Fire and Brimstone

Approach to State Aid in Restructuring the Financial Sector

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"Given that the crisis is systemic and one of inadequate capital, not just insufficient liquidity, schemes on the lines of the U.K. plan (…) make good economic sense. While state bailouts of arguably insolvent institutions are deeply unattractive, the realistic alternatives were still worse. The scheme is broadly competitively-neutral among U.K. institutions, and positive for other countries, many of whom have emulated the package.

So while it is surely state aid, it is not seriously competition-distorting aid."

John Vickers, "The financial crisis and competition policy: some economics" GCP Online, December 2008.

Outline

- Series of Communications by the Commission in step with developing crisis
- Recognition that standard R&R approach developed under Art. 87(3)(c) is inadequate to assess aid granted under Art. 87(3)(b)
- New thinking on more economic approach for aid under 87.3 – "balancing test" ("Common Principles for Economic Assessment")
- Distinguishing between "good aid" and "bad aid": differences in terms of competitive distortions, and need for compensatory measures
- In practice mechanistic approach to assessment of aid under "old" R&R criteria is prevailing in the current phase
- Blunt and formalistic, when case-by-case analysis is required to discriminate aid to structurally unsound banks from others

Commission’s evolving framework in step with crisis

- **“Banking Communication” (October 2008)**
  – Application of State aid rules to measures being taken to support financial institutions, in particular *guarantees* covering liabilities
- **“Recapitalisation Communication” (December 2008)**
  – Aimed to provide guidance on compatibility of recapitalisation measures considered by Member States
- **“Impaired Assets Communication” (February 2008)**
  – Dealing with size of losses from impaired assets
- **“Restructuring Communication” (July 2009)**
  – Measures to ensure smooth and non-distortionary return to financial stability
- **Commission recognised exceptional nature of the crisis – credited with fast and appropriate response**

Restructuring Communication (July 2009)

- **Recognition that standard R&R framework developed for Art. 87(3)(c) inadequate to assess aid given in emergency to financial institutions under Art. 87(3)(b)**
  - "…crisis has become systemic… has **become doubtful whether the R&R Guidelines were still providing an appropriate framework to tackle the crisis**, as the crisis hit also banks that could normally not be considered 'companies in difficulties'" (Spring 2009 update State Aid Scoreboard, p 8).
- **Communication refers to "systemic nature of the crisis" and "interconnectivity of the financial sector"**
- **Distinguishes between "structurally sound" and "unsound" banks – though only based on simple criteria. Requires a Restructuring Plan for structurally unsound banks.**

