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State aid and the banking crisis

In responding to the global financial crisis, Neelie Kroes, EU Commissioner for Competition, has explained that she sees competition rules as 'part of the solution', not part of the problem. But what approach to competition should the Commission take? Are all the banking interventions state aid? And what can the financial sector expect from interventions once the dust has settled and authorities turn to examining whether crisis measures should be tied to far-reaching restructuring or asset liquidation plans?

One of the central questions in banking regulation in the last 100 years has been the optimal trade-off between competition and systemic risk. In the last ten years or so, the pendulum has swung towards promoting competition, with a range of inquiries into the banking markets in Member States, and at an EU level measures to promote cross-border integration, together with sector inquiries into payment cards, retail banking, and business insurance. The systemic risk issue was relatively in the background, perhaps because there was more confidence in competition and liberalisation, and in the capital adequacy framework for ensuring financial stability.

Now the issue of systemic risk has come to the fore again with a vengeance, and the merger and state aid rules are being stretched to the limit. European governments have reportedly pledged at least €1,873 billion to shore up and part-nationalise the financial sector (see Table 1).[1] The provision under Article 87(3)(b) of the EC Treaty to allow state aid when it serves 'to remedy a serious disturbance in the economy of a Member State' is now in operation for only the second time in the EU's history.[2]

When the most immediate crisis abates, however, the debate is likely to shift to ensuring that in the aftermath of intervention there remains a level playing field within the financial sector. For example, have all recapitalisations been carried out on comparable, market terms? What price is being paid for access to emergency funds? Has access been on non-discriminatory terms?

These are matters of concern to both competition authorities and financial regulators, and within the wider context the state aid issue is a key element to ensuring a level playing field post-crisis.

Are all the interventions state aid?

Broadly, there have been four main types of intervention: guarantees of liabilities, recapitalisation schemes, nationalisation, and central bank liquidity assistance. In specific guidance issued earlier this month, the European Commission stated that 'general measures open to all comparable market players' on equal terms are likely to be outside the scope of the state aid rules.[3] Therefore, state interventions in banks either:

– do not constitute state aid, which is most likely to be the case for central bank liquidity assistance, deposit

Table 1 Selected state interventions in the European and US financial sector

	Amount[1]	Type of intervention
France	€320 billion + €40 billion	Guarantee bank lending for €320 billion + €40 billion available for recapitalisation
Germany	€400 billion + €100 billion	Bank guarantees for €400 billion + €100 billion available for recapitalisation
The Netherlands	€200 billion + €30 billion	Bank guarantees for €200 billion + €30 billion available for recapitalisation
UK	€322 billion + €129 billion + €64 billion	Guarantee new debt issued for €322 billion + €129 billion available for swap of illiquid assets + €64 billion available for capital injection
USA	€530 billion	Rescue package, including recapitalisation and troubled bank assets purchase

Note: [1] Guarantees of debt are only contingent liabilities, whereas recapitalisations require an up-front call on state resources. Hence the actual amounts that will be transferred to banks by governments are unlikely to coincide with these figures.
Source: Government websites and *Financial Times* (2008), 'Government Interventions', updated October 17th.

guarantee schemes, and interventions that satisfy the Market Economy Investor test because they are made on market terms; or

– do constitute state aid, which is most likely to be the case for guarantees of liabilities and recapitalisation schemes, when they are selective in their support and are aimed at rescuing otherwise insolvent banks. Under 'normal' conditions this type of support is classed as rescue aid for the first six months, and qualifies as restructuring aid if it persists for longer. Usually, restructuring aid must be accompanied by a plan for restructuring to solve the problem that led to insolvency.

The implication is that by no means all the recent banking measures would be considered state aid. To the extent that guarantees or capital injections are carried out at market terms, the degree of state support is correspondingly reduced.[4] For example, the UK government will receive a coupon of 12% on its preference shares as part of the recapitalisation programme.[5] Similarly, where interventions do not discriminate between financial institutions, the effect on the conditions of competition would be smaller, and the concern over distortive state aid reduced.

