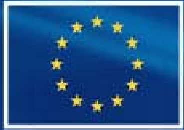

European Commission

Competition

The current financial crisis and EU Competition Policies

College of Europe, BRUGES, 16th June 2009

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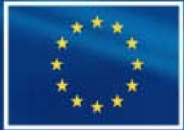
(*) Disclaimer: the views expressed in this presentation are those of the author and are not necessarily those of the European Commission.

Outline

- Objective of competition enforcement
- Taking stock of developments
  - Part I: Financial institutions
    - Ex ante guidance and specific cases/schemes
  - Part II: “Real Economy
    - Temporary Framework: schemes
- Current challenges:
  - For financial institutions: validate restructuring
    - Ex-ante and ex-post intervention
    - Business models
    - Regulatory framework
  - Real economy: level playing field and fiscal sustainability



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Part I: Financial institutions Some perspective

- 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

2 Apr '07: Bankruptcy filing of New Century Financial, one of the biggest sub-prime lenders in the US

17 Jul '07: Two Bear Stearns hedge funds investing in sub-prime investment collapse

16 Aug '07: Countrywide Financial, the largest mortgage in the US run into liquidity problems. Fed responded by a 50 bps cut of the discount rate

14–17 Sep '07: Northern Rock experienced a bank run until a government blanket guarantee was issued on 17 Sep 07.

7 Mar' 08: US$20bn Cash loan Fed intervention to banks and bond market dealers

10 Mar '08: Further US$236bn Boost from Treasury security loans and cash loans to banks in Europe

14 Mar '08: Fed Announces emergency lending facility for Bear Stearns through JPMorgan

17 Mar' 08: Bear Stearns collapses sold to JPMorgan for US$20bn

Jul '08: Alliance & Leicester, a UK mortgage lender experiencing stress was bought by Spanish bank Banco Santander.

7 Sep '08: US Government bails out Fannie Mae and Freddie Mac, the mortgage financiers. Agreeing to inject up to US$100bn per company

14 Sep '08: Lehman, the 158 year-old investment bank files for bankruptcy after failing to attract Fed help, or a buyer

15 Sep '08: Bank of America buys Merrill Lynch in US$50bn emergency acquisition

17 Sep '08: Treasury backs US$85bn deal to fund AIG, to stave off collapse of the giant insurer that plays a crucial part in the global financial system

18 Sep'08: Lloyds US$22bn Rescue take over of HBOS. Government waives antitrust provision to allow merger

21 Sep '08: Governments of the Netherlands, Belgium and Luxembourg agree to a partial nationalisation deal worth US$15.5bn to stabilise Fortis. Subsequently, Fortis' operations in Belgium and Luxembourg were purchased by BNP Paribas for US$20.1bn

30 Sep '08: Dexia Partly Nationalised by Governments of Belgium, Luxemburg and the Netherlands in a deal worth US$9bn

8 Oct '08: UK Government announces a scheme to provide £400bn of support to the banking sector including a capital injection and guarantees for banks' borrowings. Co-ordinated 50bps benchmark rates cuts by all major central banks. Nationalisation of all three major Icelandic banks

13 Oct '08: European Governments unveil €1.85tn co-ordinated plan to recapitalise banks and guarantee banks' borrowing. UK Government announces £37bn investments in RBS, HBOS and Lloyds TSB. UAE Ministry offers US$19bn liquidity injection to banks

14 Oct '08: US government guarantees new debt issued by banks for 3 years and announces plans to inject US$250bn in banks

16 Oct '08: UBS agrees "bad bank" deal with the central bank to take US$60bn in toxic assets off its balance sheet inaddition to a SFr6bn capital injection

21 Oct '08: Fed announces it would finance up to US$540bn in purchases of short term debt from money market mutual funds

Competition enforcement for financial institutions

- 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 for financial institutions

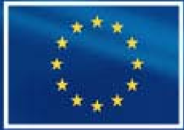
- Distortions of competition
  - In the product market (one-off versus repeat recaps)
  - In the input market (access to funds)
- Across member states
  - Banks compete across national jurisdictions
  - Member states do not internalise effects beyond their own jurisdictions
  - Different ability and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

Ex ante guidance

- Banking communication (October 2008)
  - General principles
  - Pricing of guarantees (ECB)
- Recapitalisation (December 5 2008)
  - 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 (February 25 2009)
  - Asset purchase or guarantees
  - Transparency
  - Incentives to participate
  - Asset valuation by independent experts
  - Market value, book value and real economic value
  - Remuneration in accordance with guidance on recapitalisation
- Restructuring paper in the pipeline
- EU-wide stress testing using common criteria



