The current Financial Crisis and State aid

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Outline

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Why intervene? Why state aid in a financial crisis?

- Externalities and systemic risk:
  - the failure of a large bank may create a systemic risk of generalized bank failures due to cross balance sheet relationships, that are not internalized in the failure of the particular bank
  - The failure of an important deposit institution may create bank-runs that lead to liquidity squeezes and precipitate bank failures
- Externalities between financial and real sector
  - Increasing risk of failure of banks leads them to curtail lending to firms and households precipitating a downturn in the economy
  - Loss of deposits and other household assets leads to decrease in money supply and cuts aggregate demand (specter of deflation)

And the upcoming economic crisis?

- Cross-border externalities: bank failures in one country may lead to bank failures in other countries, especially in a currency union or a financially integrated area
- Cross-border externalities also occur due to the interaction of the financial and real sector across all countries in the EU

- Information asymmetries and collapsing markets:
  - banks may not have good information about the liquidity and solvency of their domestic or commercial clients. Besides, in a mark-to-market world the values of all assets may decrease simultaneously, it may be difficult to distinguish between a relative price and overall adjustment
  - Capital markets suffer from the same asymmetries in information – difficulty in distinguishing good and bad investments (large correlation in risk)

Plus: we need to buy time for correcting regulation failures

Recommendations of ECOFIN

The ECOFIN conclusions enumerate the following principles:

– Interventions should be timely and the support should in principle be temporary;

– Member States will be watchful regarding the interests of taxpayers;

– Existing shareholders should bear the due consequences of the intervention;

– Member States should be in a position to bring about a change of management;

– The management should not retain undue benefits – governments may have inter alia the power to intervene in remuneration;

– Legitimate interest of competitors must be protected, in particular through the state aid rules;

– Negative spill-over effects should be avoided.

Ecofin, October 7th, 2008

Basic requirements for state aid control

- Timely and speedy intervention and approval
- But, no blanket solution. Each institution may require a tailor-made intervention
- Need to assess different alternatives on the specific and systemic risk

- Thus

- Requires very good Guidelines to give guidance to States and regulators on different alternatives and best practices
- Establish “de minimis” criteria
- Define measures and conditions that “most likely would be rejected” (red lines)
- Define a clear and efficient system for monitoring evolution after the aid

- Article 87
- 1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.
- 2. The following shall be compatible with the common market:
- (a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;
- (b) aid to make good the damage caused by natural disasters or exceptional occurrences;
- (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.

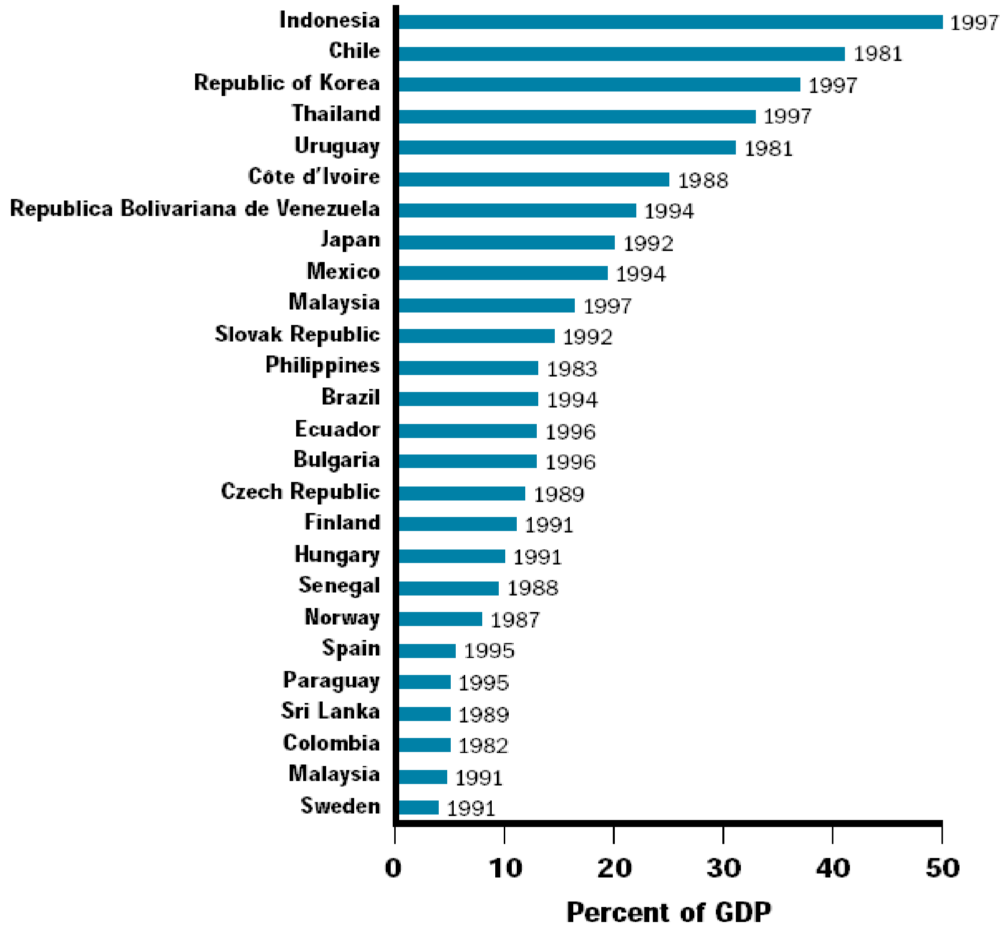
- 3. The following may be considered to be compatible with the common market:
- (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;
- (b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
- (c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;
- (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;
- (e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.

