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State Aid Regime in the Financial Sector during the Crisis : Impact on Luxembourg

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* The views of the author expressed in this article do not necessarily reflect those of the *Banque centrale du Luxembourg*.

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Introduction

1. Following the collapse of Lehman Brothers in September 2008, the fear of contagion undermined confidence in the financial markets with, in turn, severe negative effects on the financial system as a whole. In the European Union (the "EU"), Member States and European institutions reacted swiftly through strong policy responses largely justified by the nature of banks as special economic actors and the significant negative externalities stemming from their failure.[1]

2. In the outbreak of the financial and economic crisis, (i) the European Central Bank (the "ECB"), within its mandate, used both standard and non-standard monetary instruments to ensure the proper functioning of the monetary transmission and the provision of liquidity into the euro area banking sector;[2] (ii) the Council put in place the European Financial Stabilisation Mechanism (the "EFSF", the predecessor of the European Stability Mechanism or the "ESM") with a capacity of up to €500 billion to assist Member States facing exceptional difficulties; and (iii) national authorities activated rescue policies and deployed a wide range of instruments (mainly credit guarantee schemes, recapitalizations and impaired assets measures), generally constituting State aid under article 107(1) of the Treaty on the Functioning of the European Union (the "TFEU" or the "Treaty") subject to the scrutiny of the European Commission (the "Commission").

3. These combined efforts have proved to be successful in calming markets and restoring confidence in the EU financial sector. Nevertheless, interbank lending remains scarce and markets fragmented,[3] in a context where – despite stress conditions giving signs of improvements – financial stability continues to be persistently fragile.[4]

4. Given the scope of the publication to which this contribution constitutes a part, the present paper considers exclusively the State aid regime applicable to financial institutions during the crisis with a special focus on the State aid cases involving Luxembourg, namely *Dexia*, *Fortis* and *Kaupthing*. Needless

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[1] See Commission staff working paper, "The effects of temporary State aid rules adopted in the context of the financial and economic crisis", *SEC (2011) 1126 final*, 5 October 2011, p. 32.

[2] P. Cour-Thimann, B. Winkler, "The ECB's non-standard monetary policy measures: the role of institutional factors and financial structure", *ECB Working Paper Series*, No. 1528, April 2013.

[3] European Central Bank, Financial integration in Europe, April 2013.

[4] European Central Bank, Financial stability review, May 2013.

to say, in the absence of institutionalized mechanisms for coordination of aid at a European level and a harmonized EU framework for bank recovery and resolution (now under discussion), State aid played a vital role to maintain legal certainty and sufficient cohesion in the internal market. As Commissioner Almunia observed "the early days of the crisis confirmed what we had anticipated; the EU lacked common tools to resolve banks with cross border operations and to coordinate national measures".[5]

Chapter 1
State aid in figures

Section 1
EU

5. It comes as no surprise that the volume of State aid support to the financial sector increased dramatically during the crisis. As evidenced by the latest data available,[6] during the period 1 October 2008-1 October 2012 the Commission approved aid to banks totalling €5,058.9 billion (equal to 40.3% of EU gross domestic product or the "GDP"). An important caveat to these figures suggests that the amount of aid actually used constitutes only a fraction of the approved aid (around 13% of EU GDP) due to the proportion of guarantees (67% of the aid pledged) which to date have not been called upon.

6. From a dynamic perspective, trends show that State aid expenditure peaked in 2008, when a State aid of €3,457 billion (27.7% of EU GDP) was authorized. Since then, the amount of support has been gradually reduced as, *inter alia*, national budgetary conditions in most Member States tightened (new aid in 2011 was €714.7 billion or 5.7% of EU GDP, down 50% from 2010). Levels continue, however, to be considerably higher than non-crisis aid which totaled €64.3 billion in 2011 or 0.5% of EU GDP.

Section 2
Luxembourg

7. A positive correlation has been observed between the size of the financial sector and the magnitude of State aid expenditure.[7] It should be however

[5] J. Almunia, "Restructuring EU banks: the role of State aid control", SPEECH/12/122, 24 February 2012.

[6] Commission staff working document, "Facts and figures on State aid in the EU Member States", *SEC (2012) 443 final*, 21 December 2012.

[7] Commission staff working paper, The effects of temporary State aid rules adopted in the context of the financial and economic crisis", *op. cit.*, p. 38.

noted that Luxembourg has provided substantially less aid than its EU counterparts. Aid granted by Luxembourg over the period 1 October 2008-1 October 2012 totalled €8.97 billion or 20.9% of national GDP compared to the corresponding figures of, e.g., Germany (€646.06 billion, 25.1%) or the United Kingdom (€873.34 billion, 50%). Especially in relative terms, i.e. as a share of the total banking sector size, Luxembourg offered significantly less aid (0.5%) than Member States average (3%).

8. Luxembourg's aid took principally the form of State guarantees (€6.15 billion) whereas the reminder consisted of recapitalizations (€2.5 billion) and liquidity (€0.7 billion).[8] Again, these figures refer to the approved amount of aid of which only 50% has been actually used (€4.43 billion). Unlike most Member States which employed both general schemes (covering the whole banking sector) and measures tailored to specific credit institutions, Luxembourg supplied aid only in this latter form, i.e. individually targeted aid.

9. Although Luxembourg might seem to compare favourably with respect to other EU countries, it cannot be underestimated that – as a small country hosting some 140 banks whose assets exceed 20 times its GDP – Luxembourg has been "severely affected by the crisis".[9] According to the most recent International Monetary Fund (the "IMF") financial stability assessment "Several financial institutions operating in Luxembourg failed during the recent crisis owing to contagion from their parent banks abroad, necessitating swift policy interventions."[10]

10. During the crisis Luxembourg authorities contributed to provide support to cross-border financial institutions faced with liquidity and solvency problems giving rise to prominent State aid cases such as *Dexia* and *Fortis*. These cases, together with that concerning *Kaupthing*, are reviewed further below following a broad overview on the special State aid framework applicable to the financial sector during the crisis.