State aid for the financial sector –decisions

- 57 decisions so far (does not count amendments as a separate decision)
  - 32 individual measures, for 26 different banks
  - 24 schemes
- 6 on-going in-depth investigations

Decisions: Individual cases

- Pending cases with in-depth investigations
  - Northern Rock (UK, Restructuring) – 2 April 2008, extension on May 7 2009, Hypo Real Estate (DE, Aid) - 2 October 2008, May 7, Dexia (BE, FR, LUX, restructuring) March 13 2009, Bayern LB/Hypo Group Alpe Adria (DE, AU, Aid) May 12, ING (Illiquid asset facility) March 31, Fortis Bank Nederland (NE), April 8 2009
- Recent approved cases outside of schemes
  - ING (NL) - 13 November 2008 / March 31 2009
  - Roskilde (DK) – July 31 2008 / November 5 2008
  - Fionia (DK) – May 20 2009
  - Dexia (BE, FR, LUX) – 19 November 2008 / 13 March 2009
  - Fortis (BE, LUX, NL) – 19 November / 3 December 2008
  - Fortis (BE, LUX) -12 May 2009
  - Caisse d'Epargne & Banque Populaire (FR) May 8 2009
  - Aegon (NL) – 27 November 2008
  - SNS Real (NL) – 10 December 2008
  - Bradford and Bingley (UK) - 1 October 2008
  - Carnegy Investment Bank (SW) – 15 December 2008

Decisions: Individual cases

- Recent approved cases outside of schemes (continued)
  - KBC (BE) – 18 December 2008
  - Bayern LB (DE) – 18 December
  - Nord LB (DE) - 22 December
  - IKB (DE) – October 21 2008 / 22 December 2008 Conditional decision following formal procedure
  - Anglo Irish Bank (IE) – 14 January 2009 / 17 February 2009
  - Kaupthing Bank – (FI) – 21 January 2009
  - Parex Banka Latvia (LAT) – 24 November 2008 / 11 May 2009
  - Ethias Group (BE) – 12 February 2009
  - Sachsen LB (DE) – June 4 2008 Conditional decision following formal procedure
  - Commerzbank (DE) – May 7 2009
  - West LB (DE) – May 12 2009
  - Bank of Ireland (IR) – March 26 2009
  - Allied Irish Bank (IR) - May 12 2009
  - Banco Privado Português (PO) – March 13 2009

Decisions: Schemes

- Denmark (Guarantee) - 10 October 2008 / February 3 2009 (Recap. + amend. Gtee)
- Ireland (Guarantee) - 13 October 2008
- United Kingdom (Guarantee + Recap) - 13 October 2008 (amendment 22 December) / April 15 2009 (extension)
- United Kingdom (Working capital guarantee scheme) – March 29 2009
- Germany (Recap) - 27 October 2008 (amendment 19 December)
- Germany (Guarantee) – January 22 2009
- Portugal (Guarantee) - 29 October 2008
- Sweden (Guarantee) - 29 October 2008 / January 28 – April 28 (amendments + extension)
- France (Guarantee) - 30 October 2008 / May 12 2009 (extension)
- Netherlands (Guarantee) - 30 October 2008

Decisions: Schemes (continued)

- Spain (Assets) - 4 November 2008
- Spain (Guarantee) – December 22 2008
- Italy (Guarantee/Recap) - 13 November 2008 / 23 December 2008
- Finland (Guarantee) - 14 November / April 30 2009 (amendment / extension)
- Greece (Recap + Guarantee) – 19 November 2008
- Hungary (Recap + Guarantee) – 12 February 2009
- Latvia (Guarantee) – 22 December
- France (Recap) - 30 October /8 December / 29 January / March 23 (amendments)
- Austria (Recap) – 9 December
- Slovenia (Guarantee) – 12 December
- France (Recap 2) – end of January
- Denmark (Recap) – 3 February
- Sweden (Recap) – 11 February 2009
- Portugal (Recap) – May 20 2009
- Slovenia (Liquidity) – March 20 2009

Implementation

	Capital injections	Guarantees on bank liabilities	Impaired asset schemes	Liquidity & bank funding
EU Total	171.8 (311.4)	921.8 (2911.5)	34.5 (61.5)	353.4 (435)
Euro Area	130.6 (237.6)	748.5 (1850.1)	34.5 (61.5)	61.6 (42.4)

Actual take-up (total commitments in BN €)

Implementation of schemes

- Guarantee: ≈ 2.9 trillion EUR committed
- Recap: ≈ 0.31 trillion EUR committed
- Asset relief schemes: ≈ 0.06 trillion EUR committed

