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Agenda

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The financial crisis of 2014? Unwinding state aid without unwinding the economy

Uniquely in Europe, state aid policy has been used in the financial crisis to control the flow of public funds to the banking sector. For the next few years, state aid decisions will determine the timetable for aid to be withdrawn and for market principles to be restored. What lessons does the crisis provide for future state aid policy in banking? Can policy-makers put competition first? Can they take a tough approach without provoking a further crisis? And how should the difficult economic trade-offs be managed?

The challenging environment for banks in 2008 and 2009 has resulted in an unprecedented and difficult environment for European Commission state aid policy. National governments have taken a wide range of measures, including direct state aid to banks, in response to the extreme combination of asset write-downs, decreased liquidity in the wholesale funding markets, and the loss of consumer confidence. The measures taken by national governments in response to these challenges are widely understood to have played an important role in avoiding the meltdown of the financial markets, in restoring confidence (in both these markets and the wider economy), and in supporting the flow of credit to the real economy. This article focuses on two aspects of state aid policy.

- **Lessons from the past**: the unavoidable economic trade-offs that have been faced to date, in terms of helping banks while minimising distortions to competition in the banking sector.

- **Lessons for the future**: the trade-offs that might be encountered in the next five years, as a wide-ranging set of aid measures are unwound.

Before discussing these issues, it is relevant to examine the economic rationale for state aid to banks, and how this is reflected in EC state aid policy.

The economic rationale for state aid to banks

Member States have introduced a range of state aid measures intended to prevent the collapse of banks causing serious problems for the wider economy.

- First, governments supported the overall financial system. This support included, for example, the provision of exceptional liquidity facilities by the European Central Bank with the goal of preventing shortages of liquidity. Although such measures clearly benefit the banking sector (as, in general, cheaper capital means higher profits, and some institutions avoided failure), they do not generally conflict with state aid policy as they are not exclusive to any player and hence do not distort the level playing field between banks.

- Second, governments recapitalised viable banks that, due to closed capital markets and informational asymmetries,[1] could not raise capital at a reasonable price. To achieve this, governments provided Tier 1 capital,[2] and temporarily or permanently acquired banks' assets. From the state aid perspective, such interventions are justified as they seek to remedy market failures, which in this case relate to inefficiently functioning capital markets. The main consideration here is whether, in such cases, those banks in receipt of state aid benefit relative to non-aided banks due to the potentially lower price of state capital; hence, the price of any state support is key to minimising competition distortions.

- Third, governments granted aid to some fundamentally non-viable banks—ie, banks that could not cover their losses over the business cycle—which were at risk of failing. From the state aid perspective, support for such banks could have a significant impact on market structure and competition, and has fewer grounds for justification on the basis of remedying market failures in banking.

This article has benefitted from discussions during the Oxera Economics Council meeting in September 2009. A more detailed version will appear in the first issue of the *Journal of European Competition Law & Practice*, to be published by Oxford University Press.

While saving all significant institutions may have been synonymous with saving the financial system *during the crisis*, this is no longer true after the crisis. Hence, aid to non-viable banks may need to be used to efficiently restructure these banks and be accompanied by measures aimed at limiting distortions to competition, or ultimately to liquidate such banks in an orderly fashion.

European Commission policy

As well as seeking to reflect the distinction between crisis aid to banks and normal state aid policy, the European Commission has tried to capture the above distinctions within the banking sector through a series of crisis-specific Communications introduced to assess state aid granted to financial institutions.[3] For example, the Commission recognised that the severity of the crisis justified the granting of aid under Article 87(3)(b) of the EC Treaty, which allows aid 'to remedy a serious disturbance in the economy of a Member State'. It also set out a framework for the provision of public guarantees, recapitalisation measures, and impaired asset relief, whether granted by Member States to individual banks or as part of a wider national scheme.

The Commission recognises that, in current circumstances, healthy banks as well as troubled banks can be affected. It therefore establishes that healthy banks (termed 'fundamentally sound') do not need to undergo such extensive restructuring, or to pay as much (in terms of fees to the state or interest rates on loans) for the aid received.

