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Bailing out the banks: reconciling stability and competition

The financial crisis has reopened the fundamental policy debate about balancing stability and competition in the banking sector. How should competition and state aid rules be applied to banks? How can financial regulation be reformed? Thorsten Beck, Diane Coyle, Mathias Dewatripont, Xavier Freixas and Paul Seabright provide an economic perspective on these questions, based on their recent report published by the Centre for Economic Policy Research

The Great Depression led to the discontinuation of most standard competition policies in banking in order to foster financial stability. This objective was clearly achieved, but at the cost over the subsequent decades of stifling innovation and imposing a high burden on consumers. This led in turn, from the 1970s, to a swing of the pendulum towards deregulation, with more competition and innovation, but also with many banking crises (eg, in the USA in the 1980s and in Scandinavia and Japan in the 1990s, in addition to the many emerging-market crises). Each time, regulation tried to adapt, in a global fashion, leading in particular to the Basel regulatory frameworks.

The crisis has provoked two common but quite different reactions concerning the role of competition policy in the banking sector. One reaction has been to consider that financial stability should take priority over all other concerns and that therefore the 'business as usual' preoccupations of competition regulators should be put on hold. Another reaction has been to fear that intervention to restore financial stability will lead to massive distortions of competition in the banking sector, and therefore to conclude that competition rules should be applied even more vigorously than usual, with the receipt of state aid being considered presumptive grounds for suspecting the bank in question of anti-competitive behaviour. We endorse neither of these points of view. We reject the idea that the crisis requires the suspension of normal competition policy rules; in times of crisis they are more important than ever. However, we also believe that the competition rules appropriate to the banking sector are not the same as those that should apply to most other sectors. State-aided banks have a different relationship with the rest of the economy than state-aided firms in other sectors, and the rules of state aid policy should reflect these differences.

Competition concerns of state aid

State aid principles *are* different for banks

It is important to recognise that, during a financial crisis, bailing out one bank would usually imply a positive externality for its competitors, either because it prevents systemic problems, or because these competitors are themselves its creditors, and so are indirectly also bailout recipients. This means that, in contrast to the normal assessment of state assistance in other industries, bank bailouts do not necessarily require 'compensation' for competitors. In particular, forcing banks to scale down in the middle of the crisis may have the worst possible effect, as it implies a forced 'fire' sale of the bank's assets. This does not take away from the fact that in the medium-to-long term, the survival of less efficient banks can hurt their competitors and the whole banking system.

Competition policy should apply, but conditions on bailouts must reflect the specifics of banking

There is no case for applying weaker competition policy criteria to banks. Nor should competition policy be applied *more* strictly in a crisis; it should be applied with sensitivity to the circumstances that distinguish banks from other kinds of state-aided firms. In

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particular, there is no case for specific behavioural restrictions following bailouts that would put the rescued bank at a competitive disadvantage with respect to competitors, such as limitations on its pricing strategies. While it makes sense to avoid unfair advantages that public money would give to such recipients, 'tying their hands'—for example, by preventing them from being 'price leaders'—seems to us both hard to enforce and misguided: it is much better to make sure that these banks are adequately capitalised and then enforce competition on all players in the market.

Moreover, in periods where many banks have received bailouts, there are good reasons to avoid imposing conditions on the receipt of state aid that require generalised balance sheet reductions. This does not imply that concerns about balance sheet *growth* are unjustified; on the contrary, limiting growth through acquisitions does make sense as a way to prevent the recipients of a bailout gaining an unfair advantage. And, in fact, there is a case for requiring balance sheet reduction in the case of banks whose prior over-expansion was the reason for their needing a bailout. This being said, a lot of restructuring in the sector will be desirable following the crisis, and there is no reason to prevent acquisitions which are compensated by divestitures and therefore avoid net growth of balance sheets. This should, however, be accompanied by an assessment of the competitive situation in the sector taken as a whole.

Bailouts should not be permitted to lead to any move away from the single market, either through national governments directing their own banks towards domestic lending, or through the imposition of remedies that would lead banks to spin off foreign rather than domestic activities.

The need for stability justifies 'real' but not over-generous aid

While 'real' bailouts are needed, governments must avoid being 'overly generous' in bank rescues; this means in particular that, to the extent possible, bailout plans should wipe out initial equity-holders, to reduce potential moral hazard. Moral hazard and fiscal considerations also point to imposing losses on junior creditors, something which has been too much overlooked in the 2008–09 bailouts. This may be because of the fear of causing panic among creditors, but this fear is overrated; separating out the claims of junior creditors from those of depositors and senior ones may well encourage the latter to lend more rather than less freely. Of course, one should be careful about second-round effects. If junior creditors are financial institutions too, such liability re-evaluations may simply transfer the problem.

The difficulty of monitoring and enforcing behavioural restrictions on the assisted banks, and of designing restrictions which do not distort competition, make it imperative to include an end-date or exit strategy in bailout plans. For the same reason, certainly for the duration of the state aid and in many cases permanently, stricter governance of the banks rescued is needed. The prior standard corporate governance framework proved inadequate.