Implementation

- Use of schemes
  - Guarantee: ≈ 32% of total committed
  - Recap: ≈ 55% of total committed
  - Committed (could potentially be drawn upon): ≈ 30% of GDP, similar to the US
- Incentives for banks ?
  - Remuneration caps ?
  - Pricing ?
- Sovereign ratings? Existence of CDS? Timeline/Funding needs?
- 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 (SRR) and Prompt Corrective Action (PCA) have been created, but so far, little used.
- SSR and PCA potentially avoid the dilema 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 second best as compared to SRR 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: financial restructuring (liabilities)

- 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 conversion of unsecured debt/hybrid capital into common equity and/or the write-down of (part of) the unsecured debt.

Compensatory measures (assets)

- 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
- Added dimension during a systemic crisis: many sellers, few buyers
- For that reason, compensatory measures have to be tailored to the specificities of the industry (home country bias?)

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 (State aid is not “wasted”)
- Return to viability should also ensure that the firm will not require additional State support in the future. Repeated use of schemes/ad-hoc intervention?
- Orderly liquidation may constitute a realistic alternative to restructuring.

Regulatory changes and evolving business models: some thoughts

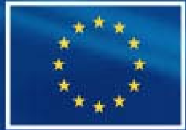
- Sources of bank funding?
- Business lines operating on a stand alone basis (including regulatory capital requirements)?
- Counter-cyclical provisioning?
- Counter-cyclical capital requirements?
- Reduce the incentive to become TBTF/TITF/TBTS
- Implementation of the De Larosière recommendations

Part II: “Real economy”
Some rhetoric

- As is usual in times of a deep recession, some have called for a temporary suspension or softening of competition rules
- The narrative:
  - Relaxing competition rules would give companies some breathing space until the good times return and could also allow firms to orderly re-structure
  - The apparent wisdom of this policy is particularly strong when the recession is triggered or at least concomitant with a financial crisis as funding for the real economy may dry out, even for viable concerns.
  - Under these circumstances, allowing firms to earn rents through the excise of market power or granting them state support in circumstances that would otherwise not be allowed would have to be part of a solution.

“Real economy”: evidence

- Relaxing competition rules reduces the discipline of triage mechanism between efficient and inefficient firms, impeding necessary adjustment.
- A downturn requires firms to adopt and change: competition provides adequate incentives
- Relaxing competition rules by transferring rents to firms depresses consumers' purchasing power, delaying recovery and resumption of trend growth. The experience of the NIRA is telling in that respect: “legal cartels” probably delayed US recovery by years
- Artificially maintaining firms active can have disastrous consequences. The Japanese experience of a long and protracted “L shaped” recession can be directly traced back to the existence of “zombie” banks undertaking “zombie” lending
- This had the effect of dampening the adjustment that would occur under normal competitive conditions, namely that the “zombies” would have shed workers and lost market share. This led to congestion created by the zombies, reduced the profits for healthy firms, which discouraged their entry and investment



“Real economy”: the “Temporary Framework

- However, state aid rules need to take into account market failures that are specific to the financial and economic crisis.
- Banks have become much more risk averse. This tightening of credit conditions not only affects weak companies, it can also affect healthy companies which find themselves facing a sudden shortage or even unavailability of private funding, whether loans or risk capital.
- This is all the more problematic since these perceptions may become self-fulfilling: lending dries out because the risk of default is perceived to be higher, which in turn leads to actual bankruptcy of initially sound undertakings and a higher perception of risks.
- Given this mispricing of risk and potential coordination failure, state support addressing these market failures may thus be appropriate.

Temporary Framework

- The EU's rule-based system has adapted to the circumstances deriving from dysfunctional financial markets and the market failures resulting thereof.
- EU competition policy has coped with this hitherto novel situation, both actively and, in a conscious manner, "passively".

Temporary Framework: not updating safe harbours

- Many control instruments devised in the context of the quiet financial waters associated with the Great Moderation have not been up-dated to take into account of the circumstances derived from the current turmoil and, in particular, the sharp increase in the perception of counterparty risk.
- This is the case for both direct finance (lending) and financial guarantees, whose associated “safe harbour” thresholds have been left untouched following Lehman Brother’s demise. *De facto*, this allows Member States to financially support firms on the basis of pre-crisis conditions.

