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The Current Financial Crisis and State Aid in the European Union: Has It Been Timely and Appropriate?

Abel M. Mateus*

I. INTRODUCTION

We are in the middle of the worst financial and economic crisis since the Great Depression. In this paper, I argue that aggressive and timely state aid and intervention are required. The Commission has acted on the measures notified by the Member States in a fast and adequate manner, and has issued generally appropriate guidance, according to a benefit-cost analysis. But this was the response to the first wave of the crisis. I argue that bank guarantees and recapitalization may not be enough to re-launch economic activity and some economies may require the "cleaning-up" of bad debts, which would require a revision of the guidelines.

Overall, the Commission has responded quickly and with the right approach and most of the governments in the European Union have responded with the right measures. However, given the experience of past crises, the menu has to be expanded and the second wave and further cycles of the crisis may warrant an expansion of the measures used so far. The last section takes this issue further and considers that, in order to jump start the economy, bolder and more unorthodox measures may be required if the crisis

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continues to deepen. This requires a more coordinated approach with other institutions, mainly the European Central Bank ("ECB") and regulatory bodies.

II. WHY STATE AID? THE COMMISSION INTERVENTION

State intervention and aid to the financial sector in a crisis situation are essential to avoid the collapse of the system. First, there are externalities and systemic risks involved: the failure of a large bank may create a systemic risk of generalized bank failures due to cross balance sheet relationships that do not remain internalized when a particular bank fails. Also, the failure of an important deposit institution may create bank-runs that lead to liquidity squeezes and precipitate bank failures. Second, there are externalities between the financial and real sectors: the increasing risk of bank failure leads banks to curtail lending to firms and households, precipitating a downturn in the economy; and the loss of deposits and other household and firm assets leads to a decrease in money supply and cuts aggregate demand (specter of deflation). The second broad type of market failure occurs due to information asymmetries and collapsing markets: (i) Banks may not have good information about the liquidity and solvency of their household or firm clients. Besides, in a mark-to-market world the values of all assets may decrease in synchronization and it may be difficult to distinguish between a relative price and overall adjustment; and (ii) Capital markets suffer from the same asymmetries in information—it is difficult to distinguish between good and bad investments, accentuated by the large correlation in risk.

There are also cross-border externalities: (i) Bank failures in one country may lead to bank failures in other countries, especially in a currency union or a financially integrated area, and (ii) There are also externalities arising from the interaction of the financial and real sector across all countries in the European Union.

The eminent collapse of the financial system, with ominous consequences to the real economy,[1] requires a timely and speedy intervention and approval systems. However, there is no blanket solution, since markets and agents are in different situations. There are economies with high- and low-leveraged households, leveraging levels of firms diverge significantly, and the quality of bank supervision is also quite diverse. Besides, each institution in difficulty requires a tailor-made intervention, from a minority stake recapitalization up to liquidation. Moreover, the menu of measures to be taken is quite large, so each country has to assess which specific policy at that time will have the best impact in reducing the specific and systemic risk. Consequently, the only way to orchestrate rescues in the financial system (that also require the maximum secrecy) and avoid bank runs, is to elaborate excellent Guidelines to give clear guidance to States and regulators for different alternatives and best practices. Similarly to other areas of state aid, the system has to: (i) Establish “de minimis” criteria; (ii) Define measures and conditions that “most likely would be rejected” (red lines); and (iii) Define a clear and efficient system for monitoring evolution after the aid.

As of December 3, the Commission was given notice by all major EU countries of measures involving state aid: deposit guarantees ("DG"), guarantees for bank lending ("BG"), bank recapitalization schemes ("BR"), companies set up to dispose of bad assets

[1] Policymakers needed to avoid the mistakes of the Great Depression, where bank failures led to a decrease in money supply of about one third. Coupled with a contractionary fiscal policy, this led to unemployment rates of about 30 percent.

("CD"), and funds to buy bad assets from banks ("BA"). The following countries have introduced general measures to shore-up the financial sector: Denmark (DG,BG,CD); Germany (DG,BG,BR); Greece (BG,BR); Spain (BR,CD); France (BG,BR); Ireland (DG,BG); Italy (BG,BR); Netherlands (BG); Austria (BG); Portugal (DG,BG,BR); Finland (BG,BR); Sweden (BG); United Kingdom (DG,BG,BR); Hungary (BG,BR); Poland (BG); Slovenia (DG,BG); and Latvia (BG). There were also 22 bank rescues notified[2] and one bank liquidation by Denmark. The majority of the interventions have been to issue state guarantees of bank liabilities and to set up funds for recapitalization. Only Denmark and Spain have set up a separate company and fund, respectively, to buy and dispose of bad bank assets. But, so far, the Commission appears to be reluctant to accept this type of intervention.[3]