[8] Commission staff working document, "Facts and figures on State aid in the EU Member States", *op. cit.*, pp. 30 ff.

[9] International Monetary Fund, "Luxembourg: financial system stability assessment – update", *IMF country report,* No. 11/148, June 2011, p. 11.

[10] *Ibidem*, p. 13.

Chapter 2
State aid legal framework

11. There are no legal provisions in Luxembourg dedicated to State aid. The relevant regime is therefore exclusively set out under EU law.

Section 1
Change of legal basis

12. State aid is prohibited pursuant to article 107(1) TFEU save for the exceptions provided under the Treaty provisions allowing for State aid measures to be authorized by the Commission on a case-by-case basis.

13. Two grounds of exceptions have been used to justify the compatibility of State aid support to the financial sector:

– Article 107(3)(b) TFEU: exempts aid "to remedy a serious disturbance in the economy of a Member State". This exception has been traditionally subject to very strict interpretation (the serious disturbance must concern the entire national economy, the disruption of a single region or sector not being deemed sufficient). Before the crisis article 107(3)(b) TFEU was practically never accepted as a legal basis to justify State aid and even during the first phase of the crisis the Commission was reluctant to apply it.
– Article 107(3)(c) TFEU: exempts aid necessary to "facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest". When aid measures fall within the scope of this exception, the Commission's compatibility assessment is performed on the basis of the so-called "R&R Guidelines".[11] The R&R Guidelines apply, *inter alia*, to the financial sector and allow undertakings to benefit from State assistance provided that a number of (stringent) conditions are fulfilled.

14. Since October 2008, however, confronted with the systemic dimension of the crisis, the Commission took a "U-turn" embracing article 107(3)(b) TFEU as a new legal basis for assessing aid to financial institutions. Banks –

[11] Commission Communication, "Community guidelines on State aid for rescuing and restructuring firms in difficulty", *OJ* C 244, 1 October 2004, p. 2.

which have been traditionally subject to the general EU State control – were suddenly considered worth special treatment.

Section 2
Temporary framework

15. The concrete scope of the broadly worded article 107(3)(b) TFEU derogation has been defined in six Communications. Three of the Communications detail the conditions for the compatibility of State aid to banks with respect to the most common types of State support, i.e. guarantees on liabilities, recapitalizations and asset relief measures. The fourth Communication deals with the rules applicable to restructuring plans prepared in the context of crisis-related State aid.

16. The philosophy underpinning these documents asserts that the shorter-term overriding objective of restoring financial stability should be reconciled with the longer-term objective of preserving competition. For this purpose, on the one hand Member States are afforded greater leeway compared to the traditional R&R Guidelines, on the other hand State aid should be kept at the minimum necessary and compensatory measures should be provided to offset distortions to competition.

17. The special regime applicable to State aid in the banking sector is of temporary nature and will be phased out as soon as market conditions will allow doing so. This would mean returning to the normal State aid regime based on article 107(3)(c) TFEU. Following a first step in this direction taken with the so-called "Exit Communication", the spread of the sovereign debt crisis persuaded the Commission to issue in December 2011 a "Prolongation Communication" to extend the temporary framework regime *sine die*, until markets will stabilize.

Sub-section 1
Banking Communication

18. The Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, the so-called "Banking Communication",[12] was published on

[12] Commission Communication, "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global crisis", *OJ* C 270, 25 October 2008, p. 8.

13 October 2008 as the Commission's first initiative to adapt the application of State aid rules, namely the R&R Guidelines, to banks in difficulty.

19. The Banking Communication puts forth a number of general principles or criteria to assess the compatibility of the relevant aid measures with the common market, focusing on State guarantees. The Communication draws a critical distinction between "fundamentally sound" banks and distressed banks suffering from endogenous problems with these latter requiring a stricter approach. It also sets out the conditions under which emergency liquidity assistance (the "ELA") granted by central banks should be qualified as State aid.

20. The list below provides an overview of the main principles discussed in the Communication:

– aid should be made available on a non-discriminatory basis;
– aid should have a material and temporal scope limited to what is necessary to ensure financial stability;
– aid should be well targeted, proportionate and minimize competitive distortions through sufficient compensatory measures;
– aid and restructuring plans should aim at restoring long-term viability, without further injections of aid;
– private sector should make an appropriate contribution to the costs ("burden sharing").

Sub-section 2
Recapitalization Communication

21. While recognizing the importance of recapitalization schemes from a financial stability perspective, the so-called "Recapitalization Communication"[13] of 5 December 2008 aims at preventing undue advantages for the beneficiary. To this effect, the Recapitalization Communication indicates several conditions, including:

– market-oriented pricing of capital injections (depending on the risk profile of the bank and in accordance with the ECB Recommendations)[14];

[13] Commission Communication, "The recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition", *OJ* C 10, 15 January 2009, p. 2.

[14] Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations, 20 November 2008.

– incentives aimed at the exit of the State from the banks' capital and its replacement by private investors;
– recapitalizations limited to the minimum necessary and behavioural safeguards to limit aggressive commercial strategies by the beneficiary.

