banks did not compete against each other. Another telling fact is that it is precisely tougher competition that has increased the risk-taking incentives of banks and pushed them to pursue risky portfolios.<sup>109</sup> Shareholders have designed compensation contracts to insure managers against failure and incentivise risk-taking. Therefore, keeping this numeracy exercise in mind is essential when questioning how state aid has been spent on banks which will be detailed next.

#### A. Main Categories of Crisis State Aid

So far the EU has offered €2,738 billion in guarantee schemes, €231 billion in the form of recapitalisation, and €76 billion in liquidity measures and asset relief. The first €26 billion bail-out went to the German IKB and Sachsen LB, which had been exposed to asset-backed securities in the US subprime market. This was followed by the UK bail-out of Northern Rock, late 2007 and early 2008. Northern Rock (fifth largest mortgage bank with a 9.7 per cent market share)<sup>110</sup> received £20 billion in a guarantee scheme and £25 billion liquidity facility from the Bank of England. There is disagreement over

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<sup>104</sup> See, eg, R Macdonald, 'The Nature and Effects of the 2007–2010 Crisis and Ways to Resolve it' in MacDonal, *Genesis of the Financial Crisis* (London, Palgrave Macmillan, 2012).

<sup>105</sup> See especially Sun, et al (eds), n 15 above.

<sup>106</sup> Vives, n 22 above, 482.

<sup>107</sup> Scherer, n 20 above, 10.

<sup>108</sup> For example, the US Dodd-Frank Act of July 2010 prohibited any merger or acquisition which results in a combined market share of more than 10% of domestic deposits. This Act aims to protect the American taxpayer by ending bail-outs and consumers from abusive financial services practices.

<sup>109</sup> Vives, n 22 above, 485.

<sup>110</sup> Lyons and Zhu, n 95 above, 49.

whether Northern Rock was a systemically important bank, since it did not trigger problems elsewhere in the banking system.<sup>111</sup> While the intervention did not allow this to happen, it created a UK precedent of intervention on the basis of TBTF. It is useful to recall here that the ECB identified some 46 systemically important banks which account for 68 per cent of EU banking.<sup>112</sup> This can only be the result of allowing mega-mergers to go ahead<sup>113</sup> and the monopoly power of banks on business lending.<sup>114</sup>

WestLB, Fortis and Dexia followed. The *Irish Daily* offered €400 billion as a guarantee scheme to cover retail, commercial, and interbank deposits. Royal Bank of Scotland received £45 billion to ensure its survival because the bank failed to maintain adequate liquidity and was involved in a risky financial strategy.<sup>115</sup>

The reaction of the EU Commission to the crisis was to issue an administrative act, the *Banking communication*,<sup>116</sup> following which it received notifications for guarantee schemes, recapitalisation, and other interventions of up to €2 trillion.<sup>117</sup> This aid was insufficient to restore market confidence as bank balance sheets continued to erode. The ECB intervened through liquidity operations. The EC's disagreement with French institutions over 'preventive recapitalization' caused alarm bells to ring in that there were some serious doubts over whether €10.5 billion<sup>118</sup> was, indeed, offered to TBTF banks. In this context, the EC issued its *Recapitalisation*

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<sup>111</sup> *Ibid*, 51.

<sup>112</sup> European Central Bank (2006 and 2008), 'EU Banking Structures', Frankfurt am Main.

<sup>113</sup> See Stucke, n 14 above, 318 who points at the post-merger consolidated assets of \$751 bn; Markham, n 19 above, 291 pinpointing that between 1980 and 1999, the number of commercial banks declined from 15000 to just 9000; HA Shelanski, 'Enforcing Competition During an Economic Crisis' (2010/2011) 77 *Antitrust Law Journal* 238.

<sup>114</sup> MH Wolfson, 'An Institutional Theory of Financial Crisis', n 2 above, 183.

<sup>115</sup> Akinbami, n 31 above, 23.

<sup>116</sup> Communication from the Commission – The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, [2008] OJ C270/8, departs from its predecessor EC Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, [2004] OJ C244/2. The latter allowed the EC to distinguish among guarantees, recapitalizations, impaired assets measures, as aid modalities, and their recipient, distressed firms. The Banking Communication made possible the authorisation of state aid in the form of guarantees, capital, asset relief or liquidity on a non-discriminatory basis, for a limited time and scope see, eg, Quigley, n 5 above, 239.

<sup>117</sup> Doleys, n 92 above, 556.

<sup>118</sup> *Ibid*, 558.



*communication*,<sup>119</sup> which provided guidance on the pricing of capital injections. It distinguished between ‘distressed’ and ‘fundamentally sound’ banks.<sup>120</sup> The former were required to pay higher coupon rates.

Following German plans to create a series of special purpose vehicles (SPV) and a heated debate over assets pricing, the EC issued its *Impaired assets communication*<sup>121</sup> to handle toxic assets. Asset relief in the form of asset purchase has meant that MS would buy the impaired asset portfolio at a fixed price, but higher than the market price. On the basis of toxic asset guarantees, MS have practically taken over a share of the default risk and losses.<sup>122</sup> The conditions for granting such aids required full disclosure of the assets; sharing the cost between MS, shareholders and creditors, and coordination among them; and restructuring distressed banks.<sup>123</sup> The German scheme allowed financial institutions to transfer structured securities to a SPV for a period of 20 years and bear the full risk of losses.

