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The current financial crisis and EU Competition Policies

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(*) Disclaimer: the views expressed in this presentation are those of the author and are not necessarily those of the European Commission.

Outline



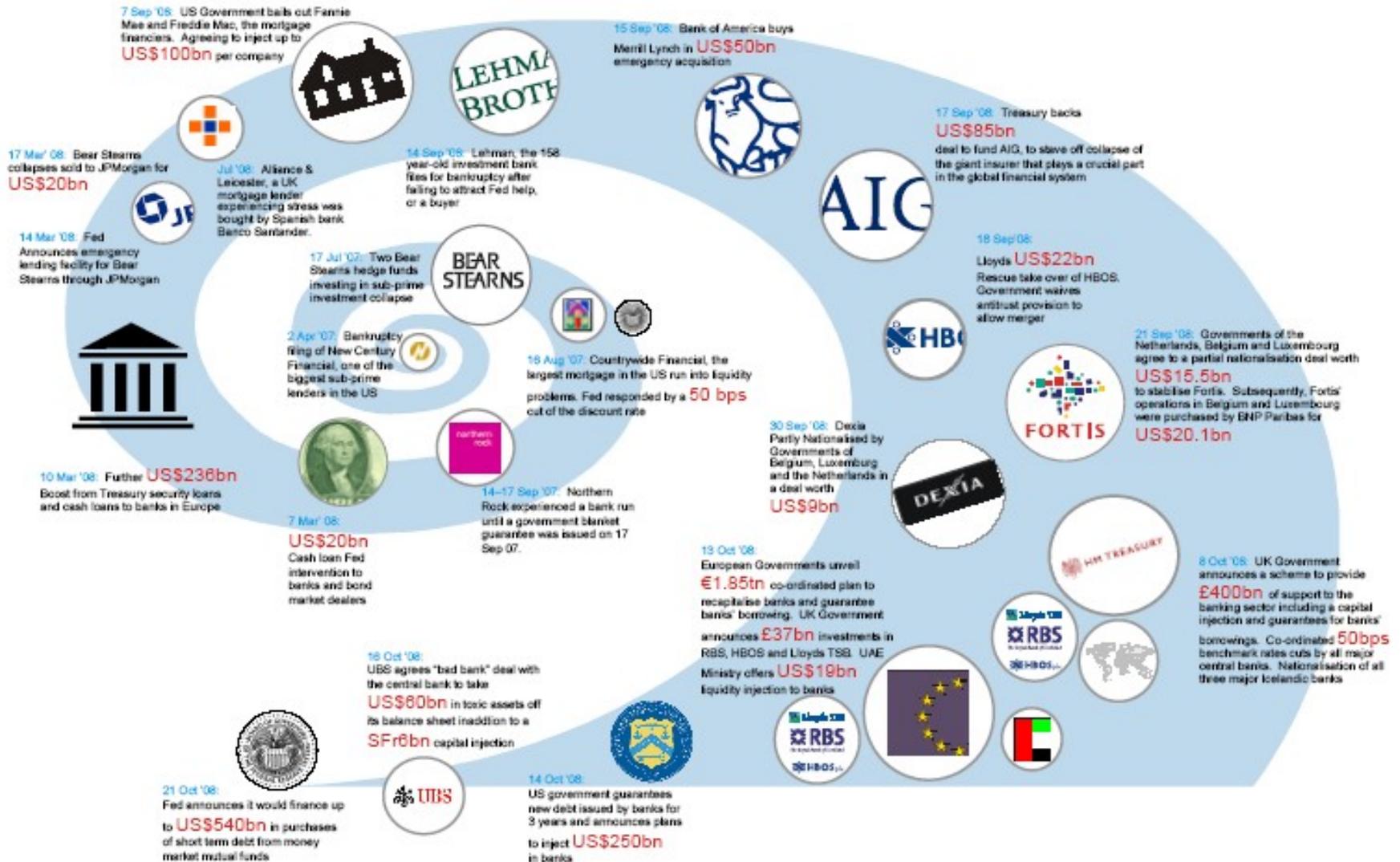
- Objective of competition enforcement
- Taking stock of developments
 - Ex ante guidance
 - Cases
- Next challenge : validate restructuring
 - Ex-ante versus ex-post intervention
 - Business models
 - Regulatory framework