Sub-section 3
Impaired Assets Communication

22. The third Communication of February 2009 provides guidance on the treatment of impaired assets under State aid law,[15] addressing important issues such as those related to the eligibility and valuation of assets. The Communication spells out the following principles:
– disclosure of impairments prior to government intervention;
– coordinated identification of eligible categories of assets ("baskets");
– common principles for *ex ante* assets evaluation and *ex post* validation by the Commission;
– burden-sharing of the costs for impairments between stakeholders;
– appropriate remuneration for the State, at least equivalent to the remuneration of State capital;
– coverage of the losses incurred from the valuation of the assets at real-economic-value by the beneficiary bank;
– alignment of beneficiary bank's incentives with public policy objectives;
– management of assets subject to relief so as to avoid conflicts of interests;
– appropriate restructuring plans, including compensatory measures, to restore long-term viability and minimize competition distortions.

Sub-section 4
Restructuring Communication

23. The so-called "Restructuring Communication"[16] of 22 July 2009 complements the three preceding Communications by setting the specific conditions for the approval of restructuring plans. Except for the stricter requirements for banks' recovery plans (which should contain stress test indicators), the

[15] Commission Communication, "The treatment of impaired assets in the Community banking sector", *OJ* C 72, 26 March 2009, p. 1.
[16] Commission Communication, "The return to viability and assessment of restructuring measures in the financial sector in the current crisis under State aid rules", *OJ* C 195, 19 August 2009, p. 9.

Communication adopts a more lenient approach towards banks in difficulties than the R&R Guidelines, as suggested by the:

- longer deadlines for implementation of restructuring plans (up to five years from the previous period of three years);
- decreased rate of banks' own contribution to the costs of restructuring, which could be lower than the usual 50% threshold;
- derogation to the "one time last time" principle.

Sub-section 5
Exit and Prolongation Communications

24. Following an adjustment upward of the pricing of guarantees since 1 July 2010,[17] the Commission issued the so-called "Exit Communication"[18] with the intention of gradually phasing out the temporary framework described above. In particular, the Exit Communication requires that, as of 1 January 2011, every bank in the EU that has benefited from State aid in the form of capital or impaired asset measures shall submit a restricting plan, thereby removing, in that respect, the distinction between fundamentally sound and distressed banks.

25. However, exactly one year later, on 1 December 2011, the effects of the sovereign debt crisis induced the Commission to issue the so-called "Prolongation Communication"[19] extending the temporary State aid crisis rules for banks. No fixed deadline is set for an end to the special framework, which will depend on the evolution of the market situation. In addition, the Prolongation Communication updates and clarifies the temporary framework (in a way favorable to banks), especially in relation to the pricing of capital injections and the remuneration of State guarantees.

[17] DG Competition staff working document, "The application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010", 30 April 2010.

[18] Commission Communication, "The application, after 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis", *OJ* C 329, 7 December 2010, p. 7.

[19] Commission Communication, "The application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis", *OJ* C 356, 6 December 2011, p. 7.

Chapter 3
State aid cases involving Luxembourg

Section 1
Dexia case

26. On 28 December 2012, the Commission approved an aid package granted by Belgium, France and Luxembourg for the orderly resolution of the Dexia Group subject to certain commitments.[20] This conditional decision follows earlier decisions and a series of in-depth investigations, possibly allowing the conclusion of the Dexia "saga" which has lasted more than four years.

Sub-section 1
Rescue aid

27. Dexia SA ("Dexia") was a Franco-Belgian financial institution specialized in lending to local authorities and, to a lesser extent, in retail and commercial banking. Dexia had increased its balance sheet considerably during the period of 2000-2008 (from €258 billion to 651 billion) expanding its range of activities, through acquisitions and subsidiaries, to several countries including Turkey, Italy Germany and the United States. In Luxembourg, Dexia was active through its subsidiary Dexia Banque International Luxembourg SA ("Dexia BIL"), one of the largest retail banks in the country.

28. In the aftermath of the Lehman Brothers' bankruptcy, and the related liquidity crisis, Dexia experienced enormous difficulties exacerbated by a number of factors including (i) its business model (borrowing short on the wholesale market and lending long to the public sector); (ii) the impairment on a large portfolio of structured credit assets, either held directly or insured through its US subsidiary Financial Security Assurance ("FSA"); and (iii) its exposure to private or sovereign counterparties in difficulties (e.g. US, Irish and Icelandic banks).

29. To avoid the collapse of Dexia, in October-November 2008 the governments of Belgium, France and Luxembourg granted rescue aid consisting of:

– a capital injection of €6 billion – of which the Commission regarded €5.2 billion as State aid from the Belgian and French States (the "Recapitalization" or the "First Bailout");[21]

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[20] See, *infra*, §6 below.

[21] In the context of the Recapitalisation, Luxembourg undertook to invest €376 million in the form of hybrid capital to be issued by Dexia BIL. As Dexia subsequently (in the restructuring plan of February 2010) waived the benefit of the investment, the subscription never took place and the

– a joint State guarantee – split into 60.5% for Belgium, 36.5% for France, and 3% for Luxembourg to facilitate Dexia's access to finance up to a maximum of €150 billion (reduced to €100 billion since 1 November 2009) and initial maturity of up to three years (thereafter extended up to five years) (the "Guarantee on Funding");
– ELA from the Belgian and French central banks (*Banque Nationale de Belgique* or "BNB" and *Banque de France* or "BdF"), guaranteed by the Belgian State;
– an additional guarantee by the Belgian and French States on a portfolio of impaired assets held by FSA for which the aid element was evaluated at €3.2 billion ($4.5 billion) (the "FSA Guarantee").

30. In the Commission's decision of 19 November 2008,[22] only the Guarantee on Funding and the ELA were authorized as rescue aid (whereas the Recapitalization and the FSA Guarantee were dealt with under subsequent separate decisions).

31. The Commission proceeded by observing the dramatic consequences the Belgian banking sector and economy as a whole would experience should the bank collapse. The estimated risks included: paralysis of local authorities' activities, general mistrust towards the Belgian banking sector leading to bank runs and interbank lending downfall.