Another *Restructuring communication*<sup>124</sup> targeted banks with unsustainable business models. Banks were required to demonstrate their own strategies to achieve long-term viability without state aid under adverse economic conditions, known as a bank ‘stress’ test.<sup>125</sup> The restructuring of banks began with Commerzbank,<sup>126</sup> which was required to divest itself of its investment banking and real estate and accepted a short-term ban on acquisitions.<sup>127</sup> Other restructured banks included RBS, Lloyds, Anglo-Irish Bank, Fortis, Dexia, Bayern LB, HSH Nordbank, IKB, WestLB, ING and ABN

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<sup>119</sup> 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, [2009] OJ C10/2.

<sup>120</sup> See T Franchoo and M Pollard, ‘The Application of European Competition Law in the Financial Services Sector’ (2012) *Journal of European Community Law & Policy*.

<sup>121</sup> Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, [2009] OJ C72/01.

<sup>122</sup> Quigley, n 5 above, 239.

<sup>123</sup> *Ibid.*

<sup>124</sup> Commission Communication, The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, [2009] OJ C195/9.

<sup>125</sup> Quigley, n 5 above, 239.

<sup>126</sup> Commerzbank case (State aid No N 625/2008); see, eg Heimler and Jenny (n 52 above, 364) criticisms on the imposition by the Commission of limitations on managers’ compensation and severance packages.

<sup>127</sup> Doleys, n 92 above, 561.

Amro. Lloyds TSB/HBOS, as a result of a rescue merger with HBOS,<sup>128</sup> received £17 billion state recapitalisation in 2009,<sup>129</sup> with £260 billion of toxic assets temporarily insured.<sup>130</sup> Lloyds was the second largest bank with 24 per cent market share in gross mortgage lending, while HSBC had 13 per cent.<sup>131</sup> As a result of its acquisition of HBOS, Lloyds and RBS were required to divest a 5 per cent market share to a new market entrant and achieve a £181 billion reduction of assets by 31 December 2014.<sup>132</sup>

As Lyons and Zhu have rightfully commented, the above ‘zombie’ banks ‘withdraw lending as they rebuild their own capital, to the detriment of lending to the non-financial sector’,<sup>133</sup> thereby contributing to the current recession. Another excellent point to make is the need to reform any banking system that ‘privatises’ shareholders’ profits and ‘socialises’ losses through bail-outs of inefficient or poor economic performance.<sup>134</sup> The EU intervention in the banking sector, on the basis of its flawed TBTF doctrine of state intervention in the economy, has transferred the economic responsibility of inefficient corporations to the social responsibility of individual taxpayers.<sup>135</sup>

#### ☑ TBTF Banks<sup>136</sup>

- ✗ rescue aids: Hypo Real Estate Holding, Commerzbank, WestLB;
- ✗ restructuring: Sachsen LB, IKB, WestLB, Landesbank Baden Württemberg, Sparkasse KölnBonn, Hypo Real Estate, HSH Nordbank, NordLB, Bayern LB;

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<sup>128</sup> Prior to its takeover, HBOS was collapsing because of its high-risk lending practices and excessive use of leverage. See P Marsden and I Kokkoris, ‘The Role of Competition and State Aid Policy in Financial and Monetary Law’ (2010) 13 *Journal of International Economic Law* 889.

<sup>129</sup> Figures are slightly contradicted by R Tomasic, ‘The failure of corporate governance and the limits of law: British banks and the global financial crisis’ in Sun et al (eds), *Corporate Governance and the Global Financial Crisis* n 15 above, 59, relying on the House of Commons Treasury Committee, ‘Banking Crisis: Dealing with the Failure of the UK Banks: Seventh Report of Session 2008-09’, London, 519.

<sup>130</sup> The UK government has recently sold part of its 43.5% equity ownership.

<sup>131</sup> Vives, n 22 above, 493. However, Lloyds was not allowed to take over Abbey in 2001.

<sup>132</sup> Quigley, n 5 above, 245; see also Marsden and Kokkoris, n 128 above, 877.

<sup>133</sup> Lyons and Zhu, n 95 above, 45.

<sup>134</sup> *Ibid.*, 47.

<sup>135</sup> See FM Scherer, ‘A Perplexed Economist Confronts “Too Big to Fail”’ (2010) 7 *European Journal of Comparative Economics* 267.

<sup>136</sup> For an overview of decisions and ongoing in-depth investigations in the context of the financial crisis see European Commission, Brussels, 20 December 2012, available at: [europa.eu/rapid/press-release\\_MEMO-12-1018\\_en.htm](http://europa.eu/rapid/press-release_MEMO-12-1018_en.htm).