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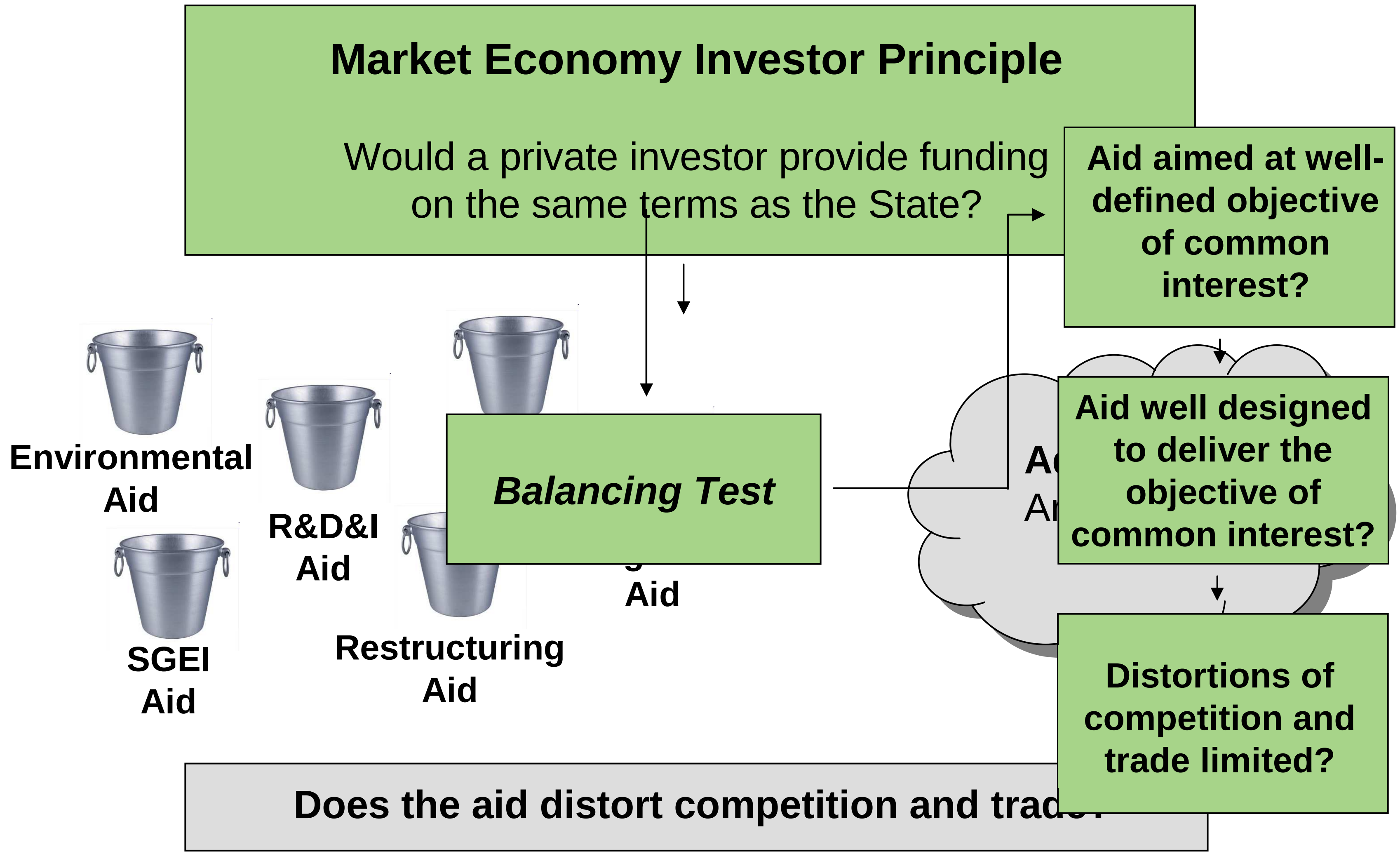
Key differences with “standard” R&R aid

- **Rationale and context of aid given under Art. 87(3)(b) *inherently different* from standard R&R aid under Art. 87(3)(c)**
- **Ad-hoc R&R aid salvages firms that should have failed in “normal” market circumstances**
  - Extreme measure not consistent with efficient functioning of competitive markets
  - Tenuous efficiency justifications, can result in serious market distortions – e.g. customers served by less efficient “rescued” firm
- **Given lack of efficiency justification, ad-hoc R&R aid subject to strict (almost punitive) “compensatory” measures (divestments and capacity reductions)**
  - Rescued firm should have failed, competitors “compensated”
- **Conversely much aid awarded under Article 87(3)(b) was aimed at *correcting* significant market failures**

Commission's "more economic approach"

- **May 2009 - Commission outlines a "more refined" economic approach to state aid in working paper "Common principles for an economic assessment of the compatibility of State aid under Article 87.3 EC-Treaty"**
- **Rules based on a *Balancing Test* and a more effects-based (economic) approach**
- **Emphasis on market failures in the form of *externalities, coordination failures, asymmetric information, and incomplete markets***
- **Many details to be clarified (including applicability), but step in the right direction**

The “balancing test”



Aid under Art. 87(3)(b) good candidate for *Balancing Test*

- ***Well defined objective?*** **Remedy two types of *market failures***
  - ***"Lemons" problem:*** **market failures leading to markets breakdown**
    - Capital write-downs led to reduced willingness to lend, and sharp fall in liquidity
    - After Lehman, markets even more uncertain as to how to measure soundness of banks. Usual capital adequacy criteria unreliable
    - Crisis of confidence: panic in wholesale and retail banking markets, freeze of inter-bank and international wholesale markets, near-collapse of credit markets
  - ***Negative externality*** **imposed by a failed financial institution on others**
- ***Well designed instrument?*** **Aid is *appropriate***
    - Guarantees granted to avoid bank runs and make interbank markets more liquid
    - Impaired asset schemes introduced to allow "value" pricing of illiquid assets
    - Recapitalisations to cover remaining impaired assets in balance sheets, and put back more equity capital to cover loans
- **Is aid *proportionate?*** **i.e. kept to minimum to achieve its benefits*?***
- ***What is the net impact?*** **is the cost of market distortions outweighed by benefit of financial stability?**

Proportionality: distinguishing "good aid" and "bad aid"