32. In the light of these considerations, given the limited scope and remuneration rate of the Guarantee on Funding (set in accordance with the ECB's Recommendations)[23], as well as the penalizing rate applied to the ELA operation, the Commission concluded that the aid measures under discussion were appropriate, necessary and proportionate.

33. The Guarantee on Funding and the ELA were therefore authorized as rescue aid under article 107(3)(b) TFEU subject to presentation of a restructuring plan (or a plan for orderly resolution). By approving the rescue aid, the Commission allowed the (temporary) survival of Dexia.

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correspondent aid element was not taken into consideration in the final calculations contained in Commission's decision of 26 February 2010.

[22] Commission Decision of 19 November 2008 in Cases NN 49/2008, NN 50/2008, NN 45/2008 – *Dexia*, C(2008)7388 final.

[23] Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, 20 October 2008.

Sub-section 2
FSA Guarantee

34. By February 2009, Belgium, France and Luxembourg had submitted an initial restructuring plan for Dexia, essentially dependent on the sale of, and the reduction of the risks associated to, US loss-making subsidiary FSA, a monoline insurer.

35. As the FSA Guarantee was regarded as a prerequisite for the sale transaction, in its decision of 13 March 2009[24] the Commission pragmatically authorized such measure. For the first time in its practice, the Commission assessed an impaired asset measure such as the FSA Guarantee relying, *inter alia*, on the then forthcoming Impaired Assets Communication, an element that demonstrates the Commission's proactive approach to the changing legal environment.

36. Sensitive to the legal certainty concerns of the prospective buyer, the Commission emphasized the final character of its positive assessment, postponing to a subsequent decision the complex quantitative issues concerning the valuation of the insured portfolio and the remuneration to be paid to the State.

37. In relation to the restructuring plan, the Commission was less indulgent as it expressed serious doubts on the capability of the plan to ensure a return to long-term viability of the bank, an adequate burden sharing between stakeholders and appropriate safeguards measures to prevent an abuse of the aid. As a result, the Commission decided to open an in-depth investigation pursuant to article 108(2) TFEU in order to more carefully scrutinize the various aid measures received by Dexia (save for the FSA Guarantee) in the light of the restructuring plan.

Sub-section 3
Revised restructuring plan

38. In the Commission's decision of 26 February 2010,[25] all the outstanding issues arising in the context of the Dexia case were comprehensively examined and settled subject to commitments.

[24] Commission Decision of 13 March 2009 in Case C 9/2009 (ex. NN 49/2008, NN 50/2008, NN 45/2008) – *Dexia*, C(2009)1960 final.

[25] Commission Decision of 26 February 2010 in Case C 9/2009 (ex. NN 49/2008, NN 50/2008, NN 45/2008) – *Dexia*, [2010] *OJ* C 274, p. 54.

39. Firstly, the Commission thoroughly examined and approved in the light of the newly adopted Restructuring Communication the revised restructuring plan as submitted by Belgium, France and Luxembourg on 9 February 2010. Secondly, the Commission gave its final approval to the rescue aid (Guarantee on Funding and ELA) provisionally authorized on 19 October 2008, essentially converting such measures into restructuring aid. Thirdly, the Commission authorized as restructuring aid the Recapitalization, which had already been executed in violation of the standstill obligation. Fourthly, the Commission clarified the outstanding issues related to the FSA Guarantee (portfolio valuation and State remuneration).

40. The Commission made conditional its decision upon the implementation of an extensive set of commitments, a typical feature of its decision-making practice during the crisis. The commitments were aimed at reducing Dexia's business activities and thereby the anticompetitive effects of the aid. They consisted of structural and behavioural measures such as domestic and international divestment programs of businesses (e.g. in the retail sector, bond portfolio) and subsidiaries (*Dexia Épargne Pension*, *Dexia Crediop*, etc.), balance sheet reductions (35%), short term funding reductions (from 30% to 11%), operation costs reductions (15%), dividend prohibition (until the end of 2011), acquisitions ban (until the end of 2011), advertising restrictions, adherence to G-20 remuneration principles.

Sub-section 4

Nationalization of Dexia Banque Belgique and temporary refinancing guarantee

41. Since mid-2011, Dexia has been hit by the sovereign debt crisis and could not refinance itself on the market. The aggravated situation prompted a number of additional measures at different stages, including: the purchase of Dexia Banque Belgique ("DBB") (renamed "Belfius") with the exception of Dexia Asset Management ("DAM") by the Belgian State for €4 billion (the "Second Bailout") as well as a temporary guarantee dated 16 December 2011 from Belgium (60.5%), France (36.5%) and Luxembourg (3%) on the refinancing of Dexia and Dexia Crédit Local SA ("DCL"), covering a maximum capital value of €45 billion (subsequently increased up to €55 billion) until 31 May 2012, extended last time until 30 September 2012.

42. Both the sale of DBB/Belfius and the temporary refinancing guarantee were temporarily approved as rescue aid by the Commission, respectively on

17 October[26] and 21 December 2011.[27] On both occasions, the Commission referred to the compelling need to "preserve financial stability", given the systemic importance of Dexia. However, as it considered that the accepted new additional aid support substantially changed the conditions of Dexia's restructuring approved on 26 February 2010 (and that Dexia had breached several commitments), the Commission decided to open in-depth investigations on the newly adopted measures. Furthermore, it required the Member States concerned to submit a new restructuring or a liquidation plan.