- ✘ WestLB €3 billion capital injections, €11 billion impaired assets of which €3.4 billion.<sup>137</sup>
- ✘ Anglo Irish Bank €29.3 billion
- ✘ Irish Nationwide Building Society (INBS) €5.4 billion;
- ✘ Hypo Real Estate €9.95 billion in capital injections, €145 billion in guarantees and €20 billion in asset relief;
- ✘ ING €17 billion
- ✘ Fortis Bank €11.2 billion

One cannot reflect on the above famous bail-outs without formulating the following question: what did these banks have in common? The answer is a very fragile funding model supported by a risky loan portfolio and the fact that, in their rescue, the EC did not come up with a pertinent ‘counterfactual’<sup>138</sup> scenario of what would have happened if they had been allowed to fail. Fortis<sup>139</sup> is yet another example of bank rescue due to excessive risk-taking as a result of its participation in the ABN AMRO merger.<sup>140</sup> Competition authorities ought to be prudent when accepting the failing-firm-defence for under-performing, inefficient, and poorly managed firms.<sup>141</sup> While Member States may block a merger in order to protect a ‘legitimate interest’, such as financial stability in the domestic market, the US Department of Justice cannot review a merger for systemic risk.<sup>142</sup> Thus competition authorities have been ill-equipped to assess the systemic risk which eroded the legitimacy of the TBTF doctrine of intervention. The latter helped inefficient banks to remain ‘viable’ on the market.<sup>143</sup> Fortunately, the EC has realised its defective implementation since it has later called for a ‘sound’ restructuring plan for banks

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<sup>137</sup> The state aid was said to be incompatible with the restructuring communication as it exceeded the real economic value of this bank’s assets.

<sup>138</sup> See also Lyons and Zhu, n 95 above, 54 on WestLB.

<sup>139</sup> On Fortis case see, eg, Pisani-Ferry and Sapir, n 98 above, 354.

<sup>140</sup> On unsustainable business models see, eg, Lyons and Zhu, n 95 above, 58.

<sup>141</sup> See, eg, Marsden and Kokkoris, n 128 above, 881.

<sup>142</sup> Stucke, n 14 above, 322.

<sup>143</sup> See also Heimler and Jenny, n 52 above, 358, both of whom are critical on restructuring aid being offered to ‘inefficient firms to remain active in the market’.

before capitalisations or taking any other asset protection measures.<sup>144</sup> This new move follows early indications that the EC is going to ‘toughen’ its state aid to failing banks.<sup>145</sup> The major criticism of the TBTF doctrine remains, however, its having been endorsed by EU policy-makers as a ‘way out’ of the crisis.

In conclusion, the above developments in administering state aid have changed the whole structure of the EU banking sector in a way which has substantially departed from the traditional prevention of distortions of competition. The next question to ask, therefore, is not whether competition enforcers have not been prepared to undertake this mission – because, obviously, they were not – but to ask how much state aid has been taken away from the overall prospects of economic growth in terms of GDP and weighted against, as mentioned earlier, the rising unemployment in the EU and the passing on of social costs through taxation. Finally, this revolutionary change of perspective makes competition law and policy the scapegoat of a New Banks Deal. Its story of success for banks and failure for citizens has been possible on the basis of the Union’s democratic deficits, since its citizens have no say in the next election of the President or of the College of Commissioners, both of which have been instrumental in matters of competition policy.<sup>146</sup> This point uncovers an existing institutional crisis; for example, the EC’s plans to create an agency to rescue or shut failed banks by 2015 against the significant backdrop of not having an EU banking union until January 2014.<sup>147</sup> The latter aspect pinpoints the politics of the crisis. Recent research suggests that, for a number of reasons, electoral competition is likely to constrain the abuse of public resources in the form of bail-outs.<sup>148</sup> This is fully evidenced in the following criticism by a member of Socialists and Democrats (Elisa Ferreira) who said: ‘We need to stop casino banking, break the link between public finance and failing banks, and ensure sustainable financing of the real

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<sup>144</sup> EC, ‘State aid: Commission adapts crisis rules for banks’, IP/13/672, Brussels, 10 July 2013.

<sup>145</sup> Bloomberg, J Brunson and E Duarte, ‘EU to Toughen Creditor-Loss Rules at Failing Banks’, 8 July 2013, at: [www.bloomberg.com/news/print/2013-07-08](http://www.bloomberg.com/news/print/2013-07-08), reported that the EU has spent €1.7 trillion on the basis of the TBTF doctrine.

<sup>146</sup> In contrast, architectural differences did not allow the US antitrust enforcers to administer bail-outs through means of antitrust policy see, eg, American Antitrust Institute, Remarks of Bert Foer, ‘Competition Policy and “Too Big” Banks in the European Union and the United States’, 27 June 2013.

<sup>147</sup> Source: EurActiv, ‘New banking authority pits Commission against Berlin’, 11 July 2013 available at: [www.euractiv.com/euro-finance/new-banking-resolution-authority-news-529225](http://www.euractiv.com/euro-finance/new-banking-resolution-authority-news-529225).

<sup>148</sup> E Wibbels, ‘Bailouts, Budget, and Leviathans: Comparative Federalism and Lessons from the Early United States’ (2003) 36 *Comparative Political Studies* 486.

economy to encourage growth'. As Wibbels rightfully put it when investigating the constitutional dimension of crisis bail-outs,<sup>149</sup> the above statement based on 'competitive politics' encourages what one commentator would famously call in competition a way of 'publicly distancing oneself'<sup>150</sup> from the culprit of bail-outs. Electoral competition should actively discourage zombie banks from looking at the welfare state as their lender of last resort.

Briefly, what this bitter crisis has taught us, so far, is that structural changes happen during a crisis whenever state intervention is insufficiently backed up by constitutional and institutional safeguarding mechanisms, since it is easier to abuse the rule of law on the basis of predicted, imminent economic downturn.