- **Benefits of the aid (avoiding economic catastrophe) is large**
- **However important to discriminate aid *proportionate* to solve market failures, from *additional* aid to rescue unviable banks**
- **Different effects in terms of potential distortions, and appropriate measures to be taken in response**
- **Aid *proportionate* to addressing financial markets breakdown ("lemons problem", crisis of confidence) just sufficient to return structurally sound banks to viability**
- ***Additional* aid was sometimes needed because of excessively risky actions of banks, rather than financial markets failure**
- **Financial/economic analysis can distinguish aid into *tranches*: aid tackling *systemic problem* vs *additional* aid**

Two potential distortions of competition

- **Moral hazard? i.e. incentivising inefficiently risky future behaviour**
  - *Proportionate aid* should not give rise to significant moral hazard – as linked to *exceptional circumstances*
  - *Additional aid:* need to tackle expectation of consequence-free bail outs
- **Potential distortions of competition in product markets? i.e. allowing inefficient players to survive**
  - Economic commentary on banking crisis focussed on need to minimise cost to taxpayers and reduce moral hazard – lot less on competitive distortions
  - For aid to have "crowding out" effect, rivals must have capacity / willingness to increase lending – but credit contraction has *limited* banks' ability to lend
  - Aid was widely available to banks – "level playing field"
  - Ad-hoc recapitalisations do not necessarily provide advantage over competitors, given strings attached. Most banks that could opt out have done so: suggests schemes do not confer advantages

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Distortions of competition (2)

- **Distortions modest for *proportionate aid***
  - Certain market failures affected all banks, so by definition symmetric
  - Remedying true market failure (not just individual failings) *improves* efficiency
- **Even for *additional aid*, unlike usual R&R aid there is a tangible benefit on competitors – preserving stability of financial system and avoiding domino effects on other banks**
- **Cannot be simply *assumed* that because some banks needed aid more than others there is a distortion of competition in the market**
- **Given systemic nature of the crisis and features of financial markets, distortions of competition likely to be limited and mostly related to moral hazard**

Mandatory asset sales not most effective or desirable compensatory measure

- **Greatest source of *moral hazard* were distorted executive incentives and failings in bank's governance**
- **Key are burden-sharing / behavioural compensatory measures to align executives incentives to banks' long-term viability**
- **Asset sales do little to tackle *moral hazard***
  - Affect most directly *current* shareholders of the bank - often not same owners. Do not directly impact debt holders or bank executive compensation
- **Peculiarity of banking and financial crisis may exacerbate problem**
  - Taking on divested assets requires **raising capital** to maintain capital adequacy ratios
  - May actually **worsen bank's solvency** if there is no corresponding reduction in liabilities, and assets are sold below book value
  - With many sellers and few buyers, may be difficult to sell a significant portion of assets without **depressing their prices** – asset sales may be close to fire sales
  - Market constraints on absorption of divested assets create risk of reduction in level of the assets (i.e. funds) available to the economy overall

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Insights from recent (and current) cases

- **No systematic analysis of reasons for the aid – approach in line with “old” R&R logic, and in contrast with Commission’s own statements e.g. in Restructuring Communication**
- **No distinction of aid to address market failures from additional aid**
  - Commission appears to set aside even established MEIP - argues there was no market, and therefore no market investor (aim was “outside MEIP”)
  - Guarantees deemed “similar to” capital injection, aid = value of assets
  - Recapitalisation = aid for the full amount
- **Focus on extracting asset divestments (up to half balance sheet) from on banks that have received significant aid (“league table”)**
- **Counterproductive behavioural undertakings to “abstain from organic growth” by restricting ability of banks to compete**
  - e.g. agreement not to be “a price leader”, not to match smaller rivals’ prices

Lessons and take outs

- **Formalistic approach prevailing in the current phase**
- **Emphasis on asset sales – though unclear some divestments are that costly to the banks… and if they are, what is policy objective?**
- **Too blunt a tool for reducing moral hazard – how do these measures reduce chances of a repeat of the current crisis?**
  - Do they help internalise the externalities that risky bank behaviour has on the economy? Do they compensate for individual agents not facing full consequences of gambles that do not pay off?
- **Sense that Commission is trying to engineer an improvement of competitive conditions in banking markets relative to pre-crisis situation, and to further market integration agenda by favouring cross-border entry in retail markets…**
- **Missed opportunity so far for a coherent effects-based approach**

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