Competition policy and the crisis – the Commission's approach to banking and beyond.

Commissioner Neelie Kroes (1)

While the crisis has been an extended one and recovery from it uneven, one of the few positive things we can take away from the experience is the general maintenance of competitive markets.

Unlike the Great Depression, and in defiance of many vocal opponents, competition in Europe remain largely unaltered by what are, by comparison, massive crisis policy measures. This is not to say that there are not threats to competition, and nor is it to pretend that financial sector aid especially has had no impact on the affected markets. However, there is strong support for the view that the competition policy architecture needs to be maintained. Supporters of the view that competition breeds competitiveness, and that European consumers and businesses benefit from a level playing field, have effectively won the argument.

Competition policy may not be loved by all governments and competitors, but the need for it to act as the backbone of the EU Single Market remains substantially unchallenged. And so, while we can never drop our defences against protectionism, we can declare that that competition policy and competition enforcers played an important role in avoiding far worse outcomes from this crisis.

Indeed, the case for a continuing level playing field in Europe is stronger than ever. In this article I hope to outline my perspective on why this outcome has been achieved, and discuss in some detail the mechanisms and politics that have been called upon to get us there. Dealing with the crisis, it must also be noted, has been about more than one element of state aid (banking aid) and instead touches upon all aspects of European competition policy enforcement. From the idea of crisis cartels, to failing firms merger applications, to tendencies of many parties to demand that financial-sector aid possibilities be extended to them.

Let me also note that the past two years have been a very challenging time for policymakers. We have had to increase our work, learn many new skills on the job, and quickly develop relationships (for example between competition authorities and central banks) that have not previously existed, and which it is now clear should have existed. These changes have been made in a highly politically pressured environment, the sort that is not normally conducive to lasting and effective policy making.

Together the various European Institutions have done much to increase confidence, deliver stability and generate more economic activity – whether via the direct stimulus of the European Economic Recovery Plan or via new state aid possibilities under the Temporary Framework for State Aid. Specifically, I am pleased to conclude that the Directorate-General for Competition stepped up to the mark as part of wider Commission efforts to minimise the impact of the crisis, even if that meant working round the clock and in temporary offices in shipping containers for large parts of 2008-9.

Early stages of the crisis

My services and I were fortunate – if that is the word – to have been involved from a very early stage in dealing with the crisis. Our first awareness of the problems to come came with the difficulties of Northern Rock and several of the German Landesbanken in 2007. This entrée into the risky behaviours and stubborn defiance of the sector helped us to ready us for massive influx of aid demands that flooded in after the collapse of Lehman Brothers in September 2008.

Knowing that banks in other Member States were likely to face problems at some point, and knowing also that the situation would be quite different from Member State to Member State, we were left with the clear impression that there would need to be common rules and a liberal use of common sense if and when the credit crisis spread.

In September 2008 the crisis not only spread, it rapidly invaded many of the key financial markets, bringing them to a standstill and the financial system to the brink of collapse. Throughout those first weeks after the collapse of Lehman Brothers, the Commission faced great pressure to set aside the competition rules on State aid, in order to allow EU Member States freedom to implement financial sector rescue measures as they saw fit. This scenario, we believed, would be the first step towards repeating a Great Depression. To avoid this fate we set out to argue the case for continued application of not only state aid control but all competition rules. We promoted this as the way to maintain a level playing field in the EU and avoid large scale movements of

(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

funds between Member States by investors in search of the highest level of protection. In other words, we wanted to stop a subsidy war.

A key element of our attempt to mobilise an intellectual and policy consensus around competition enforcement was a conference called for 13 October 2008 in Brussels. Here I set out my belief that competition policy was part of the solution to the crisis, not part of the problem

Calling on examples from across the world and across Europe's 50 years of competition enforcement, I explained how consumers needed us in this crisis and how competition drives total factor productivity growth – the productivity that comes from technical progress and organisational innovation. Giving up on competition was therefore the surest way to waste state aid funds and hurt consumers as they began to hurt from job losses, home foreclosures and the general economic malaise they would likely soon face. Giving up on the single market would cause productivity to fall by an average of 13 percent, and allow companies to raise prices and to restrict output which, in turn, would further deepen the recession.

Above all, I warned that we had to pull together as a European family and rise above the impulse for unilateral responses to what was clearly a shared problem.

The crisis moves into second gear

It is one thing to open up various sectors of the economy to competition in times of economic growth. It is quite another to assume that cheaper flights and phone calls will calm citizens and leaders in a period of great uncertainty. New ideas to help the real economy and new proof of positive action in bank rescues would be needed to keep the trust of Europeans and unlock the paralysis in our financial markets.

In order to assist Member states to take urgent and effective measures to preserve stability and to provide legal certainty, between October 2008 and July 2009 the Commission adopted four Communications indicating how we would apply the State aid rules to government measures to support the financial sector in the context of the current crisis.