As regards nationalisation, the Commission has concluded (at least in the case of Northern Rock) that it does not involve state aid elements under Article 87(1) to the extent that the shareholders are compensated only on the basis of the value of the company without any state support. Nonetheless, nationalisations could still involve an element of state aid—for Northern Rock, the Commission has stated that the commitment of HM Treasury to the Financial Services Authority to ensure Northern Rock's capital adequacy could constitute additional restructuring aid.[6]

The Commission's new guidance (see box below) explains that the new rules are based on the principles underpinning the existing Rescue and Restructuring Guidelines.[7] It has made clear that the emergency measures taken with respect to individual bank guarantees (especially when a guarantee is triggered) and recapitalisation are to be followed up by a restructuring plan to be separately examined by the Commission, taking account of the difference between support provided to what the Commission describes as fundamentally solvent banks (which might require no restructuring) and banks suffering from structural solvency problems linked to their business model (which are likely candidates for restructuring):[8]

> a guarantee scheme needs to be accompanied, in due course, by necessary adjustment measures for the sector as a whole and/or by the restructuring or liquidation of individual beneficiaries, in particular for those for which the guarantee has to be drawn upon …
> (p. 7, para 29)

> the requirement for recapitalisation as an emergency measure to support the financial institution through the crisis [is] to be followed up by a restructuring plan for the beneficiary to be separately examined by the Commission.
> (p. 9, para 35)

The timing of this follow-up to the emergency measures will depend on how long the emergency lasts (the various schemes must be reviewed every six months), but the Commission's long-term response to restructuring plans could in principle be quite different from its response to the short-term evaluation of emergency measures. Virtually all banks will benefit in some way from the emergency measures, but the set of banks subject to the restructuring aid process will be

The Commission's approach to competition set out in the guidance issued this month

The Commission's guidance sets out the main criteria for ensuring that measures minimise negative effects on competition.

- **Non-discriminatory access in order to protect the functioning of the Single Market by making sure that eligibility for a support scheme is not based on nationality**
- **State commitments to be limited in time in such a way that it is ensured that support can be provided as long as it is necessary to cope with the current turmoil in financial markets but will be reviewed and adjusted or terminated as soon as improved market conditions so permit**
- **State support to be clearly defined and limited in scope to what is necessary to address the acute crisis in financial markets while excluding unjustified benefits for shareholders of financial institutions at the taxpayer's expense**
- **An appropriate contribution of the private sector by way of an adequate remuneration for the introduction of general support schemes (such as a guarantee scheme) and the coverage by the private sector of at least a significant part of the cost of assistance granted**
- **Sufficient behavioural rules for beneficiaries that prevent an abuse of state support, like for example expansion and aggressive market strategies on the back of a state guarantee**
- **An appropriate follow-up by structural adjustment measures for the financial sector as a whole and/or by restructuring individual financial institutions that had to rely on state intervention.**

Source: European Commission (2008), 'State Aid: Commission Gives Guidance to Member States on Measures for Banks in Crisis', press release, October 13th.

more limited. This makes it relevant to return to the three cumulative criteria that must normally be met for aid to be acceptable as restructuring aid:

- the presence of a plan that will restore long-term viability;
- the aid constitutes the minimum amount of aid necessary;
- undue distortions to competition are avoided.

To see how this assessment will work, albeit in the context of a global financial crisis, it is instructive to look at previous Commission practice (see box below).

What economic principles are relevant?

First is the protection of economic welfare and efficiency. Consistent with the Commission's State Aid Action Plan, this entails taking a 'balancing test' approach to the positive impact of aid through increased stability or reduced harm to depositors, as set against the negative effect on the conditions of competition in the market.[9] Empirical studies point at the cost of a bank crisis ranging from 5% to 20% of annual GDP.[10] As such, it is difficult to see how aid that substantially solves a banking crisis, while containing some measures to prevent distortion to competition, would not pass this balancing test.

Second are principles of competition that allow the Commission to judge whether a measure is designed to minimise effects on competition. The recent guidance summarises the approach that the Commission intends to take. This is based on well-established principles such as ensuring that aid is non-discriminatory (eg, eligibility not based on nationality), is limited in time and scope to the minimum amount necessary, is followed by restructuring, and is not used to fuel expansionary strategies. There is not yet guidance on merger control in the presence of state interventions, or on the relationship between state aid control and the regulation of financial services, or between state aid control and sector inquiries. The interactions between these elements will need to be managed in due course in the interest of good regulation.