## VII. ON EMERGING ANTI-COMPETITIVE PRACTICES RELATED TO THE TBTF DOCTRINE

Recent antitrust investigations have dealt with innovative and highly sophisticated financial contracts, such as securitisation, credit default swaps (CDS) or repos, which have affected both businesses and consumers.<sup>151</sup> Therefore, this section will first detail how financial contracts operate before explaining their relevance for the purpose of recent investigations.

It was estimated that the total value of financial derivative contracts was US\$596 trillion, that is, eight times the size of the real global economy,<sup>152</sup> with a growth rate of 32 per cent per annum since 1990.<sup>153</sup> An excellent definition of derivatives is offered by Braithwaite.<sup>154</sup> Derivatives are 'bilateral contracts where the rights and obligations of the parties reference an underlying asset, benchmark, index

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<sup>149</sup> Ibid, 487.

<sup>150</sup> To quote David Bailey's excellent article on 'Publicly Distancing Oneself from a Cartel' (2008) 31 *World Comparative Law & Economics Review* 177.

<sup>151</sup> See the Commission's 'new' mission: 'Competition law should ensure that credit institutions and other financial service providers do not behave in a manner that hampers the efficient functioning of the internal market', available at: [ec.europa.eu/competition/sectors/financial\\_services/capital\\_markets.html](http://ec.europa.eu/competition/sectors/financial_services/capital_markets.html).

<sup>152</sup> See generally n 15 above, 9.

<sup>153</sup> T Clarke, 'Corporate governance causes of the global financial crisis' in Sun et al (eds), *Corporate Governance and the Global Financial Crisis* n 15 above, 31.

<sup>154</sup> JP Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets' (2012) 75 *Modern Law Review* 783.

or other variable'. *Over-the-counter derivatives* were estimated at US\$707 trillion,<sup>155</sup> that is nine times the world GDP in 2010.<sup>156</sup> An estimate of 65 million derivatives is used, for example, to hedge interest rates and credit risk, minimise tax liabilities, or speculate on currencies, etc.<sup>157</sup> Hedging itself implies a transfer of risk assets.<sup>158</sup>

*Credit default swaps* (CDSs) are financial derivative contracts designed to transfer the risk of credit default on debt obligations.<sup>159</sup> The classic example is a CDS where A and B decide on a notional sum. A agrees to pay B a fixed interest rate on that sum (periodic payment) while B agrees to pay a variable rate in return. As a result, B, who has a variable rate income but a fixed rate debt, can swap income streams with counterparties.<sup>160</sup> In practice, CDS are used by investors as a Special Purpose Vehicle (SPV) to hedge assets against default risks and assess debtors' creditworthiness. *Securitisation* is a highly sophisticated process of pooling high-risk debt assets from mortgage loans, credit cards and so on, which were sold to a SPV in return for securities.<sup>161</sup> Put simply, this process makes sure that risks associated with loans are shifted away from the original lenders to investors. First, the originator (O) applies for a mortgage loan; then the SPV buys O's mortgage to guarantee the remoteness of the cash flows in return for securities which are purchased by investors (I). The cash received from I pays O's loan. Basically, any interest rate or currency risk associated with the pooling of such assets is hedged<sup>162</sup> using a variety of credit swap transactions. Credit rating agencies<sup>163</sup> have played a key role in boosting the attractiveness of such securitised assets by assigning a credit rating for securities issued via the SPV. Investors have been overly reliant on ratings.

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<sup>155</sup> Ibid, 785, 789. Five firms dominate the EU and US OTC derivatives market, see Scherer, n 20 above, 14.

<sup>156</sup> GA Epstein and P Hubbard, 'Speculation and Sovereign Debt: An Insidious Interaction', in *The Handbook of the Political Economy of Financial Crisis*, n 2 above, 328.

<sup>157</sup> Ibid.

<sup>158</sup> P Lysandrou, 'Hedge funds', in P Lysandrou, 'Hedge funds', in *Handbook of Critical Issues in Finance*, n 12 above, 145.

<sup>159</sup> See, eg, Brummer, n 26 above, 212.

<sup>160</sup> Ibid, 784.

<sup>161</sup> See also BJ Keys, TK Mukherjee, A Seru and V Vig, 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans' (2010) 125 *Quarterly Journal of Economics* 307; S Krishnan, 'Securitization', in *Handbook of Critical Issues in Finance*, n 12 above, 290.

<sup>162</sup> Hedge funds are collective investments with a wide range of objectives, strategies, styles, techniques and assets, normally open to selected institutions.

<sup>163</sup> For example, Standard & Poor's, Moody's and Fitch.

Previously, the EC has issued guidance on how to calculate the pricing of capital injections to 'rescue' CDSs.<sup>164</sup> Later, the EC sent a statement of objections (SO) to 13 investment banks, which have acted as intermediaries in the market for credit derivatives.<sup>165</sup> Another investigation into CDSs targets the International Swaps and Derivatives Association involved in the over-the-counter (OTC) trading of derivatives.<sup>166</sup> Preliminary indications suggest that the association may have been involved in a coordinated effort of investment banks to 'delay or prevent exchanges' from entering the credit derivatives business.

Finally, a *repo* is a collateralised loan where the seller agrees to sell securities at a discount (haircut) to the buyer (lender).<sup>167</sup> Lenders are rich institutional investors, like pension funds and mutual funds, which need a liquid but relatively safe place to invest cash. Repo is a generic name for repurchase agreements and sell/buy-backs, namely, A sells an asset to B at price X. A also commits itself to repurchase the asset from a third party, C, at price Y in the near future or on demand.<sup>168</sup> In other words, in the event that A defaults, B can sell it to C to offset its loss. Despite being labelled as the sale and repurchase of securities, repo is economically a 'secured deposit' having as its purpose the borrowing and lending of cash.

