

STABILITY AND COMPETITION IN EU BANKING DURING THE FINANCIAL CRISIS: THE ROLE OF STATE AID CONTROL

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ABSTRACT

The available evidence suggests that the European Commission's State Aid ("SA") control of public assistance to the financial sector in the European Union during the period 2008-2010 has had a positive impact on both financial stability and competition in the EU's internal banking market. The particular features of the crisis regime dedicated to assessing State Aid not only allowed the disbursement of unprecedented amounts of aid, often in record time, but also rendered the aid more effective by ensuring that aid recipients, where necessary, were restructured or liquidated. The conditions imposed on banks receiving large amounts of aid have generally led to highly significant restructuring and addressed fundamental weaknesses in business models, helping to avoid the creation of "zombie banks." At the same time, where aid amounts were relatively small and banks were sound, these rules allowed financial institutions to be aided without requiring changes in their business model.

SA control has ensured that the large amounts of aid granted did not lead to major distortions in the Internal Market. Absent this control, these public interventions could have triggered a fragmentation of the Internal Market itself.

While all substantial aid is likely to have a distortive effect, available indicators suggest that SA control has effectively mitigated these consequences. There is little evidence of retrenchment behind national borders and aided banks have generally not seen their market shares increase. Moreover, the crisis framework is likely to have had a strong signalling function to financial institutions with respect to moral hazard going forward.

In the absence of EU-wide rules for bank resolution, the SA crisis regime also presently acts as the de facto EU-wide resolution framework. However, it is an imperfect tool resolution compared to a full-fledged regulatory framework that helps avoid recourse to aid in the first instance and can provide clear ex ante guidance for all market players (which in itself is confidence-enhancing).

The re-emergence of serious tensions in the EU banking sector from the summer of 2011 onwards is largely linked to concerns about the sustainability of public finances in a number of EU Member States feeding through to concerns about assets on banks' balance sheets. To remedy this, stability-oriented macroeconomic--especially fiscal--policies are required, and appropriate regulation of banking is needed. A key challenge for State Aid control in EU banking, therefore, is to ensure appropriate coordination with regulatory and macroeconomic policies as they are further developed.

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I. INTRODUCTION

The economic and financial crisis triggered by the bankruptcy of Lehman Brothers unleashed tensions in banking systems across the globe that, in terms of scale and impact, are unparalleled in modern history. Although the crisis was triggered by a shock in the United States, it spread rapidly across borders. It strongly affected European financial institutions that held many “toxic” assets originating in the United States on their balance sheets and enjoying close relationships with their U.S. peers. Preexisting weaknesses of EU banks also played a role; some had too-high leverage ratios and overly relied on wholesale markets for their funding.

Finally, the fragmented regulatory framework in the European Union clearly also played a major role in allowing these unsustainable trends to build up.² In the fall of 2008, a coordinated approach in the European Union was put in place to safeguard macro-financial stability through the provision of unprecedented resources by the European Union’s Member States to their banks. In parallel, the European Central Bank (“ECB”) and other central banks provided ample liquidity while a macro-economic stimulus package was launched to maintain demand in the EU economy. The collapse of Europe’s banking system was thereby avoided, even though the system remains under severe pressure on account of the EU sovereign debt crisis.

These initiatives revealed the challenges of coordinating Member State actions in the context of a systemic crisis where macro-financial stability concerns were pursued through Member States’ actions in an internal European market. This market is one where banks are free to operate across borders, requiring cross-country competition concerns to be factored into the design of the strategy.

The crisis also suggests that some large financial institutions had taken unwarranted risks on the back of an implicit state guarantee that they would not be allowed to fail.

Moral hazard thus had to be addressed. Lastly, most Member States had no resolution framework for banks, nor did a dedicated EU bank resolution framework exist.

The European Union does, however, have a system of centralized State Aid (“SA”) control established by the Treaty on European Union,³ whereby the European Commission (“Commission” or “EC”) vets all SA that Member States intend to grant. The Commission can approve this aid unconditionally, approve it under certain conditions (e.g. by requiring restructuring), or reject aid applications. The European Commission can also establish guidelines and frameworks that clarify the rules it will apply to individual cases. This supranational set-up is unique in the world and reflects the need to ensure common rules for State intervention in an internal market composed of Member States that enjoy significant national economic powers.

In order to deal with the challenges of safeguarding competition in the internal market, addressing moral hazard and providing a degree of coordination with regard to bank resolution, the European Commission has developed a crisis State Aid framework for financial institutions since October 2008. The framework became a de facto key microeconomic coordination framework complementing fiscal and macro-financial stability-oriented policies. Apart from the role played by the ECB and other European central banks, the latter policies were largely coordinated through the European Council and the Council of Finance Ministers (“ECOFIN”) on the basis of broad views reflecting a consensus-seeking approach among Member States.

This paper briefly describes the approach to SA control taken by the European Commission in this context and provides a concise evaluation of its effects. In particular, it assesses whether, in practice, there has been a trade-off between competition and financial stability.

II. THE EUROPEAN COMMISSION’S APPROACH TO STATE AID CONTROL IN THE CRISIS

The European Commission decided at the beginning of the crisis that State Aid control would have to complement, and indeed, support, macro-financial stability-oriented policies in order to preserve the internal market. More fundamentally, since it was the only tool available at the EU level to address moral hazard and impose restructuring of unviable business models or the liquidation of banks, the European

Commission considered that SA control could also be helpful from a macroeconomic point of view.⁴ Furthermore, lessons learned from the financial crisis in Japan were taken to heart⁵: undercapitalized banks with unsound business models (“zombie banks”) require appropriate restructuring because without it they could drag down growth for a very long period.