Assessment of the EU state aid control response

DG Competition has been very active since the autumn of 2008, and has struck a balance between the insistence on competition concerns and the acknowledgement of the specificities of banking. We agree with its general approach—in particular, its general 'permissiveness' towards broad-based plans, and its focus on only those banks that received significant individual help, especially since its potential concerns, detailed in its Communications, had an impact on the many plans and cases being put forward. In particular, it was very useful for DG Competition to insist on avoiding over-generous help, and on encouraging exit strategies.

As far as those cases where remedies were imposed are concerned, we understand the desire to counter moral hazard by insisting on balance sheet reductions. However, it should be remembered that the implications of bailouts for competitors can be quite ambiguous in the banking sector. The key concern of competition authorities should be the restoration of a level playing field among banking competitors, with sufficiently dynamic competition. In this respect, it is important that the insistence on minimum aid and on exit strategies does not lead to under-capitalised banks. Similarly, it is important that balance sheet reductions do not lead to a retreat of banks within their national borders, thereby contradicting the goal of a single market in this sector. As previously discussed, our biggest worry concerns behavioural restrictions imposed on bailout recipients.

Of course, this criticism has to be mitigated by the fact that competition authorities do not live in a first-best world: while financial stability, and in particular the prevention of moral hazard, is mainly the job of prudential regulation and not of competition authorities, the latter have to live with whatever prudential regulation exists at present times. Erring to some extent in the direction of moral hazard prevention in competition policy can therefore be justified partially (but not fully) by the excessively slow reform of prudential regulation, a topic we now turn to.

Implications of the crisis for regulation

The second theme of the CEPR report is regulatory reform. While it is true that deposit-taking institutions deserve special attention in this context, other types of institution also need regulation if they are 'too big to fail' or 'too interconnected to fail'. On the other hand, there is no need to try and prevent universal banking, but the right capital charges are needed for various business lines or products. What is dangerous is not financial innovation per se but 'excessively' risky uses of such innovation. This means that higher capital charges are needed on structured finance products and other off-balance-sheet transactions, and these should no longer be linked to the ratings they receive (since ratings are particularly inflated for non-transparent products).

There are risks associated with big banks, in particular the danger that they are too big to fail, and the moral hazard to which this gives rise. This is all the stronger because bigger banks have more lobbying muscle. However, there is value in having a single market in banking just as in other sectors. Of course, this should be accompanied by proper centralised regulatory, supervisory and burden-sharing arrangements. The way to deal with the risks of size is not to impose arbitrary limits, but to apply deposit insurance premia or capital charges that increase, in percentage terms, when banks get bigger.

It is crucial to limit the procyclical effect of the current regulation. This could take the form of dynamic provisioning (as done in Spain already), capital ratios indexed on macroeconomic variables,[1] or capital insurance.[2] Using the options provided by Pillar 2 of Basel II, which leaves it to each country to set an additional layer of capital, has proved inadequate due to competition among regulators limiting this additional capital.

Assessment of the EU financial regulatory reform so far

The recent European Banking Authority proposal and Bank Crisis Management Communication constitute a step forward in the design of a post-crisis financial regulatory regime that better coordinates supervision in Europe, a key requirement to preserve a single market in banking. Still, the loss of supervisory authority will presumably be aggressively opposed by some countries, like the UK, for which the financial industry is a strategic one. This could lead to weak European regulation dominated by national regulators. So, although moving in the right direction, there are some reasons for concern. First, the key issue, in terms of efficiency, is the need to define a European bankruptcy regime, which is only vaguely invoked at the end of the Bank Crisis Management Communication. Second, the issue of burden-sharing, also mentioned in the Bank Crisis Management Communication, will be a permanent source of disagreements among countries, precisely because the European bankruptcy regime has not been harmonised. Indeed, why would one country's taxpayers provide capital for an institution in another country that has been badly managed, badly supervised and badly regulated, especially if the main beneficiaries are the distressed institution's shareholders or even subordinated debt-holders? Third, the European Banking Authority proposal pursues two objectives at the same time: European consistency and integration on the one hand, and the creation of a new post-crisis financial regulation on the other. Although they are not incompatible, there is a risk that, as the European economies emerge from the crisis, the first objective ends up dominating the second, and regulatory reform is postponed until the next crisis.

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[1] For an example using GDP, see Repullo, R., Saurina, J. and Trucharte, C. (2009), 'Mitigating the Procyclicality of Basel II,' in M. Dewatripont, X. Freixas and R. Portes (eds), *Macroeconomic Stability and Financial Regulation*, CEPR and VoxEU.
[2] See, for example, Kashyap, A., Rajan, R.G. and Stein, J.C. (2008), 'Rethinking Capital Regulation,' mimeo.

If you have any questions regarding the issues raised in this article, please contact the editor,
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