Sub-section 5
Sale of Dexia BIL

43. In March 2012, the Luxembourg State notified to the Commission the sale of Dexia BIL (mainly Dexia BIL's retail and private banking business) for a sale price of €730 million. The transaction contemplated that a private investor (a Quatari investment group) would acquire 90% of the sold business and Luxembourg the remaining 10% on the same terms. Shortly after the notification, the Commission opened a formal investigation to assess the potential State aid elements of the transaction. The Commission was concerned that the business divested retained the benefit of the State aid previously received by Dexia BIL as part of the Dexia Group.

44. In a decision dated 25 July 2012,[28] the Commission cleared the case finding that the sale of Dexia BIL did not result in any economic advantage financed through State resources either for Dexia BIL or for the Dexia Group. The decisive factor, in line with the Commission's traditional approach, was the price of the transaction (€730 million), which the Commission considered consistent with the market price and reflecting the true value of the business disposed. The Commission therefore concluded that the sale did not entail State aid.

Sub-section 6
Orderly resolution of Dexia

45. Finally, on 21 and 22 March 2012, Belgium, France and Luxembourg presented a plan for the orderly resolution of Dexia. Following protracted

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[26] Commission Decision of 17 October 2011 in Case SA.33751 (11/C) (ex 11/N) – *Dexia Banque Belgique*, [2012] *OJ* C 38, p. 12.

[27] Commission Decision of 21 December 2011 in Case SA.33760 (11/C) (ex 11/N) – *Dexia*, [2012] *OJ* C 345, p. 4.

[28] Commission Decision of 25 July 2012 in Case SA.34440 (12/C) – *Dexia BIL*, [2012] *OJ* L 357, p. 15.

negotiations, on 28 December 2012 the Commission communicated its approval of a revised resolution plan dated 14 December 2012 and the related aid support for its implementation.[29] Similarly to the Commission's decision of 26 February 2010, such aid was made conditional upon the implementation of several commitments. While the text of the decision is to date (i.e. July 2013) not available, it can be inferred from the documentation available that the approved resolution plans consist of the following elements:

- Dexia will be subject to orderly resolution – meaning that Dexia will withdraw from all the markets, through the disposal of its commercial franchises or management in run off of its residual entities;[30]
- Belfius will undergo restructuring to ensure its long-term viability – with the aim of refocusing Belfius' activities on the Belgian economy, strengthening the bank's capital base and reducing costs. In this respect, the Commission requested several restrictions (at least for 2013 and 2014), particularly regarding proprietary trading, advertising, loans to the public sector, acquisitions, coupon payments, dividend distributions, remuneration policy and operating costs;[31]
- sale of parts of the group – including Dexia Management Agency ("DMA"), which will become part of a new French development bank exclusively devoted to financing the French local public sector under a strict control exercised by the French State (holding 75% of DMA's capital).

46. In order to support the implementation of the measures above, the Commission approved:

- a final refinancing guarantee of €85 billion divided between Belgium (51.41%), France (45.59%) and Luxembourg (3%) (replacing the temporary guarantee of 16 December 2011);
- a recapitalization of €5.5 billion (the "Third Bailout") subscribed 53% by Belgium and 47% by France.

47. The Commission's press release clarifies the reasoning behind the Commission's clearance, noting that: (i) upon resolution Dexia will exit the market thereby avoiding competition distortions; (ii) the new French devel-

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[29] Commission, "Commission approves resolution plan for the Dexia group and restructuring plan for Belfius subject to fulfilling certain commitment", press release IP/12/1447, 28 December 2012. Decision not yet published in the Official Journal.

[30] Dexia, "European Commission approval of the revised Dexia orderly resolution plan", press release, 31 December 2012.

[31] Belfius, *Annual Report 2012*, p. 12.

opment bank (originating from DMA) will merely address market failures; and (iii) the restructuring aid received by Belfius will ensure the long-term viability of the bank, sufficient own contribution, and adequate compensatory measures to offset competition distortions.

Section 2
Fortis case

Sub-section 1
Restructuring aid

48. Fortis was a Belgian-Dutch banking and insurance group with a strong presence in Belgium, the Netherlands and Luxembourg and headed by Fortis Bank SA/NV based in Belgium ("Fortis Bank Belgium" or "FBB", itself controlled by Fortis Brussels SA and Fortis SA/NV), where the largest part of Fortis' business concentrated. In Luxembourg, Fortis was operating through Fortis Bank Luxembourg SA ("FBL") handling large retail operations.

49. At the outbreak of the crisis, the Fortis Group was in a precarious position due mainly to the substantial financing difficulties, aggravated by the subprime crisis, in relation to the €24 billion acquisition of ABN-Amro in 2007 as well as the assets impairments affecting Fortis' investment in structured credits (nominally valued at €41.7 billion).

50. In the aftermath of the Lehman Brothers collapse, the vulnerabilities of the Fortis Group became evident as liquidity in the interbank and capital markets dried up and the risk of bank runs started to materialize. Within a few days, strong rescue measures were deployed to counter the emergency situation, bringing changes that would affect permanently the physiognomy of the Fortis Group.

51. On 28 September 2008, the Belgian, Dutch and Luxemburg governments announced a coordinated recapitalization amounting to €11.1 billion divided as follows: €4.7 billion to Fortis FBB by Belgium, €4 billion to Fortis Bank Netherland NV ("FBN") by the Netherlands and €2.4 billion to FBL by Luxembourg. As a result of the transaction, the three Member States acquired a 49% stake in the correspondent bank's subsidiaries. Luxembourg's intervention took the form of a three years convertible loan – converted immediately after the loan agreement – allowing Luxembourg to acquire a 49.9% holding in FBL's capital.

52. The aforesaid recapitalization proved, however, insufficient to adequately restore confidence prompting the National Bank of Belgium to provide ELA.