State Aid control was therefore seen as part of the solution from the very beginning. Not all Member States welcomed this, and some feared that unduly rigorous application of competition rules would clash with stability-oriented policies. The economic literature on this matter does not provide unequivocal answers to the question whether there is a trade-off between financial stability and competition. A more traditional strand of the literature holds that competition results in smaller and less diversified banks that are less able to withstand shocks. This suggests that the promotion of competition in banking could endanger financial stability.⁶ However, many of these drawbacks could be addressed by appropriate regulation and supervision. More recent analysis shows that large banks in concentrated banking systems may create adverse selection issues⁷ and could also lead to “too big to fail” dilemmas, creating significant mispricing of risk and moral hazard. A very concentrated banking sector itself could increase contagion risk,⁸ which, in turn, could make it more difficult to supervise and regulate the sector appropriately. As recognized by the U.K. Banking Commission,⁹ the literature points to different mechanisms that affect the interplay between competition and stability oriented policies. No structural trade-off between financial stability and competition can be identified. However, the design of both policies needs to be sensitive to spillover effects and should, especially in a crisis environment, be taken forward in an integrated manner to allow interactions to be internalized as best as possible. The European Commission recognized this in 2008 when it decided to adapt its state aid policy in the banking sector to the needs of such an approach, given the systemic vulnerabilities in the banking sector.

The European Commission was sensitive to these concerns. It designed a dedicated set of rules that took account of the need to respond to a horizontal shock to the banking system requiring the disbursement of large amounts of aid in record time to prevent a major economic crisis, while also recognizing that there were significant differences across affected banks. The approach was therefore from its inception based on the principle of proportionality.

To develop adequate rules, the European Commission adapted the preexisting rescue and restructuring guidelines¹⁰ to fit a situation where large amounts of support for banks were required for stability reasons. This framework was set up on the basis of European Treaty Article 107(3)(b), which specifically allows State Aid to be granted to deal with a severe economic crisis. The four Communications that are at the heart of this framework are briefly described in Chart 1.

Chart 1 - The EU Crisis SA Framework for Financial Institutions

Date	Communication	Main Principles
October 13, 2008	The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis ¹¹ (Banking Communication)	Adapting certain principles of Rescue & Restructuring guidelines to financial cases, i.e. allowing capital injections, distinguishing between fundamentally sound and distressed institutions.
December 5, 2008	The Recapitalisation of Financial Institutions ¹² (Recapitalisation Communication)	- Guidance on pricing of capital injections based on ECB recommendation (7 percent to 9.3 percent); - Threshold for in-depth restructuring requirement (2 percent aid/0 percent Risk Weighted Assets, as of Jan. 1, 2011).
February 25, 2009	The Treatment of Impaired Assets in the Community Banking sector ¹³ (IAC)	Valuation and assessment guidelines for transfer or guarantee by the State of toxic assets.
July 23, 2009	The Return to Viability and the Assessment of Restructuring Measures ¹⁴ (Restructuring Communication)	Principles of restructuring for rescued financial institutions: - Restoring the long-term viability without SA; - Burden-sharing; - Measures to address distortion of competition.

In practice, the crisis framework allows speedy rescues—often within 24 hours—that are temporarily approved on the basis of their compliance with the framework, that is, entry conditions. Temporary approval is followed by a final decision verifying compliance with the rules on restructuring and exit from State Aid. Exit is based on mandatory restructuring plans, initially in cases where recapitalization and/or asset relief aid was “significant,” and from January 1, 2011 onwards, for all recapitalization and asset relief aid. The implementation of the conditions set out in the restructuring plans, which can have periods of up to 5 years, is monitored by the European Commission and its dedicated “monitoring trustees.” The financial institutions concerned are thus subject to effective control from the implementation of agreed restructuring measures by the Commission for a prolonged period.

Under the crisis framework, Member States can notify the European Commission of either aid schemes or individual cases. The advantage of schemes is that once the conditions are agreed upon by the Commission, they can be used by Member States without subsequent need for agreement by the Commission. Recapitalization, asset relief, and guarantee schemes were thus established, and as of November 1, 2011, ten schemes are still in place.

The rules require that public support (whether through guarantees, recapitalizations or impaired asset measures) must be remunerated, is subject to common pricing rules to avoid distortions in the internal market, and must provide incentives for exiting aid. Moreover, *restructuring plans are assessed on the basis of viability, burden-sharing and the avoidance of distortions on competition.*

The Commission, through its binding decisions, has often required significant adjustments in the banks' restructuring plans in order to minimize distortions of competition, including closing unprofitable businesses or selling assets. The framework itself exemplifies a pragmatic approach based on the proportionality principle, marrying policies protecting macro-financial stability with the established principles of competition policy for rescue and restructuring aid.

Internally, the European Commission set up a Financial Sector Task Force to pool expertise across Commission services, drawing in a small number of external financial sector specialists who developed the necessary consistency in case practice through novel management structures and processes. At the height of the crisis the Task Force comprised about 40 members.

III. THE APPLICATION OF THE CRISIS FRAMEWORK: A REVIEW IN OUTLINE

Member States injected unprecedented volumes of aid into the financial sector. Before the financial crisis, total State Aid in the European Union hovered around 0.5 percent of Gross Domestic Product ("GDP"). Then, from October 1, 2008 to October 1, 2011, the Commission

approved € 4506.5 billion (36.7 percent of EU GDP) in aid. The bulk of the aid was authorized in 2008, when € 3457 billion (27.7 percent of EU GDP) was approved, mainly in the form of guarantees (i.e. contingent liabilities for the State). After 2008, the approved aid shifted focus to recapitalization of banks and impaired asset relief.¹⁶

Member States, however, did not use their full quota of approved aid. The overall amount of aid used in 2008-2010 stands at € 1608 billion (13.1 percent of EU GDP).¹⁷ Guarantees and liquidity measures account for € 1199 billion, or roughly 9.8 percent of EU GDP. The remainder went toward recapitalization and impaired assets measures amounting to € 409 billion (3.3 percent of EU GDP). Slightly over 72 percent of the aid used has been granted through schemes; the rest was provided on ad hoc basis. While the aids granted for recapitalizations and impaired asset measures have led to actual expenditure by the state, the guarantees have to date not been called.