In conclusion, all of the above financial contracts are characterised by an oligopoly pricing power, asymmetric information, and unequal bargaining power.<sup>169</sup> The proliferation of these contractual instruments demonstrates the value of Minsky's classification of 'financial fragility'<sup>170</sup> as (i) hedge finance, which amounts to liability

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<sup>164</sup> Source: Communication from the Commission on the application of State aid rules to support measures in favour of banks in the context of the financial crisis, [2011] OJ C356/02. The guarantee fee should be the sum of a basic fee, a risk-based fee and a risk metric composed using the following formula: the guarantee fee=40bp x (1+ (1/2 x A/B) + (1/2 x C/D)), where A is the beneficiary's median five-year senior CDS spread; B is the median iTraxx Europe Senior Financials five-year index; C is the median five-year senior CDS spread of all Member States; D is the median five-year senior CDS spread of the Member State granting the guarantees. In other words, the risk profile in recapitalisation state aid is measured through the media five-year senior debt CDS spread.

<sup>165</sup> EC, IP/13/630, Brussels, 1 July 2013. The 13 banks are Merrill Lynch, Barclays, Bear Stearns, Paribas, Citygroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, Morgan, Morgan Stanley, RBS, UBS and ISDA.

<sup>166</sup> EC, IP/13/286, Brussels, 26 March 2013.

<sup>167</sup> JS Taub, 'What We Don't Talk About When We Talk About Banking', n 2 above, 457.

<sup>168</sup> See EC, Directorate-General for Internal Policies, Policy Department Economic and Scientific Policy, Economic and Monetary Affairs, 'Note on Shadow Banking-Minimum Haircuts on Collateral' 2013, 56.

<sup>169</sup> Crotty, n 29 above, 153.

<sup>170</sup> Kregel, n 18 above, 160.

obligations to be paid with the net cash flows from routine transactions; (ii) speculative finance, where cash reserves are insufficient and require borrowing funds or selling less-liquid assets; and (iii) Ponzi finance, where there will never be enough cash to meet outstanding financial obligations.<sup>171</sup> Due to a failure to obtain additional financing, Ponzi firms have had to sell their assets, which created Fisher's 'price deflation'<sup>172</sup> for the firms' assets.

#### VIII. ON THE MANIPULATION OF INTEREST RATES DERIVATIVES: YET ANOTHER ANTI-COMPETITIVE PRACTICE?

LIBOR is a reference index sponsored by the British Banking Association used to calculate short-term interest rates on a range of financial derivative contracts.<sup>173</sup> Its daily submission indicates what each bank estimates is their cost of unsecured borrowing from another bank. Competition authorities worldwide (EC, the UK, the US, Canada and Japan) alleged that the Contributor Panel Banks exchanged information to undervalue daily submissions and that brokers colluded to manipulate LIBOR to raise the profits from certain derivatives. In other words, under competitive conditions, banks would submit their valuation independently to move away from forms of artificial collusion. In the US *USD LIBOR* scandal,<sup>174</sup> antitrust damage claims were rejected on the grounds of failure to prove conspiracy and restraint of trade, lack of antitrust standing and impossibility of recovery on the basis of the 'indirect purchaser rule'.<sup>175</sup> The US court ruled that there cannot be damage recovery without showing that the actual loss stems from a reduction of competition or that any harm is the result of the defendant's behaviour.<sup>176</sup> This interpretation endorses the traditional approach to antitrust harm, which requires proof of a resulting restriction

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<sup>171</sup> See Tymoigne, n 12 above, 99.

<sup>172</sup> I Fisher, 'The debt-deflation theory of great depressions' (1933) 1 *Econometrica* 337.

<sup>173</sup> Source: CNN MONEY, A Petroff, 'Libor moving to NYSE Euronext', available at [money.cnn.com/2013/07/09/investing/libor-nyse-uk/](http://money.cnn.com/2013/07/09/investing/libor-nyse-uk/). See C Lim, 'Libor, Strategy, and International Cartel Investigations' (2013) *Journal of European Competition Law & Policy*.

<sup>174</sup> See PDS Phillip and RP Girnys, 'No Antitrust Injury in Libor Rate-Setting? – What Happened to Effects?' (2012) *Comparative Policy International* 3.

<sup>175</sup> Established in *Illinois Brick Co v Illinois* 431 US 720 (1977).

<sup>176</sup> Following a ruling by Judge Naomi Reice Buchwald of the US District Court for the Southern District of New York.



of competition in the market for interbank loans. Since LIBOR displays only information about 'prevailing rates', the court went on to say that LIBOR quotations, even in the event that they were set artificially, did not correspond to the actual interest rate charged for interbank loans. This legal reasoning lacks a great deal of pragmatism, since the authors of this innovative anti-competitive practice are banks which have unfortunately been excluded from antitrust scrutiny. This fact also justifies the Court's reservation. Semantically different from the economics of collusion, the manipulation of exchange rates is one of the means used to deceive the bank panel and implement fraud.