Temporary Framework: loans

- The temporary framework allows Member States to provide the following types of aid:
  - As interest rate reductions by Central Banks are not adequately reflected into medium and long term interbank rates, Member States can grant loans whose interest rate consists of the sum of the central bank overnight rate plus a premium equal to pre-crisis spreads between interbank rates and overnight rates, plus a credit risk premium corresponding to the risk profile of the recipient with premia calibrated on those observed pre crisis. This allows States to provide loans that have been constructed on the basis of pre-crisis conditions in credit markets.

Temporary Framework: 500K

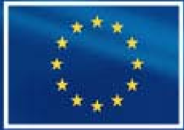
- A lump sum of aid up to €500,000 per company for the next two years which can cover investments and/or working capital. The Commission has considered that the potential distortion of competition that it may create will be compensated by the positive effects of the measure in the common market.

Temporary Framework: Guarantees

- Subsidised guarantees for loans at a reduced premium. The guarantee can cover up to 90% of the loan and it may relate to both investments and working capital loans. Member States can grant a reduction of up to 25% of an annual safe-harbour premium to be paid for new guarantees in the case of SMEs and 15% in the case of large companies
- Simplified procedure to invoke the “escape clause” for export credit insurance
- Specific initiatives related to “Green Products”

Temporary Framework: Implementation

- 37 schemes adopted and more are in the pipeline.
  - Austria: 500k (20/0309), risk capital (25/03/09)
  - Belgium: Guarantees (20/03/09)
  - Czech Republic: Subsidised interest rates (06/05/09), 500k (07/05/09)
  - Denmark: Export Credit (06/05/09)
  - France: 500k (19/01/09), subsidised interest rates (04/02/09), Green products (03/02/09), Guarantees (27/02/09), Risk capital (16/03/09)
  - Germany: Subsidised interest rates (30/12/08, 19/02/09), compatible aid (30/12/08), risk capital (03/02/09), guarantees (27/02/09)



Temporary Framework: Implementation

- Hungary: Guarantees (10/03/09, 24/04/09), subsidised interest rates (24/02/09), 500k (24/02/09)
- Ireland: 500k (15/04/09)
- Luxembourg: 500k (26/02/09), guarantees (11/03/09), export credit (20/04/09)
- Malta: 500k (18/05/09)
- Netherlands: 500k (01/04/09)
- Portugal: 500k (19/01/09)
- Slovak Republic: 500k (30/04/09)
- Spain: Green products for the car industry (29/03/09)
- UK: 500k (04/02/09), guarantees (27/02/09), green products (27/02/09), subsidised interest rates (15/05/09)

Temporary Framework: potential support

- € Billion (May 20)

500k & Other direct grants	Soft loans & subsidised interest	Guarantees	Risk capital	Green products	Export credit	Other
30.6	45.1	51.9	9.5	19.7	0.025	2

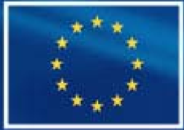
- Cash payments (500k) vs. guarantees or subsidised interest rate (effective aid is much lower than headline figure suggests)

Temporary Framework

- Uneven take-up across Member States
- More intensive users (proxied by number of approved notifications): largest economies (FR, DE, UK)
- 500k measure is very popular. Administrative simplicity? Effectiveness in terms of providing immediate breathing space?
- Actual disbursements: Member States will report next year

Temporary Framework: challenges

- Coherence across instruments:
  - Guarantees and loans
  - Guarantees and export credit insurance
- Level playing for firms
  - Different ability to provide support
  - Different willingness
- Fiscal sustainability? Loans (consolidated) vs. guarantees ("off balance sheet" operations, but the potential liabilities are huge)



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Conclusion: Part I

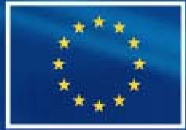
- Rescue and restructuring
  - Simultaneous – rather than staggered
  - Political versus regulatory process
- Missed opportunity ?
- In the mean time, expanding credit squeeze.
- Prospect for zombie banks and zombie borrowers

Conclusion: Part II

- The Temporary Framework introduces desirable flexibility the EU's State Aid rules in view of the systemic crisis.
- However, Member States may fall prey to the temptation to use this leeway to engage in actions that violate the Treaties' spirit. This flexibility could be used to pursue blatantly nationalistic objectives.
- It is hoped that, for the sake of the European project, our leaders will have enough moral clout and vision to put these temptations at bay.

Annex

- In case questions come up ..



Relaxing competition policy?

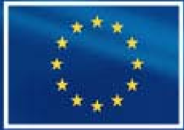
- "Excessive competition" reduces rents by eroding the franchise value of banks and induces them to bet for resurrection via excessive risk taking
- Pre-crisis returns were certainly not low; relaxing competition in the EU would not eliminate residual competition on international markets
- Distinction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