While recognising some of the distinctions of the current crisis, it should nonetheless be noted that the Commission's Communications are based on the same three general principles set out in the 2004 'Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty' (the 'R&R guidelines').[4] These principles require the following.

- **Restoration of long-term viability**—the aid should lead to restoration of the viability of the beneficiary in the longer term without state aid.

- **Avoidance of undue distortions to competition**—the aid received should be accompanied, to the extent possible, by measures to minimise distortions to competition.

- **Ensuring appropriate burden-sharing**—the aid should be limited to the minimum required and accompanied by adequate burden-sharing.

In implementing state aid policy according to these objectives, it is almost inevitable that conflicts will arise—between the objectives themselves and between recipient institutions which, as noted above, may have been fundamentally sound or not. The following section provides a few observations on conflicts that have arisen in case practice thus far.

Lessons from the crisis: economic trade-offs

A bank that fails, regardless of whether or not it was previously sound, has the potential to create both significant disruption to the economy and serious difficulties for other banks, including its direct competitors. These difficulties may affect competitors directly—if, for example, these rival banks are creditors of the failed bank—or indirectly—if, for example, the failing bank's customers are adversely affected by the impact of that bank's failure on the wider economy. Thus, in the case of the failure of a significant bank, it would be less straightforward to argue that competitors would have benefited from the removal of their rival from the market, which would be the case for 'traditional' failing firms.

This argument could imply that banks may be better off with their systemically important rivals remaining in the market, regardless of whether these rivals are efficient. If this were the case, for as long as these banks cannot be wound up without serious negative impacts, there would seem to be little merit in restricting state aid to banks on the basis of short-run competitive distortions. The benefit of saving the economy and the banking system would outweigh the risk of distorting the market in the supply of banking services.

Yet a number of recent Commission decisions include substantial 'remedies' designed to minimise distortions to competition. The Commission's logic would appear to be that, even if there is an argument for placing less emphasis on distortions to competition in the short run, in the long run a number of competitive distortions would arise, which must take some priority over other objectives.

Lending commitments

The trade-off between short-run stability and long-run healthy competition is not the only tension. Some aided banks face lending commitments imposed by Member States, which would tend to preserve or expand their market share, when, from a state aid perspective, the aided banks ought to restrict their growth or even shrink in size. What should a bank do if the requirements of the Commission are in conflict with the commitments made to its national government as part of the conditions for receiving aid in the first place? For example, certain banks have a commitment to lend to small and medium-sized enterprises (SMEs) in their domestic markets—markets in which they already have a high and static market share, with little evidence of entry. Here, any state aid remedies which restrict the growth of the aided bank are in conflict with the commitment of the bank to the Member State.

It may be that, in practice, state aid policy cannot reconcile these conflicts, and must accept as short-term priorities—in the following order—the stability of the financial system, the viability of an individual bank, and the minimisation of distortions to competition. The ultimate prioritisation will be evident from the Commission's forthcoming decisions. Looking to the future, priorities will tend to change as risks to system stability diminish, and competition concerns move to the top of the list.

Lessons for the future: the next five years

As the crisis fades, attention will turn to the future of public intervention in the banking sector, and the economics of how the unwinding process will play out. The timing, pace and sequence of the exit strategy is not predetermined, and merits further debate and scrutiny.

Timing

Decisions being made now with regard to state aid approval have direct consequences for exit strategy, and determine market expectations going forward. For example, the Commission's Restructuring Communication has set a time frame of a maximum of five years for restructuring to be completed.[5] Within this time frame, all banks in receipt of state aid should have returned to 'long-term viability', without any further need for aid.

Government guarantee schemes also have time limits attached, typically shorter than five years. These deadlines start to coordinate the timing of the withdrawal of state support, insofar as the time constraints will bind. Similarly, where state aid decisions in 2008–09 have set a timetable for the repayment of aid, or for step-ups in the rate of remuneration for state aid (ie, higher interest payments applicable on the aid received), this also helps set the pattern of, and expectations for, banks' exit strategies.

Coordination across Europe—in terms of when aided banks face step-ups—would tend to lead to a concentration of private capital-raising in a relatively short space of time, which could distort capital markets. This could also push up banks' prices to their customers as banks try to earn their way out of state support, thereby squeezing the availability of credit in the real economy.