Subsequently, on 3 October 2012, the Dutch government proceeded with the nationalisation of FBN, including its ABN-Amro activities (for a total of €16 billion). Two days later, the Belgian government increased its holding in FBB up to 99% (for a transfer price of €4.7 billion) announcing simultaneously to sell a 75% stake to BNP Paribas ("BNPP") which thereby also acquired control of 50% of FBL. In the same context, Luxembourg State sold 16% of FBL to BNPP. Following these transactions, BNPP's stake in FBL reached 67%.

53. Subject to the scrutiny of the Commission,[32] most of the measures above were qualified as State aid. In line with its consolidated practice, the Commission based itself on the so-called "private investor test", finding that the Member States concerned invested under terms which would be unacceptable to a private investor operating under normal market economy conditions.[33] The ELA supplied by the NBB was considered to be State aid as it failed to satisfy certain conditions required under the Banking Communication. In contrast, according to the Commission the purchase by BNPP of 75% of FBB and 16% of FBL did not constitute State aid as the purchase price resulted from an open and competitive bidding process and therefore reflected the market value.[34]

54. The Commission began by considering the systemic relevance of the Fortis Group not only in Belgium (as it did in the Dexia case) but also in Luxembourg, where FBL was found, *inter alia*, to be the largest retail bank for Luxembourg households. It then shifted its attention on the suitability of the aid measures with respect to the difficulties faced by Fortis, noting that: (i) the purchase by the Dutch State of FBN (including ABN-Amro) would resolve the financing problems of the ABN-Amro acquisition; (ii) the creation of a vehicle to absorb FBB's toxic assets would mitigate the risks associated with FBB's structured credit portfolio; (iii) the subscription of capital increases by the Belgian and Luxembourg governments[35] would re-establish confidence and remedy the liquidity shortage; moreover, (iv) the acquisition of FBB by BNPP,

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[32] Commission Decision of 3 December 2008 in Cases NN 42/2008, NN 46/2008, NN 53/A/2008 – *Fortis Bank, Fortis Bank Luxembourg*, C(2008)8085.

[33] This was the case for the Belgian and Luxembourg recapitalizations, the acquisition of FBN by the Dutch State, the transactions carried out by Belgium consisting in the purchase of the remaining 50% in FBB, the acquisition of 24% stake in the "bad bank" vehicle Royal Park Investments (RPI), and the sale of 75% in FBB to BNPP.

[34] It is noteworthy that when the Commission cleared the sale of Dexia BIL (see *supra*), it focused on the final price (rather than on the competitive process) as this latter had been determined in the context of exclusive negotiations.

[35] The recapitalization announced on 28 September 2012 by the Netherlands was never implemented as it was replaced by the acquisition of 3 October 2012.

one world's largest and highest rated banks, would strengthen the bank's overall position.

55. In the light of the above, the Commission concluded that the aid measures received by Fortis were well targeted and proportionate. In addition, the Commission was satisfied with the commitments offered to prevent anticompetitive effects, although these were arguably less far-reaching than those accepted in Dexia. In particular, FBB had to divest FBN (representing around 25% of its total income and 45% of its net profits) and experience some – rather limited – behavioural limitations aimed at restraining its expansion on the fast growing online savings market.

Sub-section 2
National litigation

56. On 23 December 2008, the Court of appeal of Brussels suspended the sale of the 75% of FBB BNPP and requested the consultation of Fortis Holding's shareholders. As these latter rejected the transaction, it became necessary to renegotiate the deal between Belgian and Luxembourg States, Fortis Holding and BNPP. The additional aid from Belgian[36] and Luxembourg States was eventually cleared by the Commission.[37] Luxembourg's aid consisted in the subscription of €100 million of bonds to be issued by BGL BNPP (former FBL). In the part of the decision concerning Luxembourg, the Commission noted that the newly granted aid consisted merely in a slight extension of the €2.4 billion loan which was authorized in the decision of 3 December 2008 and, as such, a new assessment was unnecessary.

Section 3
Kaupthing case

57. The collapse of the Icelandic parent Kaupthing Bank hf had inevitably an impact on its Luxembourg subsidiaries. By a decision of 9 October 2008, the Luxembourg District Court (*Tribunal d'arrondissement de Luxembourg*) placed Kaupthing Bank Luxembourg SA ("Kaupthing Bank Luxembourg") under suspension on payments. Kaupthing Bank Luxembourg attracted interest from potential investors and was the subject of a restructuring plan.[38]

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[36] A wide range of measures mainly aimed at decreasing Fortis Holding's exposure to risks in the investment vehicle dedicated to the purchase of impaired assets from Fortis.

[37] Commission Decision of 12 May 2009 in Cases N. 255/2009, N. 274/2009 – *Fortis Bank, Fortis Bank Luxemburg and Fortis Holding,* C(2009)3907 final.

[38] Unlike Landsbanki Luxembourg SA and Glitnir Luxembourg SA, which were put immediately in liquidation.

58. The restructuring plan provided that deposits with the Belgian branch of the bank (€350-400 million) were sold to Crédit Agricole Belgique/Keytrade Bank whereas the Luxembourg based private bank part (€275-325 million) was to be taken over by UK investment fund Blackfish Capital and, in turn, by a new bank called Banque Havilland. The bank's other assets (€1.2 billion) would be wound up in a hive-off vehicle and the revenue used to compensate creditors and repay the State aid.

59. On 10 June 2009, Luxembourg informed the Commission that a €320 million loan had been set up for restructuring Kaupthing Bank Luxembourg, Luxembourg and Belgium contributing €160 million each.

60. The case did not raise special concerns. The Commission[39] readily concluded that the measures provided were appropriate for the purpose of restructuring the bank's activities, which would enable depositors to access their money again. In addition, the aid was deemed proportionate, as it would not result in any undue compensation to the bank's former shareholders. Finally, the Commission appreciated the scaling down of the bank's activities and the break up of its assets pursuant to an open, transparent sale procedure in a way that prevented distortions of competition.