Recent investigations have enquired whether the submitting banks intentionally undervalued LIBOR submissions, whether traders at banks and hedge funds tried to influence the rate to speculate on interest rate derivatives, and whether traders employed within Contributor Panel Banks received information about rates, either directly or through intermediaries, such as inter-dealer brokers. The heated question has turned to whether LIBOR should be assimilated into anti-competitive practices such as price-fixing and be criminalised, as are cartels.<sup>177</sup> Exchange rate manipulation has been unknown as an anti-competitive practice, while the banking sector has been practically excluded from any competition intervention against what is known as collusion by brokers/bank panels against consumers to fix the market price artificially. For example, Barclays<sup>178</sup> submitted low US\$ LIBOR as a result of management instructions, which began in late August 2007. The EC and the UK Financial Services Authority investigated Barclays' alleged infringements between traders and rate-setters for the Euro Interbank Offer Rate (EURIBOR) in particular through mis-selling interest rate swaps to small businesses, ie low-cost protection against rising interest rates.<sup>179</sup> In practice, information asymmetries between

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<sup>177</sup> A Stephan, 'Should Libor-Rigging be treated like Price Fixing?' at: [competitionpolicy.wordpress.com/2012/07/11/should-libor-rigging-be-treated-like-price-fixing/](http://competitionpolicy.wordpress.com/2012/07/11/should-libor-rigging-be-treated-like-price-fixing/); extremely interesting on crisis cartels, see A Stephan, 'Price Fixing in Crisis: Implications of an Economic Downturn for Cartels and Enforcement' (2012) 35 *World Comparative Law & Economics Review* 511.

<sup>178</sup> According to the Financial Ombudsman Service, it is 'UK's most complained about bank'.

<sup>179</sup> Source: *The Guardian* at: [www.guardian.co.uk/business/2013/feb/05/barclays-1-billion-mis-selling-compensation-bill](http://www.guardian.co.uk/business/2013/feb/05/barclays-1-billion-mis-selling-compensation-bill).

informed contract holders and ordinary investors result in price inefficiency,<sup>180</sup> with clear evidence that the share prices of banks were artificially altered by the short selling of derivatives. Specifically, a manipulator sells the shares of a company short and then spreads negative rumours about the company's prospects.<sup>181</sup> This has led to calls for another EU proposal introducing bans on naked short selling if the price of a financial instrument falls by a significant amount in a single day.<sup>182</sup>

The above recent investigations and the record fine of £1.7 billion for the Euro interest rate derivatives cartel operated by Barclays, Deutsche Bank, RBS and Société Générale and for the Yen interest rate derivatives cartel run by USB, RBS, Deutsche Bank, JPMorgan and Citygroup,<sup>183</sup> demonstrate the determination of antitrust enforcers and policy-makers<sup>184</sup> to treat sophisticated financial derivative contracts as anti-competitive practices. This is yet another indication that the TBTF<sup>185</sup> doctrine is being constantly eroded.<sup>186</sup>

## IX. END OF STORY: END OF CRISIS?

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<sup>180</sup> B Clarke, 'Where was the 'market for corporate control' when we needed it?' in Sun et al (eds), *Corporate Governance and the Global Financial Crisis*, n 15 above, 77.

<sup>181</sup> Ibid, 78.

<sup>182</sup> See EU Regulation no 236/2012 on Short Selling and certain aspects of credit default swaps, [2012] OJ L86/1.

<sup>183</sup> See EC, Press release IP/13/1208, Brussels, 4 December 2013; EC, Case AT39861, *Yen Interest Rate Derivatives*, not available yet. Further SOs were sent to Credit Agricole, HSBC and JPMorgan for suspected participation in Euro interest rate derivatives cartel, see EC, IP/14/572, Brussels, 20 May 2014, and to ICAP for its suspected participation in yen interest rate derivatives cartels, see EC, IP/14/656, Brussels, 10 June 2014.

<sup>184</sup> See an encouraging prospect by Chancellor George Osborne, available at: [m.guardian.co.uk/business/2013/feb/04/george-osborne-investment-banks-warning](http://m.guardian.co.uk/business/2013/feb/04/george-osborne-investment-banks-warning)  
[www.guardian.co.uk/business/video/2013/feb/04/george-osborne-banking-reforms-video](http://www.guardian.co.uk/business/video/2013/feb/04/george-osborne-banking-reforms-video).

<sup>185</sup> D Bush, 'Too Big to Fail: The Role of Antitrust in Distressed Industries' (2010) 77 *Antitrust Law Journal* 277; A Mateus, "'Too Big to Fail": Banking Regulatory Reform and What Still Needs to be Done' (2011) 7 *Comparative Policy International* 22; JW Markham, 'Lessons for Competition Law from the Economic Crisis: The Prospect for Antitrust Responses to the "Too Big to Fail" Phenomenon' (2011) 16 *Fordham Journal of Corporate & Financial Law* 261. The concept of TBTF was first applied in 1914 by Treasury Secretary, William Gibbs McAdoo, to rescue the municipal government of New York City.

<sup>186</sup> Against TBTF see, eg, LH Rockwell: 'Don't Bail Them Out', 10 September 2008: 'What should have happened in 1929 is precisely what should happen now ... The government should completely remove itself from the course of action and let the market re-evaluate resource values', available at: [mises.org/daily/3104](http://mises.org/daily/3104); F Shostak, 'The Rescue Package Will Delay the Recovery', 29 September 2008: 'The government package is not going to rescue the economy, but it will rescue activities that the economy cannot afford and that consumers do not want. It will sustain waste and promote inefficiency', at: [mises.org/daily/3131](http://mises.org/daily/3131).