Some prospective



- First series of cases: Summer 2007
 - Northern Rock (UK), Sachsen LB(G), IKB (G), WestLB (G), Roskilde (DK)
- Stepping up of response from Mid-September 2008
 - Lehman Brothers failure
 - Gridlock of interbank market – explicit guarantees
- Consequences:
 - Retail deposit insurance (Council: up to EUR 100 000 per account)
 - Calls for a new legal basis : Article 87 3b): systemic crisis
 - Exemption from the classical legal framework, Rescue/Restructuring assessment
 - New forms of State intervention: Nationwide rescue packages (Denmark/Ireland)

Tsunami of SA cases



Competition enforcement



- Balancing
 - Market failure
 - Distortions of competition
- Market failure
 - Systemic effects from bank failures –an externality such the social cost much exceeds the private cost
 - Crisis of confidence - a coordination failure
- Distortions of competition
 - For the recipient : moral hazard
 - For its competitors : incentives to compete are affected because rents are allocated ex post by the state

Competition enforcement



- Distortions of competition
 - In the product market
 - In the input market (access to funds)
- Across member states
 - Banks compete across national jurisdictions
 - Member states do not internalise effects beyond their own jurisdictions
 - Different ability and willingness to support banks
- Instruments
 - Ex ante guidance
 - Assessment of schemes and individual cases

Ex ante guidance



- Banking communication (oct 2008)
 - General principles
 - Pricing of guarantees (ECB)
- Recapitalisation
 - Distinction between banks in distress because of contagion and banks that are not fundamentally sound
 - Ex ante indicators
 - Pricing of recapitalisation that reflect the instruments, the risk profile, exit incentives
 - Sliding scale for restructuring and reporting requirements

Ex ante guidance



- Impaired asset
 - Asset purchase of guarantees
 - Transparency
 - Incentives to join
 - Asset valuation by independent experts
 - Market value, book value and real economic value
 - Remuneration in accordance with guidance on recapitalisation

State aid for the financial sector – decisions



- 50 decisions so far
 - 24 individual measures, for 20 different banks
 - 26 schemes (5 amendments)
- 4 on-going in-depth investigations
- 12 pending cases

Decisions: Individual cases



■ Early cases: pending restructuring or liquidation plans

- Northern Rock (UK) – opened 2 April 2008, West LB (DE) – opened 1 October 2008, Bradford and Bingley (UK) - 1 October 2008 (No 8 in UK), Hypo Real Estate (DE) - 2 October 2008

■ Recent approved cases outside of schemes

- ING (NL) - 13 November 2008
- Dexia (BE, FR, LUX) – 19 November 2008
- Fortis (BE, LUX, NL) – 19 November/ 3 December 2008 (No 1 BE)
- Aegon (NL) – 27 November 2008
- SNS Real (NL) – 10 December 2008
- Carnegy Investment Bank (SW) – 15 December 2008
- KBC (BE) – 18 December 2008
- Bayern LB (DE) – 18 December
- Nord LB (DE) - 22 December
- IKB (DE) – 22 December 2008
- Anglo Irish Bank (IE) – 14 January 2009
- Kaupthing Bank – (FI) – 21 January 2009
- Parex Banka Latvia (LAT) – 24 November 2008 & 11 February 2009
- Ethias Group (BE) – 12 February 2009

Decisions: Schemes



- Denmark (Guarantee) - 10 October 2008
- Ireland (Guarantee) - 13 October 2008
- United Kingdom - 13 October 2008 (amendment 22 December)
- Germany (Recap) - 27 October 2008 (amendment 19 December)
- Portugal (Guarantee) - 29 October 2008
- Sweden (Guarantee) - 29 October 2008
- France (Guarantee) - 30 October 2008
- Netherlands (Guarantee) - 30 October 2008
- Spain (Assets) - 4 November
- Italy (Guarantee/Recap) - 13 November/23 December
- Finland (Guarantee) - 14 November
- Greece – 19 November
- Latvia (Guarantee) – 22 December
- France (Recap) - 30 October/8 December
- Austria (Recap) – 9 December
- Slovenia (Guarantee) – 12 December
- France (Recap 2) – end of January
- Denmark (Recap) – 3 February
- Sweden (Recap) – 10 February