Chapter 4
Commission's assessment

Section 1
Reconciling financial stability and competition

61. The *Dexia* and *Fortis* cases are representative of the internal tensions present in the Commission's State aid practice concerning the financial sector during the crisis. These tensions are primarily displayed in the Commission's attempt to reconcile the imperative of financial stability in the short run and the ultimate goal of preserving competition in the longer run.

62. The policy goal of financial stability translated into the "softened approach",[40] embodied in the temporary framework, which has guided the Commission's application of State aid rules to banks in difficulty. *Dexia* illus-

[39] Commission Decision of 9 July 2009 in Cases N. 344/2009, N. 380/2009 – *Kaupthing Bank Luxembourg*, C(2009)5640 final.

[40] H. Gilliams, "Stress testing the regulator: review of State aid to financial institutions after the collapse of Lehman", 2011, 36, 1, *ELR*, pp. 11 to 13.

trates this approach clearly with the Commission recognizing that rescue aid under article 107(3)(b) TFEU can take the form of impaired assets, capital increase and even nationalisation measures despite these being of structural nature, in contrast with the formal requirements of the R&R Guidelines (according to which rescue aid is "by nature temporary and reversible assistance").

63. It should, however, be noted that the Commission's flexible approach never went as far as to automatically or unconditionally authorizing rescue/restructuring aid.[41] The Commission imposed for instance considerable balance sheet reductions to Fortis (40%) and Dexia (35%) in order to counterbalance anticompetitive effects stemming from the vast aid received. Furthermore, Dexia was faced with changes, which had a considerable impact on its size, business model and commercial behaviour as compensatory measures.

64. In this regard, the Commission has been criticized by some authors for pursuing a *de facto* regulatory agenda, being non-transparent, and imposing commitments that would make it more difficult for restructured banks to return to viability.[42]

65. A legitimate counterargument would suggest however that, given the emergency situation and the absence of a harmonized EU resolution framework, the imposition of commitments was a necessary evil in order to refrain from rewarding unsound business models, and inefficient or inept banks. A final assessment of the Commission's practice will however require the time necessary to assess the overall impact of the Commission's compensatory measures on financial stability and economic growth in the EU.[43]

Section 2
Reconciling swift decisions and in-depth assessment

66. During the financial crisis, the Commission faced the need to reconcile swift decisions with in-depth assessments. On 1 October 2008, during

[41] *Ibidem*, p. 9. However see also fn. 50 where the Commission's approach has been criticized for being excessively lenient. For similar criticisms on the laissez-faire approach of the Commission in *Fortis* see C. Ahlborn, D. Piccinin, "The approach to State aid in the restructuring of the financial sector during the financial crisis", 2010,1, *EStAL*, p. 50.

[42] For some of these criticisms see, *inter alia*, D. Zimmer, M. Blaschzok, "The role of competition in European State aid control during the financial market crisis", 2011, 32, 1, *ECompLR*, pp. 9 to 16.

[43] International Monetary Fund, "European Union : financial system stability assessment", *country report,* No. 13/75, March 2013, p. 28.

a period where the Lehman Brothers shock wave reached its highest point and Member States were constructing rescue packages overnight, Commissioner Kroes was delegated (for a period of three months) to authorize emergency rescue measures even within matter of 24 hours. In this context, it took only two months for the Commission, similarly to most of the Commission's decisions during that time, to clear the restructuring aid to Fortis in Phase I thereby avoiding lengthy market testing exercises.

67. Unlike *Fortis*, in *Dexia* the complexities of the case probably induced the Commission to engage in a more delicate balancing exercise between the conflicting instances of emergency and thorough assessment. Initially notified to the Commission in the same context as *Fortis* (i.e. September-October 2008), the *Dexia* case was subject to a two-fold approach. On the one hand, the Commission provisionally approved in a few days the rescue package needed by Dexia to be kept afloat. On the other hand, the Commission did not hesitate, by separate decision, to open a Phase II in-depth investigation under article 108(2) TFEU to further inquiry on the compatibility of the State support in the light of the restructuring plan submitted. It is noteworthy that, in the very same decision opening the Phase II proceeding, the Commission continued to reserve special consideration to emergency concerns, as evidenced by its decision on the sale of insurance business FSA: the Commission promptly authorized the sale reserving time consuming quantitative issues for a later decision.[44]

Section 3
An evolution of the Commission's decision-making practice?

68. *Dexia* and *Fortis* stand out as the first cases where the cross-border dimension of the credit institutions involved induced various Member States to closely coordinate in collective rescue efforts. Analysing the similarities between the two cases, it should be observed that the typology of measures deployed were largely consistent (State guarantees, capital injections, impaired asset measures). Also, a similar pattern can be identified in both cases, which led to the nationalisation of DBB/Belfius and FBN respectively by the Belgian and Dutch State.

69. However, *Dexia* and *Fortis* diverge eminently from a procedural perspective. As noted above, the aid to Fortis was dealt by the Commission in Phase

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[44] A. Winckler, F.C. Laprevote, "When the watchman must take the wheel – State Aid control of financial institutions and other political imperatives during the economic crisis", 2009, 2, *Concurrences – Trends*, p. 15.

I, within approximately two months from the notification of the aid (overall seven months if one considers the approval of the additional measures stemming from the Belgian litigation). In contrast, the Dexia saga developed over an intense period of four years characterized by a series of new or extended measures triggering correspondent decisions or investigations. Also the remedies approved in Dexia appear more extensive as they include, in addition to divestments (of Dexia Asset Management and several other subsidiaries or businesses), the set up of a new development bank, the orderly resolution of the group and far-reaching behavioural commitments.