Expressed as a percentage of the size of the EU banking sector (approximately € 42 trillion), this equates to some 2 percent of banking sector assets given as guarantees and other liquidity measures, and about 1 percent in capital injections and asset relief measures.

In the period between October 1, 2008 and October 1, 2011, the Commission took a total of around 250 decisions in the financial services sector under the crisis rules. These decisions authorized, amended or prolonged more than 30 schemes and addressed the situation in 37 financial institutions in the form of individual decisions. The Commission has so far taken only one prohibition decision. Financial crisis measures were taken in all Member States, except Bulgaria, the Czech Republic, Estonia, Malta and Romania.

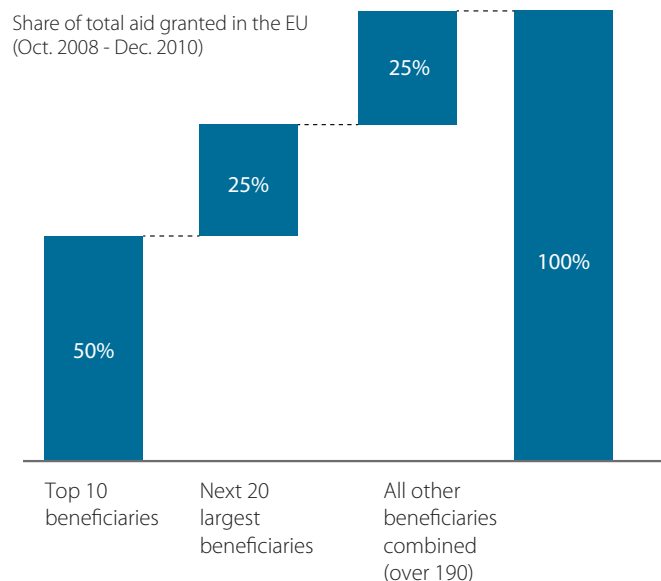
An interesting feature of the distribution of SA is the strong concentration in certain Member States and financial institutions. Banks in Germany, the United Kingdom and Ireland received about 60 percent of total aid. However, there was considerable variation in the relative importance of aid, i.e. as a percentage of the banking sector's size.

While Member States granted aid to, on average, 3 percent of the assets of their national banking sector, Greece and Ireland granted more than 8 percent.

The concentration of aid by bank was much more pronounced. Of the 215 Institutions receiving aid in the crisis until December 2010, 10 institutions were responsible for 50 percent of the aid; the next 20 took 25 percent of the aid. With the exceptions of Denmark and Spain, in all other Member States the top 3 beneficiaries received more than 50 percent, and in many cases more than 80 percent, of the aid.

Figure 1: Concentration of Aid by Member State, October 2008 – December 2010

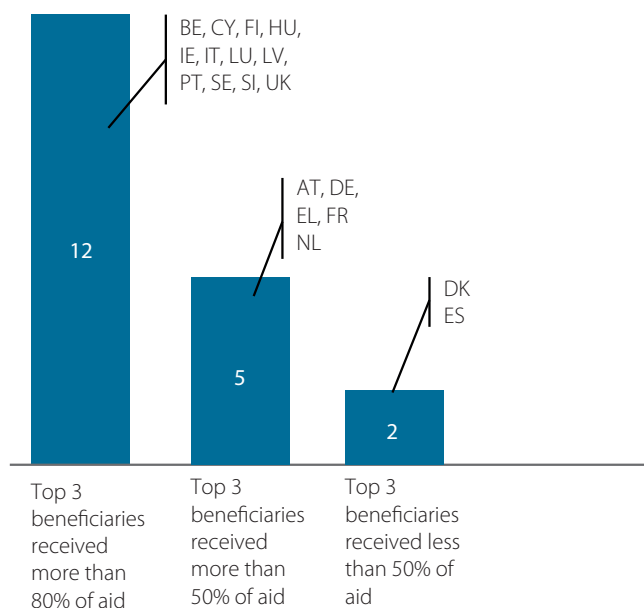
In the Single Market as a whole, 50% of aid was granted to 10 financial institutions.



Source: Commission Services

In most Member States, aid was concentrated on a few financial institutions

Number of Member States



Source: Commission Services

Although the crisis was triggered by a horizontal and systemic shock, there were significant differences in the vulnerability of individual banks, often reflecting the strength of underlying business models. In fact, the Commission's decisional practice demonstrates that it believes only a small minority of banks was truly inherently vulnerable to the effects of the systemic shock on account of preexisting weaknesses.¹⁸

It was the uncertainty surrounding the precise situation of all the banks that subsequently led to system-wide contagion.

Addressing the root causes of the problems in weak institutions therefore had to be an essential component in any effective strategy to restore confidence in the banking system and to promote macro-financial stability.

A framework for access to aid to be applied all throughout the European Union needed to be coordinated to avoid stability-oriented policies by individual Member States that would be at the expense of other Member States. For example, the initial conditions of the proposed Irish guarantee system were such that a deposit outflow from UK and foreign banks located in Ireland (which were not covered) was triggered.

The Commission intervened to amend the scheme ensuring that all banks located in Ireland were covered.¹⁹ This, in turn, also underlines the synergies between competition and stability policies as pursued by the European Commission.

Many of the largest recipients of aid had fundamentally unsound business models, were characterized by excessive risk taking, and often relied on excessive wholesale and short-term funding. The largest recipients of aid were all (relatively) large banks in their Member State of origin relying on an implicit state guarantee that, together with their funding model, led to a significant mispricing of risk.