Precedents for state aid to banks

In 2002 Germany agreed with the Commission to abolish certain state guarantees for Landesbanken and savings banks, following a transition period.[1] Similarly, state aid cases involving Sachsen LB (June 2008),[2] BAWAG-PSK (June 2007), and Bankgesellschaft Berlin (BGB) AG (February 2004) were concluded prior to the application of Article 87(3)(b), and offer a guide to the Commission's thinking on individual bank restructurings.

- **In Sachsen LB, according to the Commission the bank's difficulties related to being 'caught in the maelstrom of the still ongoing US subprime crisis'. The Commission emphasised that the sale of Sachsen LB to LBBW (Landesbank Baden-Württemberg) was 'key to solving the difficulties', and commented that 'the Commission recognises that the old owners of the bank and the management are not involved any more in the activities of Sachsen LB, which provides a valuable signal against moral hazard.' The sale of a troubled bank to a more successful one also naturally helps with the Commission's 'one time, last time' policy of prohibiting repeated government interventions.[3] The Commission noted as valid compensatory measures the complete closure or divestiture of the bank's structured finance activities in Sachsen LB Europe and East Merchant GmbH, plus the abandonment of proprietary trading and international real estate activities. Until summer 2007, Sachsen LB Europe was the main source of profits for the Sachsen LB group.[4]**
- **In BAWAG-PSK the Commission again saw the sale of the troubled bank to a new investor as a key aspect of the restructuring (it was sold to a consortium led by a US private equity group): 'The transfer of BAWAG-PSK as a whole under the control of a private investor is regarded by the Commission as a central element for solving the difficulties of the past and enabling positive economic development for the Bank.'[5]**
- **In BGB the Commission required substantial cut-backs in the bank's activities, with the effect that it expected the bank's market share in certain segments to be reduced by one-third.[6] The restructuring plan did not include the sale of the bank, but did require the sale of the bank's real estate services business, the sale of retail banking businesses (including Berliner Bank), the closure of branches, customer centres and capital markets offices, withdrawal from some lines of business, and reduction measures in several divisions, including staff reductions of 50%.**

Notes: [1] European Commission (2002), 'Germany Agrees on the Implementation of the Understanding with the Commission on State Guarantees for Landesbanken and Savings Banks', press release, IP/02/343, February 28th. [2] European Commission (2008), 'Commission Decision of 4 June 2008 on State Aid Implemented by Germany for Sachsen LB', C(2008) 2269 final, June 4th. [3] European Commission (2004), 'Communication from the Commission: Community: Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty', (2004/C 244/02), October 1st, para 5. [4] European Commission (2008), 'Commission Decision of 4 June 2008 on State Aid Implemented by Germany for Sachsen LB', C(2008) 2269 final, June 4th, para 121.[5] European Commission (2007), 'Commission Decision of 27.VI.2007 on State Aid n° C 50/2006 (ex NN 68/2006, CP 102/2006) Implemented by Austria for BAWAG-PSK', June 2007, para 175. [6] European Commission (2005), 'Commission Decision of 18 February 2004 on Restructuring Aid Implemented by Germany for Bankgesellschaft Berlin AG (notified under document number C(2004) 327), May 4th, para 302.

More controversial from a competition perspective are those elements of the Commission's guidance that involve limits on market shares, restrictions on seeking new business, or the prevention of aggressive market strategies.[11] While in individual cases these measures may be the only practical course to minimise distortions to competition, if such behavioural measures were applied to a large part of the financial sector, this may dampen competition while the banks are recipients of state aid.

The Commission will therefore need to consider the systemic effects of compensatory measures, as well as their appropriateness in individual cases. Where possible, it would be preferable that the aid itself were restricted, rather than the behaviour of banks, since there is a cost to competition in setting a climate in which many banks are timid in competing for new business.

What will the Commission focus on?

In assessing restructuring plans the Commission will bear in mind the nature of market failures in the banking sector (eg, systemic loss of confidence, misalignment of incentives). This may lead it to question and challenge the rationale behind some strategic and operational decisions, and potentially demand that restructuring plans involve a greater de-risking of a bank's business model.