Finally, it is not possible to understand the dimension of the current crisis without a proper critique of the role neoliberalism has played. It is known that neoliberalism called for the deregulation of financial markets<sup>187</sup> in the first instance and for a weak state.<sup>188</sup> Neoliberalism departs fundamentally from ordoliberal ideas of individual freedom as coerced by the state, or as Bonefeld put it,<sup>189</sup> this ‘ordered freedom’ positions itself somewhere between collectivism and laissez-faire liberalism, as a true guardian of markets. As the ordoliberal ideology emerged from attempts to address the problems created by the economic crisis in the 1920s, it has led to a different model of liberal governance, which is generally distrustful of markets. In other words, ordoliberalism was originally packaged as a hybrid product which has prided itself on being sympathetic (a ‘humane’ economy)<sup>190</sup> to the sociological effects of industrialisation and market competition on workers. However, Rüstow contradicts the human economy at least for ‘unionised’ workers who threaten the ‘weak’ state.<sup>191</sup> His ideas hold water as regards pressure groups, such as lobbyists, monopolists or even oligopolists. For Eucken, in contrast, the ‘well-being of capitalism’ is almost synonymous with being competitive, risk-taking and self-responsible.<sup>192</sup> In other words, it is inconceivable that where the entrepreneurial spirit fails in practice, society should take on the responsibility for such a failure. This is precisely the rather hidden message of the ‘social market economy’ according to Bonefeld,<sup>193</sup> namely, a social policy that ensures that individuals act as self-responsible entrepreneurs. Applied to our crisis scenario, the big players of speculative games will have to agree to demonstrate social and corporate responsibility if, as Vanberg put it,<sup>194</sup> such players

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<sup>187</sup> On the US deregulation of swaps markets see M Greenberger, ‘Derivatives in the Crisis and Financial Reform’, in Krugman and Wells, *Macroeconomics*, n 2 above, 473, through the Commodity Futures Modernization Act of 2010 which removed OTC derivatives transactions from exchange trading and clearing requirements.

<sup>188</sup> See, eg, W Bonefeld, ‘Freedom and the Strong State: On German Ordoliberalism’ (2012) 17 *New Political Economy* 635.

<sup>189</sup> *Ibid*, 639.

<sup>190</sup> A Rüstow, ‘General Social Laws of the Economic Disintegration and Possibilities of Reconstruction’ in *Afterword to Röpke, W International Economic Disintegration* (London, W Hodge, 1942); W Röpke, *A Human Economy* (Wilmington Delaware, ISI Books) 1998.

<sup>191</sup> Rüstow, 276.

<sup>192</sup> W Eucken, ‘Staatliche Strukturwandlungen und die Krise des Kapitalismus’ (1932) 36 *Weltwirtschaftliches Archiv* 297.

<sup>193</sup> Bonefeld, n 188 above, 647.

<sup>194</sup> V Vanberg, “‘Ordnungstheorie’ as Constitutional Economics, The German Conception of a “Social Market Economy”” (1988) 39 *ORDO* 26.

‘systematically’ perform poorly. Reflecting on the social and economic cost of the EU crisis through bail-outs this principle has failed in the EU.

For Röpke, the challenge of capitalism lay in the measure of state intervention, ie a ‘crisis of interventionism’.<sup>195</sup> This is also true for the EU crisis. Academics agree on one vital point: the real disaster did not happen because banks started to fail, but because the EU and its Member States rescued precisely those national champions of poor performance and, in the case of toxic assets, of fraud.

The final question after the assessment of law in action and neoliberal policy, as has been implemented in real life, is to challenge the ideological foundations of neoliberalism as a proper model of social and economic governance. It is recognised that no social change can take place without shaking the economic ideology and the politics underpinning such ideology. Neoliberalism has been portrayed as ‘the ascendancy of financial capital over industrial capital in the pursuit of profit’.<sup>196</sup> Capitalism survived several generalised recessions (1974–75 and 1980–82) with high unemployment, a collapse in investment, and high inflation.<sup>197</sup> As has previously been explained in Section IV, because of the lost battle over the achievement of Keynesian ‘full employment’, this idealistic goal<sup>198</sup> has had to surrender to austere monetary policies to combat inflation. This influenced policy-makers to re-configure their focus on labour rigidities, market imperfections and distortions and to call for aggressive competition for both workers and capital.<sup>199</sup> As O’Connor suggested, ‘coercive’ competition replaced the ‘socialisation’ of economic activity by embedding at its foundation ideas of state rationalisation, market contestability, and mobility. How were these three ingredients implemented? Contestability of markets called for the prohibition of discrimination and eradication of market barriers to ensure a level playing field which would, in turn, guarantee labour mobility so as to enable capital to be relocated profitably elsewhere and to facilitate workers’ wage flexibility, ie

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<sup>195</sup> W Röpke, *Crisis and Cycles* (London, W Hodge, 1936) 160.

<sup>196</sup> G Duménil and D Lévy, *Capital Resurgent: Roots of the Neoliberal Revolution* (Cambridge MA, Harvard University Press, 2004).

<sup>197</sup> See, eg, O’Connor, n 51 above, 694.