Implementation



	<u>Capital injection</u>		<u>Guarantees</u>	<u>Impaired asset schemes</u>		Total as % of GDP
	Scheme	Outside scheme		Purchases	Guarantees	
EU total	114 (268)	54	198 (2096)	12,8 (153)	251	22%
Euro area	74 (198)	54	123 (1677)	13 (98)	250	23%
US	181 (191)	61	130 (1068)	40 (1062)	337 (699)	29%

Table entries: actual take-up in bn EUR (total commitment in bn EUR)

Implementation of schemes

- Guarantee: \approx 2.1 trillion EUR committed
- Recap: \approx 0.32 trillion EUR committed
- Asset relief schemes: \approx 0.4 trillion EUR committed

Implementation



- Use of schemes
 - Guarantee: $\approx 9\%$ of total committed
 - Recap: $\approx 50\%$ of total committed
- Incentives for banks ?
 - Remuneration caps ?
 - Pricing ?
- Complementarity between guarantees and recapitalisations
- Substitution between instruments – recapitalisation and impaired asset schemes
- Need for a specific regime ?

Special resolution regimes



- At the time of Lehman's demise, Member States had no special regime for dealing with distressed financial institutions
- Since then, Special Resolution Regimes (SSR) and Prompt Corrective Action (PCA) have been created, but so far, little used.
- SSR and PCA potentially avoid the dilemma between fully fledged bankruptcy *à la* Lehman and a bail-out at taxpayers' expense
- Properly implemented, proto-insolvency allows for dealing with systemically important institutions without endangering financial stability. It also prevents minority stakeholders from impeding prompt and orderly restructuring of the distressed institution

Implementation



- In principle, the Commission could veto bail-outs but has not done because of financial stability concerns
- The implementation of a restructuring plan for fundamentally unsound banks that received State support is a distant second best as compared to SSR comprising PCA.
- At the same time, the design of the restructuring plans could potentially address many of the root causes of the current turmoil, and in particular, issues of moral hazard.

Restructuring plans



- These plans are based on three pillars:
 - private (“own”) contribution to the coverage of the restructuring costs (aid to the minimum)
 - compensatory measures
 - and ensuring long-term viability

Own contribution/burden sharing



- In principle, the first requirement could ensure restructuring costs are borne by the owners, creditors, and managers of the entity receiving support
- Potentially, this allows for an ex-post implementation of standard feature of SSR/PCA, namely the mandatory conversion of unsecured debt into equity and/or the write-down of (part of) the unsecured debt.

Compensatory measures



- Compensatory measures aimed at reducing competition distortions.
- For non-financial institutions, compensatory measures typically consist of asset disposals and/or capacity reductions that “compensate” competitors for the survival of the distressed firm
- For financial institutions, the disappearance or downsizing of a bank may actually *hurt* competitors
- For that reason, compensatory measures will have to be tailored to the specificities of the industry

Return to viability



- The third pillar seeks to ensure that State intervention has a lasting positive effect on the aided firm and the sector in which it operates
- Return to viability should also ensure that the firm will not require additional State support in the future.
- Orderly liquidation may constitute a realistic alternative to restructuring.

Regulatory changes and evolving business models



- Sources of bank funding?
- Business lines operating on a stand alone basis (including regulatory capital requirements)?
- Counter-cyclical provisioning?
- Counter-cyclical capital requirements?
- Reduce the incentive to become TBTF

Conclusion



- Rescue and restructuring
 - Simultaneous – rather than ex ante
 - Political versus regulatory process
- Missed opportunity ?
- In the mean time, expanding credit squeeze.
- Prospect for zombie banks and zombie borrowers

Annex



- In case questions come up ..

Relaxing competition policy?



- “Excessive competition” reduces rents by eroding the franchise value of banks and induces them to bet for resurrection via excessive risk taking
- Pre-crisis returns were certainly not low; relaxing competition in the EU would not eliminate residual competition on international markets
- Distinction between competition and the *conduct of competition policy*

Relaxing competition policy?