The 15 largest beneficiaries of State Aid in the form of asset support during the reporting period have been restructured following a decision by the Commission, or submitted a restructuring plan that is still being assessed by the Commission. Those heavily-aided institutions originate from a few Member States: the United Kingdom (RBS and Lloyds Banking Group),

Ireland (Anglo Irish Bank, Allied Irish Banks), Belgium (Fortis, supported together with the Netherlands and Luxemburg; Dexia, supported together with France and Luxemburg; KBC), Germany (Bayern LB, Commerzbank, HSH Nordbank, IKB, LBBW and West LB), and the Netherlands (ING and ABN Amro).²⁰

Given these facts, addressing moral hazard is of key importance in the case practice of the European Commission. Moreover, they further underscore the role of competition policy in the context of stability oriented financial assistance policies.

Chart 1: The EU Crisis SA Framework for Financial Institutions

Date	Member State	Restructured Institution	Date of decision	Type of decision	Aid received as % of RWA (capital injections and asset relief)
2008	Germany	IKB	21/10/2008	Restructuring	26%
	Denmark	Roskilde Bank	5/11/2008	Restructuring	-
2009	Germany	Commerzbank	7/05/2009	Restructuring	8.2%
	Belgium, Netherlands and Luxembourg	Fortis	12/05/2009	Restructuring	4.1%
	Germany	West LB*	12/05/2009	Restructuring	18.0%
	Luxembourg	Kaupthing Banl Luxembourg	9/07/2009	Liquidation	-
	Latvia	Parex Banka	15/09/2009	Restructuring	29%
	United Kingdom	Northern Rock	28/10/2009	Restructuring	>14.4%
	Netherlands	ING	18/11/2009	Restructuring	5.0%
	Belgium	KBC	18/11/2009	Restructuring	5.1%
	United Kingdom	Lloyds Banking Group	18/11/2009	Restructuring	4.1%
	United Kingdom	Royal Bank of Scotland	14/12/2009	Restructuring	19.6%
Germany	LBBW	15/12/2009	Restructuring	8.3%	
2010	United Kingdom	Bradford & Bingley	25/01/2010	Liquidation	-
	United Kingdom	Dumfermline Building Society	25/01/2010	Liquidation	-
	Netherlands	SNS REAAL**	28/01/2010	Restructuring	<2%
	Belgium, France and Luxembourg	Dexia	26/02/2010	Restructuring	5.5%
	Sweden	Carnegie Investment Bank	12/05/2010	Restructuring	-
	Belgium	Ethias	20/05/2010	Restructuring	13.8%
	Spain	Caja Castilla - La Mancha	26/06/2010	Restructuring	15.1%
	Austria	BAWAG	30/06/2010	Restructuring	2.4%
	Ireland	Bank of Ireland*	15/07/2010	Restructuring	4.8%
	Netherlands	Aegon	17/08/2010	Restructuring	3.8%
	Germany	Sparkasse Koln/Bonn	29/09/2010	Restructuring	3.3%
	Denmark	Fionia Bank	25/10/2010	Liquidation	-
	Spain	Caja Sur	8/11/2010	Restructuring	19.0%
2011	Austria	Kommunalkredit	31/03/2011	Restructuring	18.4%
	Netherlands	ABN Amro Group	05/04/2011	Restructuring	2.75%-3.5%
	Greece	Agricultural Bank of Greece	23/05/2011	Restructuring	8.3%
	Denmark	Eik Banken	06/06/2011	Liquidation	-
	Ireland	Anglo Irish Bank - INBS	29/06/2011	Liquidation	~50%
	Germany	Hypo Real Estate	18/07/2011	Restructuring	31.5%
	Germany	HSH Nordbank	20/09/2011	Restructuring	11.6%
	Ireland	Quinn Insurance Ltd	12/10/2011	Restructuring	-

* Both Institutions received State aid after the restructuring decision and are thus in the process of submitting an amended restructuring plan.

** Aid to SNS REAAL did not exceed 2% of RWA and therefore the Commission's decision is based on a viability review.

*.- Indicates that only liability support was provided

As illustrated in Figure 2, of the 250 institutions receiving State Aid until November 1, 2011, only the banks receiving the proportionally largest SA were subject to restructuring decisions. This reflects the proportionate approach the European Commission follows. Recipients of SA in excess of 5 percent of their risk weighted assets ("RWA") were typically required to undertake a wide set of restructuring measures to ensure viability, burden-sharing and minimization of competition distortions, including closing of unprofitable activities, sale of subsidiaries, acquisition bans, and prohibitions on paying out dividends or interest on capital instruments. In some cases, the set of restructuring measures led to significant downsizing of the institution, of at least 50 percent or more.²¹ On the other hand, no restructuring decisions were imposed on the vast majority of institutions that benefited from small recapitalization aid amounts or guarantees.

Consistent risk-based pricing of these guarantees across EU banks ensures that sufficient coordination is achieved.

In taking restructuring decisions, the European Commission explicitly weighs the risk that divestments of foreign subsidiaries would fragment the internal market. In a number of cases, the Commission requested that banks divest assets in domestic markets instead,²² with a view toward ensuring competitive market conditions therein. The business models of many banks were de-risked in this process, leading to greater viability. Of the 34 restructuring decisions taken by the Commission between October 1, 2010 and November 1, 2011, 6 ended up in a formal liquidation. In all, Member States also resolved a number of banks without resorting to State Aid, but the absence of resolution frameworks led to far fewer banks being liquidated in the European Union than in the United States, where the Federal Deposit Insurance Corporation resolved hundreds of (predominantly smaller) banks by relying on its federal resolution powers.²³

In deciding aid applications, the Commission systematically applied the crisis framework to ensure a consistent treatment of all banks in all Member States. For example, the Commission Communications set out in Chart 1 require aid schemes to allow for non-discriminatory coverage of banks and financial institutions have to pay for the aid on the basis of EU-wide pricing rules. The key principles of the restructuring communication—long-term viability, burden-sharing

and measures to limit distortions of competition— were applied to all institutions undergoing restructuring in the following ways:

- The Commission pursued restoring the **long-term viability** of banks through requirements relating to their business models. This often involved the divestment of weak subsidiaries and limitations on future investments (i.e. acquisition bans), when they would go at the expense of capital positions. Corporate governance changes were often essential to ensure a return to viability, including, where necessary, changes of management.