70. These differences, possibly explainable on the basis of the different degrees of complexity between the two cases, might also signal an evolution in the Commission's decision-making practice as recently suggested by Koenig and Hellstern: "An important evolution in the State aid clearing practice of the Commission and its objectives [has occurred] in the past four years: at the beginning of the financial crisis, the main focus was on rescuing banks by providing liquidity and reinforcing the capital base, while today State aid measures approved by the Commission aim at the recovery of the long term-viability of the aid recipient or – if the long term viability without State aid cannot be achieve within a reasonable period of time – its liquidation."[45]

71. As markets progressively stabilize, it is expected that the temporary framework, including the use of article 107(3)(b) TFEU, will be phased out to enter into a more permanent, post-crisis State aid regime. In the context of the announced modernisation of the State aid rules, a new set of R&R Guidelines is likely to be issued in order, *inter alia*, to target the specificities of credit institutions. It remains to be seen whether the modernisation process will be an opportunity to expressly address the challenges for State aid arising from the current legislative and regulatory developments, namely those connected to the banking union:

– Firstly, one should ask the question of how the EU State aid regime/practice will react to the long awaited adoption of the new European crisis management framework (notably of the prospective Bank Recovery and Resolution Directive (the "BRRD") as well as the expected establishment of a Single Resolution Mechanism (the "SRM")).[46]

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[45] C. Koenig, M. Hellstern, "The European Commission's Decision-making on State Aid for Financial Institutions – Good Regulation in the Absence of Good Governance?", 2013, 34, 4, *ECompLR*, 2013, p. 209.

[46] International Monetary Fund, *supra*, note 43.

– Secondly, a further challenge would be to determine – especially in relation to crisis management – the institutional framework and the exact scope for coordination between the various ESAs, ESRB, SSM, and the prospective SRM on the one side and, on the other side, DG COMP.[47]
– A final point to be clarified relates to the treatment of ELA, a function that some authors suggest should be centralized at the ECB level upon completion of the banking union.[48] In the presence of such scenario, the question arises whether ELA, granted by an EU institution enjoying special independence safeguards such as the ECB, should be notified at all to the Commission (or rather be subject exclusively to the potential *ex post* review exercised by the Court of Justice of the European Union on the basis of article 119(1) TFEU).[49]

72. As addressing these questions might take this paper outside its intended scope, it is hereby only submitted that an answer should be provided rather rapidly as the creation of the banking union is progressing steadily. The SSM is expected to begin supervision by the end of 2014 and, by the same time, the legislation establishing the SRM and the BRRD is expected to be adopted. The question related to the centralization of ELA appears relatively less pressing. Indeed, such centralization would require a high degree of centralization of fiscal responsibility, which for now – despite the ESM – would remain largely within Member States.

Conclusion

73. Restoring confidence in the financial sector following the Lehman Brothers collapse has been a formidable challenge for Member States and European institutions alike, with the Commission and ECB *in primis*. This paper has focused on the State aid cases in the financial sector involving Luxembourg with the intention of assessing the significance of the State interventions for Luxembourg during the crisis, streamlining significant State aid cases and drawing insights from the Commission's practice.

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47 *Ibidem*.

48 C. Wyplosz, "Banking union as a crisis-management tool" *in* T. Beck (Ed.), *Banking Union for Europe: Risk and Challenges*, CEPR, 2010, pp. 20 ff; T. Huertas, "Banking union: what will it mean for Europe?", *LSE Financial Markets Group Paper Series*, November 2012, p. 4.

49 In this sense, in relation however to the ELA provided by national central banks, see G. Psaroudakis, "State Aids, Central Banks and the Financial Crisis", 2, 2012, *ECFR*, pp. 214 to 218.

74. Data show that Luxembourg has managed to keep State aid expenditure for the financial sector at a lower level than its European counterparts both in absolute and relative terms. Luxembourg for instance offered aid representing only 0.5% of its banking sector total assets compared to the Member States average equal to 3%.

75. Nevertheless, as a highly interconnected market, Luxembourg has been concerned by prominent State aid cases such *Dexia* and *Fortis* originating abroad. These cases provide a significant understanding of the Commission's State aid approach to financial institutions in difficulties during the crisis and its likely evolution. In a context of unprecedented emergency, the Commission strategically turned to the legal basis of article 107(3)(b) and created a new temporary framework to temper the rigour of the R&R Guidelines allowing vast amounts of aid to be approved.

76. The Commission strived to ensure that the softened approach described above did not negatively affect competition as the philosophy guiding the application of State aid during the crisis asserts that a healthy financial system requires a positive interaction between financial stability and competition. In other words, competition has always been regarded by the Commission as part of the solution and not of the problem. It therefore comes as no surprise that the Commission imposed substantial commitments on large beneficiaries of aid such as *Dexia* and *Fortis* in order to avoid an abuse of State aid to the detriment of competitors.

77. The assessment of the Commission's practice is not uncontroversial. In our view, the Commission should be praised for performing its tasks consistently with a much-needed balance between flexibility and legal certainty. A final assessment will, however, require to duly take into account the impact of the Commission's compensatory measures on financial stability and economic growth in the EU. This should not be read as a criticism to DG COMP's work as it is ultimately the role of regulation and not that of State aid to provide macroeconomic responses to systemic problems.

78. Finally, it is submitted that the liquidation of Dexia might potentially signal that, as markets gradually stabilize, the Commission will revert to a more stringent approach to State aid in the banking sector. In the context of the expected modernisation of State aid rules, the treatment of State aid to banks in a post-crisis scenario and the adjustments required by the creation of the banking union will be worth a special attention.

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