Stability and Competition in Banking after the Financial Crisis

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1. Introduction

- Competition is a cornerstone of the single market in the EU
- The Commission ensures fair competition through the use of three tools:
  - Anti trust controls
  - Merger controls
  - State aid controls
- The crisis posed a major challenge for State aid control:
  - Massive State aid supports to the financial sector in order to preserve financial stability
  - Trade-off between competition and financial stability?
  - Necessity to suspend State aid control?
2. The Commission’s approach in the crisis

- « Competition policy is part of the solution to the crisis, not part of the problem »

- The challenge: swiftly authorising massive State aid support to the financial sector to ensure financial stability…; conditions imposed on restructuring plans

- As of October 2010, the total amount of aid approved by the Commission:
  - State guarantees and liquidity support to the financial sector: € 3641 bn
  - Recapitalisation of financial institutions: € 546 billion
  - Impaired asset measures: € 402 billion

- …While imposing conditions to the aid so as to preserve competition
  - Phase 1 conditions: minimum remuneration of the aid and behavioural conditions
  - Phase 2 conditions: in-depth restructuring or liquidation of distressed institutions
2. The Commission’s approach in the crisis

- Approval of aid under Article 107.3(b): aid to remedy a serious disturbance in the economy of a Member State
- Four communications detailing in practice the conditions associated to the aid granted:

<table>
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<th>Date</th>
<th>Communication</th>
<th>Main principles</th>
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<td>13 October 2008</td>
<td>The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (\text{(Banking Communication)})</td>
<td>adapting certain principles of R&amp;R guidelines to financial cases i.e. allowing capital injections, distinction between fundamentally sound and distressed institutions.</td>
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| 5 December 2008    | Commission Communication Recapitalisation of financial institutions \(\text{(Recapitalisation Communication)}\) | • Guidance on pricing of capital injections based on ECB recommendation (7% to 9.3%)  
• Threshold for in-depth restructuring requirement (2% aid/RWA – 0% as of 01.01.2011) |
| 25 February 2009   | Communication from the Commission on the Treatment of Impaired Assets in the Community Banking sector \(\text{(IAC)}\) | Valuation and assessment guidelines for transfer or guarantee by the State of toxic assets.               |
| 23 July 2009       | Communication from the Commission “The return to viability and the assessment of restructuring measures “ \(\text{(Restructuring Communication)}\) | Principles of restructuring for rescued financial institutions:  
• Restoring the long term viability without SA  
• Burden sharing  
• Measures to address distortion of competition |
2. The Commission‘s approach in the crisis

• The restructuring or liquidation of distressed banks is of paramount importance to ensure financial stability while preserving competition

• Restructuring or liquidation is triggered when institutions have received a significant amount of aid, mainly through capital and asset relief
  – e.g. amount of aid (recapitalisations and asset relief) is above 2% of risk-weighted assets (until 31.12.2010)
  – The amount of aid received is an indicator of the size of difficulties encountered by the bank; those difficulties must be definitely addressed through a restructuring plan

• The restructuring plan must:
  – Ensure the institution’s return to long-term viability without State support: avoid « zombie banks » and ensure stability of the whole banking system in the long run (i.e. avoid a Japan-like situation);
  – Share appropriately the restructuring cost among the State and the stake holders (i.e. shareholders and creditors, except depositors) : address moral hazard;
  – Compensate for distortions of competition caused by the aid received
2. The Commission’s approach in the crisis

• The restructuring in practice: Lloyds TSB and Dexia

• Lloyds TSB: aid support triggered mainly by the acquisition and difficulties of HBOS
  – £ 14.7 bn net recapitalisation and £ 5.9 bn State participation in Seaview project (replacing LBG participation in the APS) ; heavy reliance on guaranteed funding
  – Long-term viability is ensured by running down £181 bn of risky assets and recapitalisation within the Seaview project
  – Moral hazard is addressed through the dilution of existing shareholders and a ban on payments on Tier 1 and Tier 2 instruments
  – Distortions of competition are addressed by the carve-out and sale of 600 branches in the UK retail market (3.3 million customers and £ 70 bn assets)

• Dexia: aid support triggered mainly by funding difficulties
  – € 8.4 bn recapitalisation and asset relief and up to € 95-135 bn of State guarantees and liquidity assistance
  – Long-term viability is ensured through the reduction of funding and maturity gaps
  – Moral hazard is addressed through the dilution of existing shareholders and a ban on payments on Tier 1 and Tier 2 instruments
  – Distortions of competition are addressed through divestments of profitable assets
3. The way forward

• The new challenge now is to exit from the crisis related State aid framework while withstanding the new sovereign debt crisis; this requires:
  – Repairing the banking sector to ensure it can continue to provide effective intermediation;
  – Providing an appropriate regulatory and supervisory framework;
  – Maintaining public debt sustainability.

• Three initiatives to address the first two challenges
  – The EU-wide bank stress test to accelerate the financial repair;
  – New banking and financial sector regulation, inter alia to enhance bank capital requirements and put in place a new resolution regime;
  – The review of the State aid framework to phase out the exceptional crisis-related measures and ensure return to « normal » post-crisis State aid regime.
3. The way forward

• No structural trade-off between financial stability and competition:
  – Traditional analysis of competition resulting in smaller and less diversified banks, which could endanger financial stability (Diamond 1984, Allen 1990);
  – However, those drawbacks can be addressed by appropriate regulation and supervision;
  – Furthermore, more recent analysis show that large banks in concentrated banking systems may create adverse selection issues (Boyd & De Nicolo 2005), result in « too big to fail » problems (Mishkin 1999), increase the contagion risk (Wagner 2008) and make it more difficult to supervise and regulate.

• Regulatory measures at EU level:
  – New regulatory regime for banks to avoid excessive risk taking and strengthen capital buffers;
  – Macro-prudential surveillance to address interconnectedness and « too big to fail » issues.
3. The way forward

Regulatory Framework for banks

Healthy financial sector

Macro-financial stability

State aid regime

Fair burden-sharing between public and private sector in bearing the cost in a case of bank failure or sovereign crisis

Strengthened economic surveillance framework and ESM

Full compatibility
3. The way forward

- As far as State aid is concerned, the work going forward consists in:

- Ensuring a progressive phasing out of crisis-related measures until 31 December 2011:
  - Change in conditions for State guarantees as of 1 July 2010 (increase remuneration and requirement for a viability plan);
  - Removal of the distinction between fundamentally sound and distressed banks as of 1 January 2011 (i.e. all banks receiving capital injection or asset relief measures must undertake in-depth restructuring);
  - Extend the crisis legal framework (the four communications) until 31 December 2011 (Communication of 1 January 2011).

- Putting in place a transitional arrangement for rescue and restructuring of financial institutions under normal circumstances after December 2011:
  - Take stock of lessons learned during the crisis to adapt the Commission’s rescue and restructuring guidelines to financial institutions;
  - Transitory framework until national resolution regimes for banks are in place to ensure full compatibility between new regulation and competition rules.
3. The way forward

- Sequencing of policy initiatives
4. Conclusion

• No structural trade-off between financial stability and competition in banking

• During the crisis, the Commission’s competition policy contributed to the preservation of stability

• Looking forward, the new regime for banks will rely on three mutually reinforcing pillars (a new regulatory regime, enhanced macro-prudential surveillance, and a revised State aid framework) that will preserve competition and reinforce stability.
Sources