<sup>198</sup> See, eg, HM Oliver, ‘German Neoliberalism’ (1960) 74 *Quarterly Journal of Economics* 128 on the use of Keynesian measures to combat unemployment regarded as ‘foolish’ by German neoliberals.

<sup>199</sup> *Ibid*, 695.

cheaper labour.<sup>200</sup> In contrast, the Keynesian vision stands out for higher wages and extensive social protection.<sup>201</sup>

According to O'Connor, neoliberalism re-established unemployment in the early 1980s so as to curb welfare benefits and collective bargaining agreements which was followed by the complete liberalisation of capital markets.<sup>202</sup> Capital mobility enabled governments to finance their fiscal deficits, by putting upward pressure on the exchange rate and domestic taxation.<sup>203</sup> Ultimately, due to fierce competition among capital owners, financialisation pushed down credit rates and risk premiums.<sup>204</sup> Others argued that financialisation contributed to a sluggish overall performance based on consumption and export-oriented growth models.<sup>205</sup>

Regrettably, this re-configuration of influence has essentially led to a weakening of the social and economic position of labour. Perhaps, one of the most pervasive drivers of neoliberalism lies primarily in its ambition to achieve the global financialisation of markets. This architectural configuration is plausible since the idea of economic integration has been the fundamental principle of an internal market: where individuals' migration is achieved through free movement, and mobility has served this purpose as a cheaper source of labour which boosts capital profits through workers' flexibility; the free movement of capital has achieved financialisation and the free movement of goods has succeeded in opening up markets through active competition.

As alluded to earlier in Section V.(A), under Article 119 TFEU, the idea of 'free competition' disguises the neoliberal idea of 'coercive competition' rather than of 'ordered freedom' since its macroeconomic foundations, which endorse explicitly an efficient use of Union resources by its Member States, bear much of the neoliberal austerity imprint in the convergence criteria rather than the 'human' ordoliberal

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<sup>200</sup> Ibid, 696.

<sup>201</sup> Ibid, 697; see also J O'Connor, *From Welfare Rights to Welfare Fights: Neoliberalism and the Retrenchment of Social Provision* (Mimeo MA, University of Massachusetts, Amherst, 2002).

<sup>202</sup> OECD, 'Open Markets Matter', Paris, 1998.

<sup>203</sup> P Genschel, 'Globalization and the welfare state: a retrospective' (2004) 11 *Journal of European Public Policy* 619, 623.

<sup>204</sup> Ibid.

<sup>205</sup> See E Stockhammer, 'Financialization', in Sun et al (eds), *Corporate Governance and the Global Financial Crisis*, n 15 above, 124.

ideology previously formulated. This is revealed by another position supported by German neoliberalism<sup>206</sup> which argued that monetary policy should ‘complement’ monopoly policy to maintain the rule of law established by the ordoliberal concept of ‘ordered’ constitutional freedom. Thus, on the one hand, at a microeconomic level, this ‘order’ will safeguard individual economic rights, such as free enterprise or the freedom of contract, except when this promotes monopolies and, on the other hand, at a macroeconomic level, the rule of law will safeguard price stability, output, the distribution of income and the allocation of resources. Since the breakdown of Bretton Woods, the ‘macroeconomics trilemma’<sup>207</sup> of open markets with free competition has favoured floating exchange rates without capital control to the detriment of other objectives of monetary policy.<sup>208</sup> In times of crisis coercive forms of competition dictated the EU’s macroeconomic policy of restructuring banking and dominated the free competition paradigm at microeconomic level.

In conclusion, while the architectural representations of coercive freedom have not been entirely in the negative in terms of achieved impact on the economy and society as a whole – for example, one cannot deny certain positive benefits of free movement of EU citizens<sup>209</sup> – the Achilles’ heel of the above freedoms is currently *financialisation* being used as a means to misappropriate the human capital to uncover corporate responsibility for speculative pursuits.<sup>210</sup> Furthermore, the social costs of this full-blown financial crisis have shown that the speculative gains of this kind have not been short-termism.<sup>211</sup> Rather, those in pursuit of speculation of profits have embraced in the long run the mature cost of a financial servicing industry which was even highly respected as a successful driver of capitalism until its ‘Big Fail’ finally spread across the globe. Finally, the remaking of capitalism would not have been possible without active deregulation, a previous lack of competition intervention

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<sup>206</sup> Oliver, n 198 above, 144.

<sup>207</sup> Attributed to P Krugman, ‘The return of depression economics’ (1999) 78 *Foreign Affairs* 56.

<sup>208</sup> G Cozzi, ‘Capital controls’, in Sun et al (eds), n 15 above, 27.

<sup>209</sup> On the other hand, O’Connor, n 51 above, 704, reminds us that ‘even elite migrant workers are more likely to sell their labour power at a lower price and work in poor conditions’, much of which is experienced in real life. Generally on fundamental freedoms see C Barnard, *The Substantive Law of the EU: The Four Freedoms*, 3rd edn (Oxford, Oxford University Press, 2010).

<sup>210</sup> Before the breakdown of Bretton Woods in 1971 it is said that only 10% of foreign exchange transactions were purely speculative.

<sup>211</sup> See also O’Connor, n 51 above, 702.

in the banking sector and an aggressive competitive culture. On a positive note remain, however, the recent derivative cartels investigated and fined by the EC. These recent developments infuse EU taxpayers, who must bear the costs of previous bail-outs, with optimism for the future, and demonstrate a much welcome change of perspective on financial derivatives.