- ❑ Anticompetitive mergers to create “stability enhancing rents”?
 - Net benefits for the merged entity are uncertain and take time to materialise. Appealing to economies of scale and scope is not convincing (quickly exhausted; necessity of Chinese walls)
 - Duration of the stream of monopoly rents potentially unlimited, while State support is time-limited
 - Plough the seeds for future systemic crises by contributing to create FIs that are TBTF or TITF
 - License to extract monopoly rents without condition. Rewarding mismanagement by the right to exercise market power compounds problems of moral hazard.

En vogue tribute



"The theory of economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method, rather than a doctrine. An apparatus of the mind, a technique of thinking, which helps its possessors to draw correct conclusions."

Keynes

Banking Communication (1/3) (13 Oct 2008)



General principles:

- Co-ordination and overall coherence
- No protectionism, no discrimination
- No softening of substantive rules
- Inbuilt-flexibility to allow for different types of measures
- Ex ante « benchmarks » and tailor-made conditions (e.g. duration of guarantees)

Euro-system recommendations

- Pricing

Recapitalisation Communication (5 Dec 2008) (2/3)



- Ensure lending to the real economy
- Differentiation in treatment of **fundamentally sound** and **distressed** banks in relation to price, safeguards, and the extent of future restructuring
- Which banks are **fundamentally sound**?
 - Assessment by the MS *ex ante* when deciding about the eligibility
 - COMP will monitor *ex post* when reviewing the schemes on the basis of MS's reports
 - Set of indicators (Annex 1) and a role for national supervisory authorities: capital adequacy, size of recap, current CDS spreads, rating & its outlook

Recapitalisation Communication: Fundamentally sound banks (2/3)



- **Remuneration** to reflect:
 - Banks' risk profile
 - Type of capital (subordination)
 - Exit incentives and safeguards against abuse
 - Risk-free rate benchmark
- **Entry price:**
 - Euro-system methodology (20 Nov 2008)
- **Exit incentives:**
 - Increasing remuneration, redemption clauses, link with dividends distribution
- **Safeguards:**
 - Ban on aggressive commercial strategies, M&As by competitive tendering, use of capital for lending
- **Reporting & follow-up** after 6 months:
 - soundness of the banks, individual recaps conditions, use of capital for lending, path towards exit

Recapitalisation Communication: Banks not fundamentally sound



- Higher risk – **higher** remuneration
- **Stricter** safeguards (e.g. limitations on executive remuneration and bonus, maintenance of higher solvency ratio)
- Follow-up: **far-reaching** restructuring (restructuring or liquidation plan to be assessed according to principles of the rescue and restructuring Guidelines)

Impaired asset communication (3/3)



- Need for a consistent EU approach:
 - avoiding a “race to the top” triggered by the first-mover effect (public finance implications)
 - avoid arbitrage for cross-border banks
 - avoid protectionism in an internal market
- State aid rules for a coordinated action
- Balancing immediate financial stability and return to normal market functioning
- Cater for different situations across the EU

Principles for designing asset relief measures under State aid rules



- **Forms** of relief measures:
 - asset purchase (“bad bank”), asset insurance, asset swap and hybrid solutions – free choice on the principle of equivalent treatment
- **Methodology:**
 - Ex ante full **transparency** and **disclosure prior to** State intervention
- **Assets eligibility:**
 - Flexibility as to the type of assets to cater for national specificities
 - Impaired at cut off date
 - Categorisation (asset baskets)
- **Assets valuation:**
 - Independent third party’s certification & supervisory authorities’ validation
 - Bank’s viability review by supervisory authorities
 - Expert panel to assist the Commission
 - International benchmarks and uniform haircuts
- **Aligning incentives** to participate with public policy objectives
 - 6 months enrolment window when not mandatory

Principles for designing asset relief measures under State aid rules



- **Costs burden-sharing:**
 - **Δ book value / market value = aid**
 - **Transfer value = real economic value**
 - **Bank to absorb Δ book value / real economic value**
 - **Up-front amortization**
- **Remuneration:**
 - At least equivalent to the remuneration of State capital
- **Follow-up:**
 - General principle of **restructuring** and **return to viability**
 - Graduation according to fulfillment of above principles
 - Global assessment the total aid whatever its form
 - Presumptive criteria (insolvency, >2% RWA)
 - Remedy to competition distortion