There are some common benchmarks developed by this new case law: (i) Eligibility and non-discrimination: subsidiaries of foreign banks, systemic branches, (ii) 6 months as the normal duration of schemes with review clauses, although this term seems too short in view of the normal 2 to 3 years duration of a financial crisis, (iii) Limitations on the issuance windows for guarantees; limitations in the maturity of the debts (3 years), and (iv) Minimum remuneration of capital injected by the State. In 6 months the Commission will review the measures already approved; Member States will have to

[2] Belgium, Germany, and Netherlands with 4 cases each, Luxembourg, U.K .and Sweden with 2 each and France, Finland, Portugal, and Latvia with 1.

[3] Similar measures were taken by the United States during the Great Depression and the Savings and Loan crisis. The Reconstruction Finance Corporation was created to recapitalize banks, manage their share portfolio, and supervise the banks from a commercial shareholder perspective. The Resolution Trust Corporation was set up to buy bad assets.

notify their restructuring plans for beneficiary entities. There will also be an assessment of the adequacy of the measures and of their distortive effects.

We can learn some lessons by comparing two recent financial crises: the Swedish crisis of the early 1990s that was quickly dealt with, with a small fiscal and economic cost, and the Japanese crisis of the 1990s that led to a decade of low growth and a financial cost ten times larger. Capital injections into banks are just a beginning. Stringent asset evaluation and sufficient write-offs of toxic assets as well as the purchase of bad assets by public asset management companies may be required in highly-leveraged economies.

III. AN ECONOMIC-BASED APPROACH TO THE MENU OF MEASURES

We have demonstrated the need of financial aid to stop a market failure. In order to study the most appropriate measures for state aid we need to establish their impact on reducing systemic risk and improving the solvability and liquidity of the financial system, with an ultimate view of reducing the losses of (consumer) welfare in the economy. Next, we should study how the incentive changes the behavior of banks and agents, which in this case presents a real problem of moral hazard and adverse selection. Finally, distortions to competition and trade should be reduced to a minimum.

For each specific case, a benefit-cost analysis could be undertaken with the help of some simple financial models, based on the Net Present Value ("NPV") of a stream of benefits and costs. Direct benefits arise from avoiding a contraction of credit to the economy (use can be made of the credit multiplier or financial accelerator estimated by the ECB). Indirect benefits arise from containing both systemic risk and the overall risk of recession, after computing the impact on financial risk. On the costs side, there are obvious immediate and delayed taxpayer costs. Over the short-term are the interest costs of public debt and cost of guarantees. Over the medium-term there are potential costs due to asset valuations and institutional bankruptcies. There are also administrative costs related with the implementation of the measures that may be significant in some cases (consulting, management, etc.). Finally, there may be also direct costs to depositors and investors, mainly an option cost of inaction. Financial specialists use similar models for evaluating mergers and acquisitions ("M&As") or buyouts in two or three days; we trust that similar methodologies be used by state aid specialists.

A summary analysis of these measures shows that a minority stake may cost taxpayers substantially if there is no previous capital write-off that covers the marginal losses of the bank. These are some important aspects that MS should take into consideration when designing a program; but some other considerations are in line.

First, no additional state aid should be given without a depositor guaranty, since this measure has the highest score of benefits relative to costs. All modern financial systems have this type of insurance. But a blank guarantee of all deposits should be only temporary.

Second, in recapitalizations of banks the Government should require that shareholders not profit directly or indirectly from the infusion of capital to cover the banks' losses.[4] There should be previous write-offs of the capital and reserves, including

[4] This is in fact mandated by the Ecofin statement.

all the provisions. Payment of dividends should be limited or even prohibited during state intervention.

Third, nationalization of banks should be a measure taken only as last resort. State officials are not good bank managers and Governments may be tempted to use banks for “other purposes” than commercially-oriented operations (profit at minimum risk). Thus they should avoid being involved in bank management and privatize as soon as possible.

Finally, the effectiveness and cost to taxpayers of state aid to each individual institution is certainly subject to moral hazard, depending on restructuring and system recovery measures, so the Commission should look carefully at those plans that an institution has said it will require.

IV. THE WAY AHEAD AND CONCLUSIONS

With national regulatory systems, it makes little sense to have EU-wide interventions in the financial system, as the recent German and French episodes showed.[5] However, as the French President has stated, EU-wide measures, due to their reinforcing and spillover effects, are very important. Besides leadership at the political level and fiscal and monetary coordination, there is an additional important role that the Commission can play on state aid.