Cases Notified to the Commission

	Deposit guarantees	General bank guarantee	Bank recapitalization	Company to dispose bad assets	Buying bad assets
BL					
DK	Y	Y		Y	
DEU	Y	Y	Y		
ELLAS		Y	Y		
ESP		Y			Y
FR		Y	Y		
IR		Y			
ITA		Y	Y		
LUX					
NETH		Y			
AUS		Y			
PT	Y	Y	Y		
FIN		Y	Y		
SUE		Y			
UK	Y	Y	Y		
HUN		Y	Y		
POL		Y			
CZCH					
SLV	Y	Y			
EST					
LIT					
LAT		Y			
SLO					
CH					
ML					
BUL					
ROM					

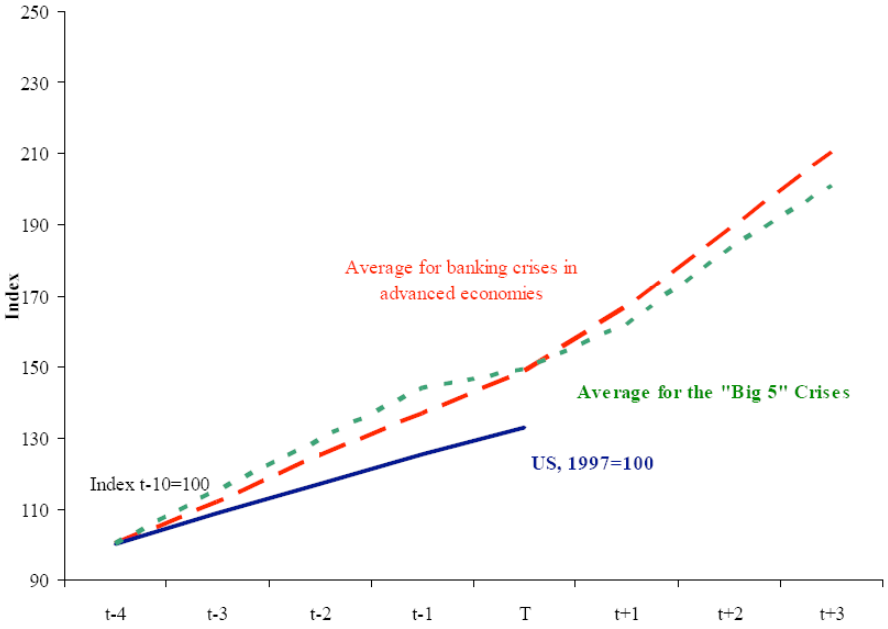
	Bank rescues	Bank liquidation
BL	4	
DK		1
DEU	4	
ELLAS		
ESP		
FR	1	
IR		
ITA		
LUX	2	
NETH	4	
AUS		
PT	1	
FIN	1	
SUE	2	
UK	2	
HUN		
POL		
CZCH		
SLV		
EST		
LIT		
LAT	1	
SLO		
CH		
ML		
BUL		
ROM		
Total	22	

Figure 2.1 Total fiscal costs (increases in the stock of public debt) relative to the flow of GDP in the year of crisis



Source: Honohan and Klingebiel (2000); Caprio and Klingebiel (1999).

Figure 5: Public Debt and Banking Crises



Two contrasting cases of resolutions: Sweden

- Facts:
  - large shock (bank losses between 13 and 37% of lending)
  - Fiscal costs: 2.1% of GDP; GDP cost: app. 3.5%
  - Crisis solved in 2-3 years, with asset resolution up to 5 years
- Main instruments: bank nationalization (2 major banks), bank guarantees and bank recapitalization
- Set-up agency for “toxic assets” (Securum) that got all bad assets from banks intervened
  - Totally owned by State, but independent and staffed by specialized professionals
  - Started by recuperation of assets – most cases declare owner bankrupt – became largest real estate owner, but did not dispose immediately assets
  - Third phase: (i) firms owned run efficiently, (ii) repackaging for maximizing value, (iii) maximizing sales value by IPOs, corporate transactions and selling individual properties.