Starting with Guidelines on Recapitalisation issued in October 2008, we soon realised what a mammoth task we faced. Setting the price of recapitalising a bank must surely be one of the hardest policy tasks of all. There can be many types of capital, for banks with many different risk profiles. Understanding that risk profile was virtually impossible, especially as the banks themselves clearly misunderstood their own risk profiles. Furthermore, the scheme needed to work for banks not in need of capital but who may have been asked to join industry-wide schemes. Our dialogue with the European Central Bank and Member States were invaluable in this process.

In November attention began to turn to the real economy and, precisely, to saving jobs. The European Economic Recovery Plan launched on 26 November 2008 rested on two pillars:

- a boost to purchasing power which would increase demand and confidence and
- immediate actions to boost long-term competitiveness such as investments in green technology.

Some of the measures in the plan were sure to involve State Aid. My message to Member States was two-fold. In the case of the 26 categories of aid covered by the General Block Exemption Regulation, I borrowed the famous tagline: 'just do it!' For other types of aid, in recognition of the need to maintain a human face to competition policy, we created a Temporary Framework for State Aid that would maximise what Member States could squeeze out of the system without fundamentally altering it.

When our Real Economy communication was delivered on 8 December 2008 its measures were based on Article 87.3(b) and justified due to the exceptional difficulties of raising finance at the time. It took account of the fact that in this next stage of the crisis financially sound banks may have needed state capital not to survive, but to provide enough loans to companies in the rest of the economy. Where state capital was to be provided, we insisted on safeguards:

- That the money go to real economy lending, not bank expansion plans.
- That the money be offered with incentives to encourage banks to end their reliance on state support as quickly as possible.
- That the money be offered in a way that did not wreck the level playing field between Member States.

By December 2008 – even with only around 50 experts dealing with the banking cases - we had built up a good track record. Instead of taking weeks or months, decisions to approve the rescue of troubled banks were delivered in as little as 24 hours in the case of Bradford and Bingley. Cases such as Dexia and Fortis required three-state solutions: complex cross-border solutions for cross-border banks. The solutions ranged from guarantee schemes to asset purchase schemes and individual recapitalisations. In some Member States, notably the UK and Germany, holistic schemes were introduced to cover all potential problems. In all cases the Commission worked with Member States to transform their plans into reality.

We succeeded up to this point because we were flexible and transparent – the only way to gain trust, build new relationships, absorb new thinking and get to the heart of the market conditions confronting us. This precedent has indeed set very high standards for the Competition Directorate-General to live up to in the future, but the pain was worth the gain.

This approach to the crisis also enabled us to see its changing shape – including new demands for further clarity and transparency about how troubled banks would be handled.

In that light, we issued in December 2008 detailed guidance on how the Commission would assess recently approved bank recapitalization rescue schemes, complementing the October 13 guidelines. In particular, the *Recapitalisation Communication* established the principles that the price of capital injections should be linked to the risk profile of a given ban, and that the banks needed a strong incentive to pay back the aid and get off state support.

To address continued uncertainty about the value and location of impaired assets held by banks, the Commission also adopted Communication on the treatment of impaired assets on February 25, 2009. Transparency and Europe-wide cooperation were the key themes of this document. While wishing to make impaired asset measures available, the undoubted complexity of such valuations did eventually mean that relatively few asset measures were approved, bringing the total number of banking aid decisions to more than 70.

It was in February and March that I began stressing that restructurings would necessarily follow the various bank rescues that had been carried out, and that alongside those structural changes there would also need to be cultural changes in the banking sector. If a single phrase summed up my conclusion, it would be that 'business as usual' was no longer an option – a point made even clearer when restructuring decisions were announced from May 2009.

Indeed, the *Restructuring Communication* stipulates that a successful restructuring plan is viewed as one whereby the bank in question can demonstrate strategies to achieve long-term viability under adverse economic conditions. The banks need to undergo rigorous stress tests to prove this. Divestments would nearly always follow in due course to deliver that viability and/or balance out the negative competition impact aid had created; but the Commission is also realistic about finding buyers. Those buyers may or may not be non-aided banks, who separately but rightly want to know what the Commission is doing to protect their right to a level playing field. Taxpayers and national government also want to make sure they are not paying the bills of others.

It is therefore obvious that we need restructurings that deliver banks viable without state support, and not a threat to the system, minimal taxpayer bills, a fair chance for non-aided banks to keep succeeding

Speaking of specific cases, the various problems of the German Landesbanken were plain to see in advance of our first restructuring decisions. Less expected, perhaps, was the tough approach we took to the UK banking sector.

However, when one looks at the numbers it is impossible to disagree with the need for the Commission to act. According to the Bank of England, the UK financial sector has been propped up by more than £1 trillion of government support. The sector has accumulated losses of £250bn since the collapse of Lehman Brothers - far outweighing fresh capital, and is home to the two worst-performing banks in Europe. This has generated a funding gap of £800 billion pounds, a gap between loans and deposits that grew four-fold since 2001. Banks such as the old HBOS pursued loan to deposit ratios of nearly 180%, ratios that were clearly not sustainable and which, thankfully, or no longer even possible because of the failure of the wholesale funding model they relied on.