Coordinated disengagement

The process of unwinding and disengagement may need to be tailored to the individual circumstances of different Member States, since a coordinated process would be too fast for some banks and too slow for others. The unwinding of short-term liquidity and confidence-building measures, such as some guarantee schemes, might occur first, while the disposal of equity and impaired assets is likely to take much longer. The optimal strategy for avoiding market disruption, returning assets to the private sector, and maximising recovery rates will tend to vary across Europe, and inevitably some EU countries will reach a point of stability and confidence in the financial sector before others.

From the state aid perspective, however, a tailored disengagement may be sub-optimal—it raises the prospect that some EU banks could lose their state guarantees, as well as their state capital and asset protection schemes, before others. This would seem to be fundamentally contrary to the objectives of state aid control, which are to ensure a level playing field and avoid 'beggar-thy-neighbour' interventions whereby state protection in one country can lead to problems for non-protected banks in another.

Tailored disengagement will therefore need to be carefully managed to avoid further cross-border distortions within the single market. Pursued unilaterally, tailored disengagement could harm collective interests. At the same time, pressure to disengage unilaterally will come from non-aided banks, which will not want to see their domestic competitors endlessly propped up.

A gradual process

The two problems identified—a 'crunch point' where all support is withdrawn simultaneously (via time limits which bind or step-up clauses), and a beggar-thy-neighbour problem where support is withdrawn in some EU countries but not others—are difficult to reconcile. Either disengagement can happen according to individual circumstances at different points in time or it could occur more symmetrically. Staggered removal of guarantees and other measures could create *cross-country* distortions, whereas simultaneous removal could expose vulnerabilities in financial stability and delay the process of disengagement (with the result that distortions within national markets are prolonged).

From an economic perspective, state support should be withdrawn gradually and with a degree of international coordination. As market conditions improve and step-up clauses kick in, the value of state protection ought to fall such that, even if disengagement is partly staggered, the distortion to competition will remain very limited. This disengagement process should naturally recognise that, post-crisis, the rescue of individual banks might not be the same as saving the system.

Hence, part of the solution might be to force non-viable banks to liquidate, depending on local market conditions.

The timing of this would also be contingent on policy initiatives designed to make it easier to wind up financial institutions without contagion impacts; in this respect current differences in European cross-border bankruptcy legislation may not be helpful, to the extent that they impede the winding-up of troubled institutions.

Decisions on the extent to which state aid policy will permit the implementation of tailored solutions according to local market conditions cannot be postponed for very long, making the debate on the phasing-out of state aid policy measures a key priority for 2010.

The Oxera Economics Council

The Oxera Economics Council convened in Brussels for its fourth meeting on September 18th 2009, and focused on policy intervention in the EU banking sector. Chaired by Mathias Dewatripont of Université Libre de Bruxelles, questions discussed included the following.

- **Is the European Commission's state aid framework appropriate for dealing with banks in the current financial crisis?**
- **Should state aid policy be concerned with the wider structural problems in the banking sector, and should it impose restructuring remedies to address these?**
- **Is there a trade-off between competition and financial stability?**
- **What does 'too big to fail' mean, in a world in which banks of all sizes are being bailed out?**

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[1] Informational asymmetries can result in markets in which financially healthy and unhealthy banks cannot be distinguished. In extreme cases, informational asymmetries can result in the complete closure of markets.
[2] Tier 1 capital is the highest form of capital held by a bank, and is regarded as broadly equivalent to equity. This means that this capital must be capable of absorbing losses to the extent that the bank concerned is able to continue trading, even if it incurs losses up to the value of that capital.
[3] European Commission (2008), 'The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis', the 'Banking Communication', October 25th, para 2.
[4] European Commission (2004), 'Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty', October 1st.
[5] European Commission (2009), 'The Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis Under the State Aid Rules', the 'Restructuring Communication', August 19th, para 15.

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

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- **a new dawn for nuclear power? Where the risks remain**
- **boost for broadband? Is there a case for government intervention?**
- **the (potentially) topsy-turvy world of energy regulation** ***Tim Tutton, Senior Adviser, Oxera***

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