Linklaters

When in a hole stop digging.

The Commission’s application of the Principles of Restructuring Aid to Banks during the Financial Crisis

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Overview.

> The Financial Crisis to date
> The Commission’s response: a policy in four acts
> Application of the restructuring aid principles in the widget industry
> Application of the restructing aid principles to the banking industry
> The impact of the Commission’s remedies in the banking sector
> Two lessons to be learned.

The financial crisis to date.

The causes…

> abundance of cheap money
> increasing reliance on wholesale funding
> increasingly risky lending policy
> false assessment and lack of transparency of risks (securitisation)

The effects. . .

> collapse of prices in the asset markets (in particular the housing markets)
> breakdown of inter-bank trust, leading to the dramatic reduction in credit availability
> spreading exposure to risky lending practices to banks in current account surplus countries

The Commission response (I).

Phase I (2007 – Sep 2008)

- *Northern Rock (I), Sachsen LB, IKB*
- idiosyncratic flaws in the banks' business models
- rejection of Article 87(3)(b)
- standard application of the R&R Guidelines

Phase II (Oct 2008 – Feb 2009)

- Lehman Brothers and the threat of a financial meltdown
- focus on safeguarding the stability of the financial system: Article 87(3)(b)
- the rescue phase: approval of 25 aid schemes and a number of ad hoc cases
- distinction between fundamentally sound and unsound banks
- *Banking Communication* and *Recapitalisation Guidelines*
- *Fortis*

The Commission response (II).

Phase III (Feb 2009 – July 2009)

> from rescue to restructuring aid

> second (and third) helpings: LBG, RBS, KBC, ING…

> standard application of the R&R Guidelines

> the pendulum swings back: renewed focus on R&R principles

> *Impaired Asset Guidelines*

> *WestLB* and *Commerzbank*

Phase IV (July 2009 onwards)

> R&R principles on steroids

> state aid control as industrial policy

> compensatory measures inspired by merger control “to enable entry or expansion of competitors”

> *The Financial Crisis Restructuring Guidelines*

> *Northern Rock (II), ING* and *LBG*

Restructuring aid principles in the widget industry.

General assumptions

> significant overcapacity in the market

> inefficient aid recipient and the problems due to idiosyncratic flaws in commercial policy

> high risk that circumstances are likely to arise again

Policy Implications

> weak social policy objectives of restructuring aid

> significant competition concerns: moral hazard, predation, distortion of incentives, inefficient cost structures

> simple "per se" rule appropriate in the circumstances

Impact of Remedies

> remedies restricting the activities of the aid recipient address moral hazard and distortion of incentives but do not significantly harm (ex post) competition

Characteristics of the banking industry.

> Key characteristics of the banking industry during the financial crisis…

  > there is no “overcapacity” in the banking market; to the contrary, the financial crisis has led to a “credit crunch”

  > the banking industry is crucial for the performance of the wider economy

  > substantial degree of systemic risk due to role of confidence and the interconnectedness between the financial institutions

  > financial crises of this magnitude are (mercifully) rare events

> … do not correspond to the general assumptions for the restructuring principles in the widget industry.

Policy Implications (I).

> Governments intervention on a massive scale

> Intervention seems to have prevented the total collapse of the financial system and reduced the likelihood of a prolonged and deep economic recession

> Social benefits of state aid to the banking sector during the financial crisis are significant

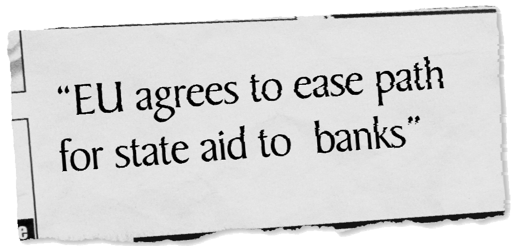
  > due to the systemic risks, include benefits to non-aided financial institutions

  > include benefits to sectors of the "real economy"

> Commission has recognised the primary importance of safeguarding financial stability.

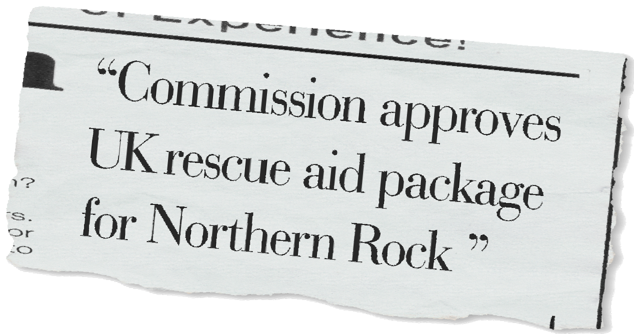
Policy Implications (II).

- Commission's concern about potential for moral hazard:
  - *"the current scale of the public intervention necessary for financial stability and the possible limits to normal burden sharing are bound to create even greater moral hazard that needs to be properly corrected to prevent perverse incentives and excessively risky behaviour to reoccur in the future"*
- Article 87(3)(b) only applies in the context of a severe financial crisis which is exceedingly rare
- The Financial Crisis has severely affected shareholders, bondholders, management and employees
- Addressing moral hazard requires clear distinction between fundamentally sound banks and other banks
- Other policy instruments are more effective to prevent excessive risk taking.



Policy Implications (III).

- Harm to competitors
  - “*banks across the Community have been hit by the crisis to a very varying degree and State aid to rescue and restructure banks may harm the position of banks that have remained fundamentally sound, with possible negative effects for financial stability.*”
- Harm may incur in two ways
  - through “crowding out”
  - through distortions of competition
- Harm through crowding out is unlikely due to severe under capacity resulting from the credit crunch
- Harm through distortions of incentives raises some of the same issues as moral hazard.



Impact of remedies (I).

> Balance sheet reductions and behavioral constraints
  > reductions of balance sheets in the range of 40-50%
  > restriction on growth, pricing, dividends, acquisitions
> Remedies aimed at reducing the presence of the aid recipient bank
> Impact
  > worsening of credit crunch
  > restriction of (ex post) competition
> Not clear what concerns the remedies are designed to address.

Impact of remedies (II).

> Divestments of non-core assets
  > divestments of non-core activities
  > divestments of activities in non-core countries
> Remedies aimed at getting aid recipient banks to focus on core capabilities
> Impact
  > no direct effect on competition
  > risk of de-Europeanisation of markets
  > risk of fire sales
> Not clear what concerns the remedies are designed to address.

Impact of remedies (III).

- Divestments of core assets
- Remedies aimed at increasing competition through structural changes
- Impact
  - does address competition directly, but not the distortions arising from aid
  - risk of fire sales
  - has a negative impact on non-aided banks
  - problem of maintaining divestment business for up to 5 years.

Lesson 1.

> “First, do no harm”

> Choice of policy instrument

> Issue of complexity

> Three key functions for state aid control

  > act as a gatekeeper for Article 87(3)(b)

  > ensure long term stability

  > ensure adequate remuneration.

Lesson 2.

- > Clarify the policy objective of state aid control
- > Define harm to competition
- > Highlight the difference between harm to competition and harm to competitors
- > Use counterfactuals
- > Develop framework for an effects-based analysis
- > Formulate a theory of harm and support it by facts

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