- **Burden-sharing** is achieved through management changes, dilution of ownership and control (which, in some significant cases like Northern Rock and ABN Amro, led to bank nationalizations), and dividend and coupon bans. Capital operations—buybacks of existing shares, exercising call options on hybrid capital instruments, or early redemption of subordinated debt at nominal value—are typically not allowed for the duration of the restructuring plan. The remuneration of management was also addressed, by requesting compliance with the Commission and G20 guiding principles.

- **Measures to limit distortions of competition** are introduced to mitigate the consequences on the competitive position of the aided bank. These measures comprise the sale of profitable subsidiaries or changes in the balance sheet that seek to promote more equitable conditions of competition. Behavioral measures such as price leadership bans and minimum return on capital standards for new loans have also been taken in a number of cases,²⁴ particularly where no relevant structural measures could easily be identified.

It is important to emphasize that while the European Commission seeks to apply a consistent approach to all banks, it does not follow that the measures it requires are identical in all cases.

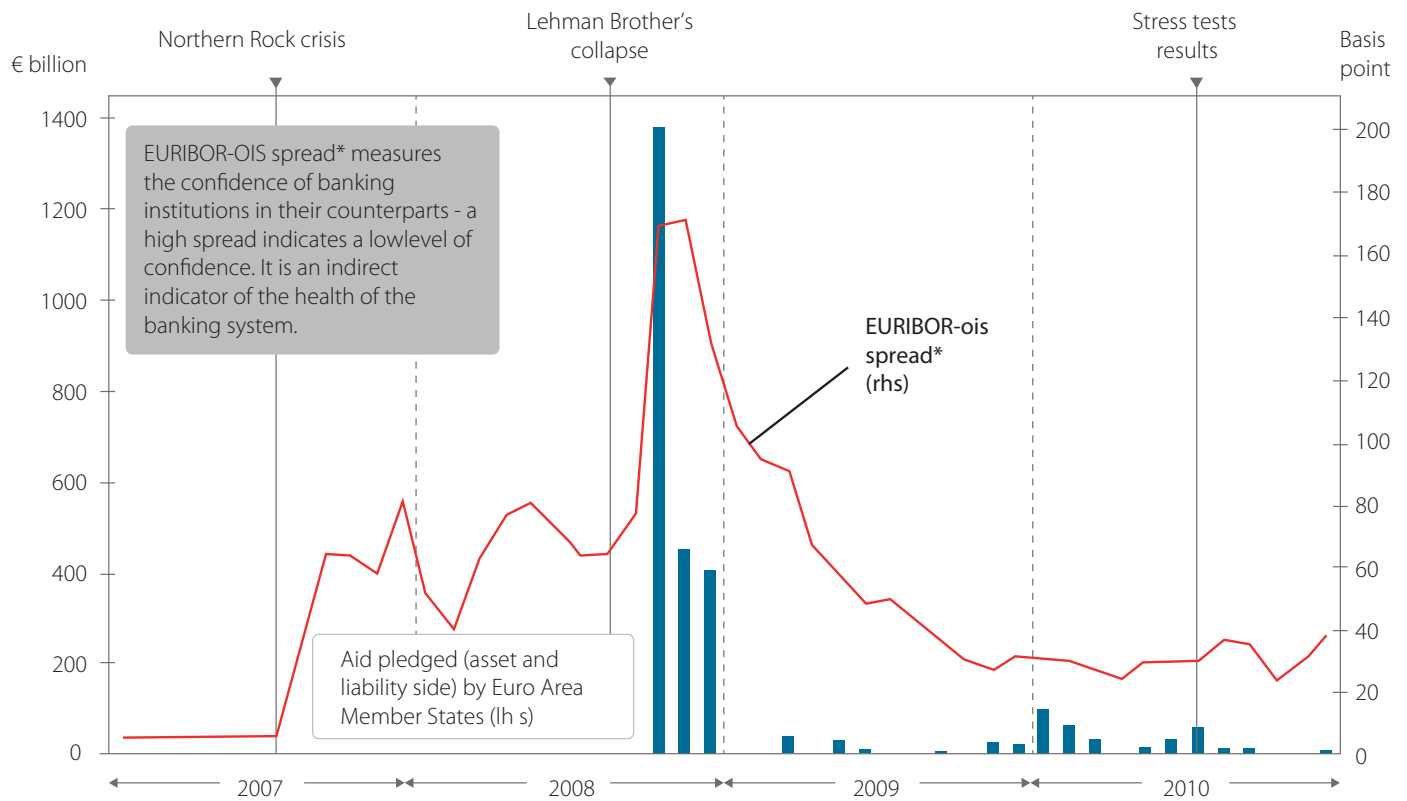
The restructuring requirements take the differences between banks into account, precisely in order to ensure equal treatment across all institutions concerned. The set up of the Task Force and the checks and balances in the European Commission all serve to ensure that this objective is met. Some Member States have taken action before Community Courts against crisis decisions by the

European Commission, but only a small number of complaints has been lodged,²⁵ and to date, no EC decision has been overruled by the Courts.