It all depends on policies! Japan: the lost decade

- Facts:
  - Large shock (nonperforming loans: 25% of GDP in 1995 (Caprio), 18% of GDP in 1998; bad loans still 35% of total loans in 2002)
  - Fiscal cost: 22% of GDP; GDP cost: app. 22.5%
  - Crisis lasted for more than a decade
- Instruments: Obushi Plan (1995) provided 12% of GDP in public funds for depositor protection, buying bad loans, recapitalization
  - 7 banks nationalized, 61 institutions closed, and 28 merged.
- Problems:
  - Too strict conditions on use of state aid in the first 5 years
  - Banks concealed bad debts (with regulators inaction) and kept lending to insolvent clients: the zombie syndrome

Main lesson: transparency of bank real situation is fundamental,
and decisive action “in cleaning up”,
with immediate impact on the real economy
will shorten crisis

Main lessons

- **Debt restructuring is absolutely necessary to prevent a vicious cycle**
- Debt relief and rehabilitation of viable but debt-ridden firms and the liquidation of nonviable firms are crucially important to wipe out the payment uncertainty from the economy and restore market confidence. If zombie firms stick around in the market, uncertainty and business shrinkage will linger on. Capital injections into banks are just a beginning.
- **Stringent asset evaluation and sufficient write-offs**
- Stringent and conservative evaluation of the toxic assets should be the premise behind bank-capital injections and debt restructuring. Financial regulators should establish task forces for asset evaluation and push financial institutions to recalculate their asset values conservatively enough so that the market can rely on their numbers. Evaluate toxic derivative securities by “reverse engineering”.

Main lessons (2)

- **Purchase of bad assets by public asset management companies**
- To stop the vicious cycle of debt deflation, the governments struggling with the financial crisis should establish asset management companies, public entities that purchase and hold the bad assets. The purchase and freezing of toxic assets is necessary to stop debt deflation. The public entities should then restructure the bad assets and sell them off gradually after the market stabilizes.
- **Suspension of mark-to-market accounting has a long-term side effect**
- If bankers hide bad assets, zombie firms will persist and the payment uncertainty will remain, setting the stage for very low long-term economic growth.

- First phase of crisis:
  - Banks took excessive risk from households (and firms)
  - Investment banks securitized and leveraged risk
  - Fall in housing prices, coupled with drop in liquidity and complex derivatives led to investment banks collapse and large losses in commercial banks
- We are now in second phase
  - Fall in housing prices: 10 to 30% of households with negative equity in some developed countries
  - Capital markets: largest drop since GD (50% since 2007)
  - Unemployment climbs fast to record levels (in the US and EU may reach 10% by 2009-10)
  - Record level of corporate failures
  - Which will have a further negative impact on banks balance sheets

- Entering a third phase
  - Bank losses accumulate with household and enterprise failures
  - Monetary policy impotent (liquidity trap) with record low interest rates
  - Fiscal stimulus starting to operate, but concerns of a large public debt hang-up

  - So …

  - Need for an expansionary demand policy
  - Combination of monetary and fiscal policy to fight stag-deflation
  - Further bank state aid
  - Strengthening bank regulation

Effects-based approach to evaluate state aid

(a) *Is there a market failure or another objective of common interest? (e.g. social or regional cohesion)*

(b) *Is the aid measure targeted, i.e. does the proposed aid address the market failure or other objective? In particular,*

i. *is the aid measure an appropriate instrument, i.e. are there other, better placed instruments?*

ii. *is there an incentive effect, i.e. does the aid change the behaviour of firms?*

iii. *is the aid kept to the minimum, i.e. could the same change in behaviour be obtained with less aid?*

(c) *Are the distortions of competition and effect on trade sufficiently limited, so that the overall balance is positive?*

Criteria for evaluation: total welfare (efficiency plus consumer surplus) with equity considerations

The economic approach (effects-based) to state aid

- A benefit-cost analysis, based on the NPV of stream of benefits and costs
- Direct benefits: avoiding contraction of credit to economy (use credit multiplier)
- Indirect benefits: contain systemic risk and overall risk of recession (compute impact on financial risk)
- Costs:
  - To taxpayers
    - Short-term: interest costs of public debt, and cost of guarantees
    - Medium-term: potential costs due to asset valuations and bankruptcy of institution
    - Administrative costs of implementing measures
  - To depositors and investors (option cost of inaction)