Throughout this process, the Commission will face a difficult issue: how to distinguish, ex post, between solvent banks that were victims of a liquidity crunch and failing banks that were being dragged under by both their own risky behaviour and the liquidity crunch. As the Commission has set out, the former should not undergo restructuring, and the latter should. How to tell the difference? This is a complex task, and a (non-exhaustive) list of relevant indicators could include:

- credit rating before the liquidity problems became significant;
- short-term vs long-term liabilities on the balance sheet;
- Tier One capital ratios;
- exposure to sub-prime lending;
- customer deposits as a proportion of the funding base.

The fundamental issue is to distinguish structural insolvency from liquidity-induced difficulties. A possible screening tool would be to prioritise banks about which concerns were raised before liquidity dried up. As such, the Commission may be less concerned about restructuring banks that did not look unhealthy before summer 2008.

Conclusion

Systemic risk is an overriding concern and priority, but as the regulatory pendulum swings towards that concern, and competition/state aid rules are stretched to cope with the financial crisis, it is important not to lose sight of the useful lessons that have been learned in the last ten years about where and how competition in the banking sector can actually work.

If financial innovation coupled with light-touch regulation led to a profitable but inappropriate risk–reward trade-off (eg, it is now generally accepted that incentives were misaligned in mortgage sales),[12] it is natural that in competitive markets banks would pursue that profitable trade-off. It is, however, not obvious why non-competing banks would systematically avoid pursuing the same trade-off. It may therefore be right to recognise where incentives were misaligned and to focus on failings of financial regulation, as well as competition per se.

From an economic perspective, less competition leads to higher prices and high profits, which could help achieve more solvent banking institutions. On the other hand, less competition is normally associated with less choice for consumers, less innovation, less efficiency, and possibly worse management. Healthy competition, with correct incentives provided by financial regulation, may deliver long-run stability at the (not inconsiderable) price of market exit by an inefficient bank. As such, the approach to state aid and restructuring as the financial crisis abates needs to recognise the value of ensuring a level playing field in the financial sector—for example, by ensuring that access to state capital is on symmetric, market-based terms.

In the long run, if competition were allowed to wither, this could not only have negative consequences for consumers in terms of pricing, but could also remove the market dynamic that, albeit imperfectly, can serve long-term financial stability by separating the weak from the strong.

[1] *Financial Times* (2008), 'Europe's €1,873bn Bail-out Boost', October 14th.
[2] The first application of Article 87(3)(b) was in relation to a budgetary imbalance in Greece in the 1980s.
[3] European Commission (2008), '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', October 13th, para 51.
[4] This is difficult to assess in practice. The very reason for state intervention in this context is that there is no 'active' market for the provision of liquidity or capital at that point in time. In other words, it is difficult to assess what a market investor would have done if the precise reason for the intervention is that funds could not be obtained from the market. In the case of guarantees, the amount of state aid is especially uncertain, because even if the guarantee is not ultimately drawn upon, it has had some value in the interim—more precisely, the value is the expected drawdown at the point the guarantee was given, which is difficult to quantify.
[5] Royal Bank of Scotland (2008), 'Royal Bank of Scotland Group PLC: Capital Raising', press release, October 13th.
[6] European Commission (2008), 'State aid C 14/08 (ex NN 1/08): Restructuring aid to Northern Rock', Invitation to submit comments pursuant to Article 88(2) of the EC Treaty, (2008/C 135/06), June 3rd, para 9.
[7] European Commission (2008), 'State aid: Commission gives guidance to Member States on measures for banks in crisis', press release, October 13th.
[8] European Commission (2008), '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', October 13th, paras. 30 and 35.
[9] European Commission (2005), 'State Aid Action Plan: Less and Better Targeted State Aid: A Roadmap for State Aid Reform 2005–2009', consultation document, June 7th, para 11.
[10] Hoggarth, G., Reis, R. and Saporta, V. (2002), 'Costs of Banking System Instability: Some Empirical Evidence', *Journal of Banking & Finance*, **26**:5, pp. 825–55; Bordo, M., Eichengreen, B., Klingebiel, D., and Martinez-Peria, M. (2001), 'Is the Crisis Problem Growing more Severe?', *Economic Policy*, **16**:32, pp. 51–82.
[11] European Commission (2008), 'Communication from the Commission: The application of State Aid rRules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis', October 13th, para 27.
[12] In an 'inappropriate' risk–reward trade-off, there is a significant wedge between private cost and social cost.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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