IV. OVERALL EFFECTS OF STATE AID AND STATE AID CONTROL DURING THE CRISIS

The significant volumes of aid to the EU financial sector, together with the intervention of the European Central Bank and the national banks, have helped mitigate the stability-eroding effects of the crisis. As Figure 3 shows, during the 2008-2010 period, the injections of aid are correlated with increases in confidence in the banking system as measured by the EURIBOR-OIS spread.

Figure 3: Evolution of EURIBOR-OIS Spread and of State Aid to the Financial Sector Pledged by Euro Area Member States



The rapid and large increases in capital in combination with the restructuring of the institutions concerned also led to improved lending conditions in the real economy as of the end of 2008 until the end of 2010.²⁶ A similar pattern is visible in the United States;²⁷ this experience stands in marked contrast with the handling of the Japanese banking crisis in the 1990s during which recapitalization, and especially restructuring, took place over the best part of the "lost decade."

Simulations using the QUEST-II macroeconomic model of the European Commission²⁸ also suggest that the amounts of State Aid have had a major positive effect on EU GDP. In the model, the interventions to support the financial sector mitigate the increase in equity risk premiums, thereby supporting investment that was particularly hard-hit by the crisis. Recapitalizations especially have a large GDP multiplier according to the model results.

Banks also managed to rebuild balance sheets and increase capital ratios, with the Core Tier 1 capital ratio rising by over 2 percentage points over the 2009-2010 period. The European banking sector as a whole also returned to profitability from the second quarter of 2010 onwards.

Evidence also suggests that after the initial strong tightening of credit standards and reduction in lending to the real economy, the situation began to improve again in 2010.²⁹ Although it is notoriously difficult to disentangle demand and supply factors, the overall evolution of the banking sector in 2010 suggests that the improvement in supply conditions played at least a supportive role.

The injections of large amounts of aid during the period 2008-2010 thus seem to have been effective in reaching their objective of strengthening macro-financial stability.

However, since the early summer of 2011, the situation of Europe's financial markets has started to deteriorate. The decline is caused by concerns with the sustainability of public finances in a number of distressed EU economies, in particular Greece, which led to steep increases in sovereign credit default swap spreads. This is illustrated in Figure 4.³⁰

Figure 4: Sovereign Bond Spreads and Financial Market Stress

	10/27/2011	7/27/2011	Average 10/2008 – 3/2009	Average 10/2008 – 3/2009
Selected sovereign bond spreads over 10 year German Bunds				
Belgium	204	181	85	7
Greece	2,166	1,236	201	24
Spain	316	352	85	3
France	94	65	45	4
Ireland	625	850	178	1
Italy	370	331	123	22
Portugal	1,018	848	108	12
EU Default perceptions (Itraxx), spreads**				
High grade financials	207	173	132	n/a
Low grade financials	411	305	221	n/a

** 1 basis point equals annual cost in € 1000 for insuring against the default of € 10 million of debt for 5 years.

With markets increasingly concerned about the valuation of sovereign bonds in the hold-to-maturity accounts, the asset positions of banks, especially those located in countries with distressed sovereigns, started looking far less solid. Concerns about the consequences for the banks concerned and uncertainty about the true direct and indirect exposure of banks to weak sovereigns subsequently led to term funding drying up for many banks. On October 12, 2011, the European Commission published "Roadmap to Stability and Growth,"³¹ a five-point strategy to break the vicious circle of doubts over the sustainability of sovereign debt, the stability of the banking system and the European Union's growth prospects,³² including a plan to strengthen the resilience of the banking sector. As part of the overall support for such a comprehensive approach, ECOFIN subsequently endorsed on October 26, 2011 a proposal by the European Banking Authority ("EBA") to create temporary capital buffers after a prudential valuation of sovereign debt, and to require temporarily a 9 percent core Tier 1 level from all European banks by June 2012.³³

It is estimated by the EBA that the largest European banks would need to reinforce their capital positions by around € 106 billion.

Although this should be accomplished from private sector sources, it is likely that further State Aid will be required. This is also likely to be the case for the effective implementation of coordinated initiative for term funding guarantees that the ECOFIN has also called for. In any event, this phase of the crisis has accentuated the strong interrelationship between the sustainability of public finances and the health of the financial sector in Europe.

The State Aid granted in 2008 and 2009 has had a positive effect on the stability of Europe's banking system (at least until the onslaught of the feedback loop from distressed sovereigns to banks), but it is difficult to isolate the effect of State Aid control during this period. The available indicators discussed below, however, suggest that the effect has been positive, both in terms of influencing stability through enhanced viability of the aided institutions, as well as with regard to its impact on the internal market.

The solvency ratio of aided institutions has increased broadly, similarly to that of non-aided institutions

over the 2008-2010 period,³⁴ suggesting that the restructuring and viability requirements of the former category have been successful, and that many of these banks have subsequently been able to inject private capital.

Moreover, the concentration on national and EU markets does not seem to have increased on account of the effects of the crisis and the State interventions that took place. The share of banking assets in individual Member States held by domestic institutions went up slightly in 2008, yet the trend subsequently stopped suggesting that there has not been a systematic retrenchment from cross-border activity in 2009 and 2010.³⁵ This is remarkable given that the State Aid framework could not substitute for public support at the European level, and cross-border banks in serious distress like Fortis and, in 2011, Dexia, had no choice but to break up into national parts as a consequence of the provision of financial support by their respective governments.

Across the European Union as a whole, the banking market does not seem to have become much more concentrated: overall, the level of concentration as measured by the Herfindahl-Hirschman Index went up by 10 percent in 2008 compared to 2005-2007, but this then decreased to 6 percent in 2009.³⁶ Aided banks have also not seen their overall share in the market increase. The largest aided banks typically experienced very significant balance sheet reductions as well as periods of low profitability: of the seven banks receiving aid in the Top 20 of the EU banking sector in 2008 Q1, only three still figured on the list in Q4 2010: Lloyds, Royal Bank of Scotland and ING.³⁷

It is also important to emphasize that there does not seem to be much evidence that SA control would have led to a negative effect on lending to the real economy by forcing across-the-board deleveraging. Given that only banks with problematic business models were asked to divest assets, there is no indication that SA control under the crisis framework has exerted a general downward pressure on lending.