One merciful consequence of the crisis is a renewed understanding that banks need a strong retail deposit base and to be anchored in the real economy. This was clearly not the case with the former Royal Bank of Scotland business model, which saw RBS tripling its balance sheet in just two years from 2006. At its height, the £2.4 trillion pound balance sheet of RBS made it larger than all but the economies of the United States, Japan, Germany and China. The bank then went on to record the largest trading loss in history, of US$60bn in one year, forcing a Government take-over in order to save it. This bank was not merely too big to fail, it was too big to supervise and operate.

The sheer scale of the bad risks taken by banks such as RBS and the finger-pointing engaged in (publicly and privately) by leading figures in the industry gave me great pause for thought as we undertook banking restructuring negotiations. It served as a constant reminder of the value of applying the Commission's tried and tested state aid rules. And it helped me develop a healthy respect of those like Jan Hommen of ING when he set ING on a "back to basics" strategy.

Of course such initiatives never swayed the Commission as it made objective, tailored decisions on restructurings as quickly as the parties allowed.

But while some have viewed our decisions as too simplistic, I point to cases such as the KBC plan as proof that we are neither the *bancassurance* model or complex cross-border operations. I have never suggested that the finance sector should be only about simple deposits and small loans. But banks do need to offer products and services they actually understand, instead of racking up massive leverage on the back of opaque alphabet soup products. It is not simplistic to hold this view, and when one turns down the self-interested noise of the financial sector and thinks clearly for a moment, it is obvious that this approach enjoys the support of a wide range of economic and public voices.

The Commission can be proud of its work to shape stronger banks out of weak ones, an in giving a fair opportunity for prudent and strong banks to do even better.

Wider regulatory reform and culture change in the financial sector

Mistakes in regulation haunt us – we are often stuck dealing with problems the regulators don't see or can't fix. For me key elements of new regulation must involve greater transparency and better supervision. Self-regulation didn't work.

If there must be a trade-off between liquidity and profits, then liquidity must win. Sensible choices like that are amongst the reasons why most of the world's AA-rated banks now come from Canada and Australia: their more prudent regulatory approaches took better account of the system's long-term needs. And each of these banks remains profitable, despite the different regulation.

What was better understood by regulators and bankers alike in those jurisdictions is that banking is more than an industry - it is also a profession. And in exchange for the freedoms we grant professions, we demand trust and high standards in return. Shirking responsibility and cost is not part of the deal – you simply have to live up to high standards. The world does not owe bankers a living; bankers are not better or smarter than the rest of us. These facts must be remembered in the face of hard lobbying against change.

Other sectors have greatly improved their executive culture to recognise the benefits of competition and the need to operate fairly and transparently. Banking should use the crisis to follow this path,

Beyond banking aid

Beyond the financial sector the Commission consistently maintained that while aid was distributed at the national level it needed to be implemented within a coordinated framework. This horizontal approach works in times of growth and recession. And in the case of the Temporary Framework delivered support measures such as interest rate reductions on loans to finance SME investments.

Non-state aid elements of competition policy have proved well equipped to withstand the crisis. In some cases—such as the Lloyds/HBOS merger in the United Kingdom and the Commerzbank/Dresdner merger in Germany— this is because merger activities do not involve the Commission and are dealt with instead at the national, rather than pan-European, level. Yet robustness and flexibility of the EC Merger Regulation is evidenced by the Commission's ability and willingness to adopt its authorization decision two weeks before the normal deadline in the BNP Paribas/ Fortis case in December 2008. We did not extend such flexibilities to wider considerations, such as employment, because experience clearly shows the EC Merger Regulation is most effective when it is directed to one single objective. Employment concerns need to be addressed through other instruments. We have been equally firm that "crisis cartels" aren't a long-term benefit to anyone – not the companies involved, or consumers – and that consumers must remain protected against the short-term damage that a cartel inflicts on their purchasing power and options. Likewise, allowing a company to abuse a dominant market position is never a good idea.

In short, while the Commission has gone and will continue to go to great lengths to be sympathetic to new ideas and ways of working, its core strategy for recovery has a robust and rigorous competition policy at its heart.

Conclusions

In my time as Competition Commissioner, I met with dozens of bank CEOs and it depressed me. It suggested to me that they were on a long learning curve – and that public policy-makers would have to watch and guide this learning. Why? Quite simply there is no money for a second bail-out and, in any case, we have other parts of the single market to improve – like the online single market. We can't spend the next decade debating whether bankers deserve a different set of rules to the rest of us. So the bottom line is, for competition professionals, for banks, and anyone else involved in these issues: we have to continue to address this crisis together.

That must mean a clear role for competition enforcers as virtually all markets need referees of one kind or another – and none more so than the largest market in the world, the EU. This is a message I have passed repeatedly to forums of all kinds over my five years as Competition Commissioner. In particular, I have stressed that companies that do the right thing have nothing to fear from either our antitrust and