There are three theoretically strong justifications for the Commission to take a “hard line” position on state aid. First, to avoid “subsidy races." Second, national

[5] The French proposal was to set-up a large fund for supporting banks in the eurozone. But who was going to finance the fund? The German Government reacted by saying that German taxpayers were not willing to bail out other countries' banks. This position is rational, given that German households have some of the lowest leverage in the European Union and the German economy does not have the negative external assets position that is threatening some smaller countries. In fact, the Stability and Growth Pact was built on the assumption that no big country would bail out small countries' economies.

governments have a commitment problem: they are not able to commit to clear rules and a fixed budget ex-ante (this is the Kornai problem of soft budget constraint). There is also the problem of economic agents asking national states for a renegotiation of conditions along with the difficulty in setting conditions. At the same time, regulatory, administrative, and political capture are recognized to be easier at national levels. The third problem is the difficulty for national governments to respect dynamic commitments which may create intertemporal inefficiencies.

Notwithstanding, the Commission needs to promote a more aggressive and transparent approach by Member States to solve the crisis. As I now argue, it needs to revise its approach, taking into account the hard lessons of the Japanese case, the tendency for complacency by some national regulators, and the lesser transparency in the European markets in relation to the United States.[6]

The Commission Guidance has already established some solid principles for state aid in the context of a financial crisis. Priority, as we discussed above, is given to guarantees of bank deposits. In case guarantees are extended to other bank liabilities, like subordinated debt, restrictions have to be imposed in order not to let shareholders take a "free ride."[7] The Guidance also establishes that recapitalization of the banks is also appropriate, but only for sound institutions, i.e. institutions with no major solvability risk and can recover when normal market circumstances prevail.[8] This recapitalization should

[6] In fact, for quite a number of financial instruments that measure bank or corporate risk, markets in Europe are substantially underdeveloped.

[7] The economic model of a bank is based on the idea that shareholders and managers are the agents of the principals, which are depositors. So, when a bank takes an abnormal amount of risk the primary persons responsible are the shareholders and managers.

[8] Once more, this is an analysis that financial analysts are able to carry out.

be done at market prices through three accepted modalities: preferred stocks with adequate remuneration, claw back mechanisms, or better fortune clauses. These are right for "shoring-up" the banks. However, the Guidance stops short of recognizing the most important need, which is to enable the bank to supply further lending.

Most of these measures, especially the way they are molded, support liquidity. But according to most of the market news European banks now have plenty of liquidity, still mainly provided by the Central Bank, as the economic situation deteriorates rapidly. Households are cutting consumption and increasing savings, due to large wealth losses and an expected drop in income, at the same time that unemployment rises at alarming rates. And corporations are cutting investment and production. So we have a vicious circle of dropping demand for loans and banks cutting lending. The figures show a fall in actual corporate lending in the United States, the deceleration in the eurozone, and rapidly deteriorating expectations.

Certainly fiscal stimulus is an important policy in this situation, and some fiscal measures can also help resolve the financial crisis when they help the real sector to stimulate demand.[9] Structural measures to increase productivity are also of tremendous importance at the time of the economic crisis.

Direct intervention at a household level may be required in a prolonged recession, to decrease the rate of foreclosure, although generalized schemes are difficult to administer. These measures are very important for equity purposes, since they usually

[9] Governments should also think hard about the large implicit subsidy that they are giving homeowners that some economists have argued are also at the root of the crisis in mortgage lending.

help the poorest taxpayers, or taxpayers that have suffered a sudden loss in their income.[10]

Direct intervention to help small and medium enterprises ("SMEs"), through fiscal measures, debt rescheduling, reduction in interest costs, or guarantees, are also very important, since these companies are the backbone of the European economy—especially in a prolonged recession. They have also a significant impact on employment support.

These direct measures for the economic agents are seen as an important counterweight, in equity and political terms, to the other measures for “saving the bankers:" funds for loan guarantees or setting risk clubs.

But, still, the most important measure that needs to be introduced in high leveraged economies is the “cleaning and restructuring” of bank balance sheets. To jump start the economy Central Banks[11] and State institutions, using specially created vehicles, may need to start buying toxic assets (as the Spanish proposal envisaged).

I conclude by reiterating that we need to use all our expertise and lessons learned from past crises, and all the possible instruments—fiscal, monetary, state aid, and regulatory policies—in a coordinated and harmonic way to fight the “once in a generation crisis” that has now reached global proportions.

[10] There are economists, such as Nouriel Roubini, that have advocated these type of measures because they have an immediate impact on the real economy by helping the most illiquid households and thus have a larger multiplier effect.

[11] The Fed is already using some unorthodox measures, by extending the securities used for collateralizing its operations and even conducting open-market operations and buying toxic assets directly from banks. This is pure money creation that may help fight deflation.