In this context, many divestments primarily lead to a reorganization of the structure of the banking sector, rather than to an impact on aggregate credit provision to the real economy.

While there is some anecdotal evidence that in the context of recently announced tighter capital standards, some banks may prefer to deleverage through reducing risk weighted assets or selling assets, rather than through accepting recapitalization aid, there is as yet no evidence that SA control has actually clashed with stability-oriented policies on account of this mechanism.

This positive assessment should be qualified in at least three ways. First, with the crisis still unfolding in the European Union, and given the short time period over which the effects of SA control have been assessed, any results at this stage are clearly preliminary and will need to be validated at a later stage by much more rigorous analysis. Second, it is clear that State Aid control cannot substitute for a reformed and revamped EU banking regulatory system, which through its design (e.g. through capital and liquidity requirements) reduces the likelihood of bank failure, and if a bank does fail, ensures that there are transparent and predictable rules in place to manage their resolution.

The Dodd-Frank Wall Street Reform and Consumer Protection Act,³⁸ for example, would have, according to the Federal Deposit Insurance Corporation ("FDIC"), allowed for an orderly resolution of Lehman Brothers.³⁹ Finally, sound macroeconomic policies, notably with regard to public finances, are a precondition for the effectiveness of all structural policies, both competition and regulatory. This latter observation is particularly relevant to the recent reemergence of the banking crisis in the European Union.

V. OUTLOOK

The European Commission is extending the SA crisis framework into 2012 to allow SA cases to be dealt with under these dedicated rules for as long as the crisis lasts. This will, therefore, apply to State Aid measures that may flow from the recapitalization and guarantee measures for European banks proposed by the EBA and endorsed by the ECOFIN Council on October 26. Given that the trigger point for these measures is linked to the EU sovereign debt crisis, it is expected that the application of the principle of proportionality will take full account of the extent to which recapitalizations occur, to offset losses resulting from prudent valuations of sovereign debt on bank balance sheets. The present framework is the appropriate tool to assess such cases, as also recognized by the European Council.

In the longer run, it is clear that SA control will need to be complemented by an appropriate regulatory framework in order to provide more stability and help de-risk the EU banking system. This principally relates to new capital and liquidity requirements for financial institutions, as well as European Union-wide rules on bank resolution. The European Commission has drawn up an ambitious work program in this respect, and many of the key proposals have already been tabled, including the CRD IV proposal made in July 2011, proposing key rules on, inter alia, capital, liquidity and leverage.⁴⁰ The creation of the European Banking Authority has strengthened centralized EU-level supervisory oversight, which is of particular relevance at the present time, given the close links between banks and the sovereign in which they are headquartered, particularly in the euro area.

An important characteristic of the proposed new capital requirements are the more demanding capital ratios required of large financial institutions: this would, to some extent, internalize the “too big to fail” advantage these institutions have in terms of funding costs. Moreover, as highlighted above, a bank resolution framework, on which the European Commission has announced that it will make a proposal,⁴¹ would allow reducing aid to the banks in the first place or in the event of financial distress.

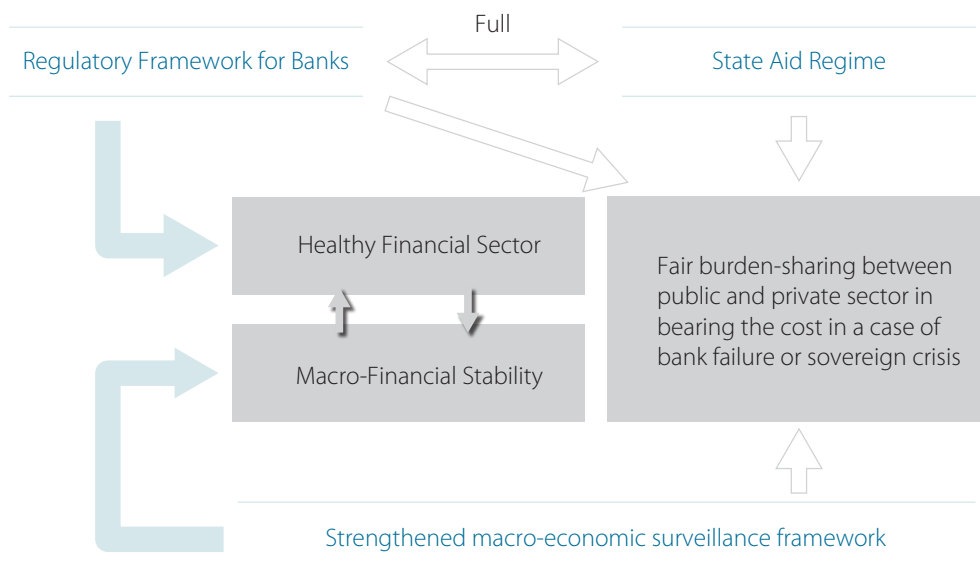
A mid-term challenge will be to ensure full consistency and compatibility between the SA rules and the regulatory framework.

This will be particularly relevant for the approach to be taken for burden-sharing. To the extent that the regulatory regime in the rules applying to all companies at all times effectively deals with moral hazard, it would fall less to the enforcement of State Aid control to achieve these objectives. Similarly, regulatory means could assist with ensuring that distressed banks would need to reform business practices and shed loss-making entities for viability reasons, even before they access public aid, if necessary and justified. It is premature to take this analysis forward at this stage, but it is already clear that the interplay between competition and regulatory policies will become more significant as the latter is further elaborated.

At the same time, a further strengthening of macroeconomic surveillance policies, including with regard to macro-prudential matters, will be of key relevance to strengthen macro-financial stability, particularly in the euro area.

Here, a more effective framework could reduce some of the pressure on State Aid control that presently attempts to integrate these concerns, inter alia, through the application of the proportionality principle. Most importantly, however, the further development of banking regulation and macroeconomic surveillance policies will lead to better overall results in terms of stability and competition in EU financial markets.

Figure 5: Complementarities Between SA Control, Banking Regulation and Macroeconomic Policies



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- 1 This article draws heavily on European Commission, *The Effects of Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis* (Commission Staff Working Paper, SEC 1126 final, 2011), to which many colleagues in the Competition department of the European Commission have contributed. I would also like to thank Sean Berrigan, Alexander Italianer, Stan Maes and Nicola Pesaresi for their valuable comments on a previous version of this article. Needless to say, the views expressed in this article cannot be ascribed to the European Commission and all remaining errors are mine.
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 - 3 Treaty on European Union, 1992 O.J. (C 191), Art. 106-108.
 - 4 For an analysis of the available options, see Gregory Nguyen, Mathias Dewatripont, Peter Praet & André Sapir, *The Role of State Aid Control in Improving Bank Resolution in Europe*, 4 BRUEGEL POL'Y CONTRIBUTION (2010), available at <http://www.bruegel.org/publications/publication-detail/publication/404-the-role-of-state-aid-control-in-improving-bank-resolution-in-europe>.
 - 5 See European Commission, *Impact of the Current Economic and Financial Crisis on Potential Output* (Directorate-General for Economic and Financial Affairs Occasional Paper No. 49, June 2009).
 - 6 Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393 (1984); Franklin Allen, *The Market for Information and the Origin of Financial Intermediation*, 1 J. FIN. INTERMED. 3 (1990).
 - 7 See John H. Boyd & Gianni De Nicoló, *The Theory of Bank Risk-taking and Competition Revisited*, 60(3) J. FINANCE 60, 1329 (2005),
 - 8 See Wolf Wagner, *Diversification at Financial Institutions and Systemic Crises* (Tilburg University, Center for Economic Research, Discussion Paper 2006-71, 2008).
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 - 10 Communication from the Commission — Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, 2004 O.J. (C 244/2).
 - 11 Communication from the Commission — The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C 270/8).
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 - 15 See, e.g. State Aid C-11/09, Commission Decision on the Measures implemented by Dutch State for ABN AMRO Group NV (Apr. 5, 2011), available at http://ec.europa.eu/competition/state_aid/cases/230806/230806_1235915_338_2.pdf; State Aid N 428/09, Restructuring of Lloyds Banking Group, 2010 O.J. (C 46) 2.
 - 16 EUROPEAN COMMISSION, STATE AID SCOREBOARD, AUTUMN UPDATE (2011) (forthcoming), pp. 31-51.
 - 17 *Id.*
 - 18 See Figure 2, *infra*, for an overview of the main Institutions concerned.

- 19 State Aid NN 48/2008, Guarantee scheme for banks in Ireland, 2008 O.J. (C 312) 2.
- 20 European Commission, *The Effects of Temporary State Aid Rules Adopted in the Context of the Financial and Economic Crisis* (Commission Staff Working Paper, SEC 1126 final, 2011).
- 21 See, e.g., Press Release, European Commission, State aid: Commission approves restructuring plan of Hypo Real Estate and clears the aid (July 18, 2011), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/898>
- 22 See, e.g., State Aid N 428/09, Restructuring of Lloyds Banking Group, 2010 O.J. (C 46) 2; State Aid C 18/09, Commission Decision on the State aid implemented by Belgium for KBC, 2010 O.J. (L 188) 24.
- 23 For a list of banks, see Federal Deposit Insurance Corporation, Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Dec. 9, 2011).
- 24 See, e.g., State Aid N 528/2008, Participatie in het kernkapitaal van ING, 2008 O.J. (C 328) 4; Press Release, European Commission, State aid: Commission temporarily approves rescue aid for Dexia Bank Belgium; opens in-depth investigation (Oct. 17, 2011), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1203>.
- 25 See, e.g. Case T-33/10, ING Groep v. Comm'n, 2010 O.J. (C 80) 40.
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- 27 Troy Matheson, *Financial Conditions Indexes for the United States and Euro Area* 9-10 (International Monetary Fund, Working Paper 11/93, 2011), available at <http://www.imf.org/external/pubs/ft/wp/2011/wp1193.pdf>.
- 28 See Jan In't Veld & Werner Roeger, *The Effects of Bank Rescue Measures in the Recent Financial Crisis* (Sept. 2011) (forthcoming).
- 29 See Directorate-General for Economic and Financial Affairs of the European Commission, EUROPEAN ECONOMIC FORECAST (Spring 2011).
- 30 *Weekly Credit Market Pulse of 10/28/2011*, internal publication of the Directorate General for Economic and Financial Affairs (on file with author).
- 31 Communication from the Commission — A Roadmap to Stability and Growth, COM (2011) 669 final (Oct. 12, 2011).
- 32 The five priorities are: (1) Give a decisive response to the problems of Greece; (2) Enhance the Euro area's backstops against the crisis; (3) Strengthen the banking system, namely through recapitalization; (4) Frontload stability and growth enhancing policies, and; (5) Build a more robust and integrated economic governance.
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- 34 European Commission, *supra* note 18, at 82.
- 35 *Id.*, at 100.
- 36 *Id.*, at 98.
- 37 *Id.*, at 101.

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- 39 FDIC, *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5(2) FDIC Q. 31 (2011).
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- 41 European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, regulating financial services for sustainable growth*, COM (2010) 301 final (June 2, 2010).