Need to establish templates for quick evaluation
It will shorten time of analysis and "focus the discussion"

A menu of state aid interventions

Type of aid	Impact on financial institution	Impact on economy	Distortion on behavior agents	Distortion competition	Cost taxpayers	Administrative costs and complexity	Duration
General deposit guarantees	High (insurance of large share of debt in commercial banks, but not others)	High on securing the banking system	Creates moral hazard on commercial banks (1)	General measure: no distortion	Medium to low. Equal to probability of a bank failure times the potential losses of bank (2)	Low	Long
State guarantee to bonds or other credits issued by banks	Medium: main impact is increasing liquidity	May be important to resume bank lending to the economy	Creates moral hazard on banks because they can take additional risk	General measure: no distortion	Low. Equal to probability of default on those credits times potential losses of banks	Low	Duration of crisis and recovery of each institution

State takes minority stake in bank capital	Avoids bank failure	Depends on share of bank assets on total market assets (problem of "too big to fail")	Creates moral hazard by bank management and invites taking on excess risk (3)	High, since it "saves the offender" that took excess risk	Small, since preferred shares may be required to earn a minimum return, and probability loss depends on probability of bank failure	Low, esp. if government does not intervene in administration	Duration of crisis and recovery in institution
State takes majority stake in bank capital	Avoids bank failure	Depends on share of bank assets on total market assets (problem of "too big to fail"	Creates moral hazard by bank management and invites taking on excess risk (3)	High, since it "saves the offender" that took excess risk	Medium, since preferred shares may be required to earn a minimum return. Probability loss depends on probability of bank failure	Medium	Duration of crisis and recovery in institution
Nationalization bank	Avoids bank failure	Depends on share of bank assets on total market assets (problem of "too big to fail")	Creates moral hazard by bank management and invites taking on excess risk	It "saves the offender" that took excess risk. Depends on terms of compensation.	High, since State has to cover all present bank losses. Only recovered loans in future will lower that cost	High. Government has to designate new administration	Duration of crisis and recovery in institution

Merging of banks or assets acquisition	Avoids bank failure	Avoids bank runs. Depends on bank share of total market	No major problem	Potentially high	No cost if simple merger. But State may have to sweeten the deal or get part of bad assets	Low	Immediate solution
Bank liquidation	Allow an orderly unwind of operations	Avoid bank runs and asset deterioration. Can have a high impact on risk of other bank failure	No problem	No major problem	State may have to pay depositors and creditors for losses	Low (liquidating committee nominated)	Low to medium depending on time needed to liquidate

Buying toxic assets from banks thru "reverse auctions"	Avoids bank failure if buying price by government above mark-to-market	High. Reduces bad assets on bank assets and creates "room" for new lending	Creates moral hazard by bank management and invites taking on excess risk	Potentially some distortion, rules of access should not be discriminatory	Very high. Equals amount of assets times part not recovered	Very high. Government has to administer assets and recover loans	Long. Until credits are recovered
Direct aid to households (mortgage reform)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to households and gives an incentive to increase demand	Reduced distortion, since only households in trouble are "saved"	Low, since there is no discrimination between institutions	Very high. To have an impact on financial system has to be carried out in large amounts	Very difficult and complex to administer. Needs to target each household in bankruptcy	Long

Direct aid to SMEs (direct loans)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to firms and gives an incentive to resume production	Reduced distortion, since only small firms in trouble are "saved"	Low, since there is no discrimination between institutions	High to medium. It is equal to probability of SMEs failing times average loss	Difficult and complex to administer. Needs to define clear criteria for access	Long
Direct aid to SMEs (loan guarantees)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to firms and gives an incentive to resume production	Reduced distortion, since only firms in trouble are "saved"	Low, since there is no discrimination between institutions	Medium. It is equal to probability of SMEs failing times average loss	Difficult and complex to administer. Needs to define clear criteria for access	Long
Direct aid to SMEs (reducing loan charges)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to firms and gives an incentive to resume production	Reduced distortion, since only households in trouble are "saved"	Low, if there is no discrimination between firms	Medium. It is equal to probability of SMEs failing times average loss	Difficult and complex to administer. Needs to define clear criteria for access	Long

Direct aid to large firms (direct loans)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to firms and gives an incentive to resume production	Creates moral hazard by management of firms, that may be complacent to restructuring needed	Highly distortionary	Very high. It is equal to probability of bankrupcy times average loss	Very difficult and complex to administer. Needs to define criteria for access. Needs to analyze and monitor restructuring plan	Long
Direct aid to large firms (loan guarantees)	Limited at beginning. Builds-up as larger share of bank assets is "cleaned from the books"	Limited at beginning, and increasing. Increases liquidity to firms and gives an incentive to resume production	Creates moral hazard by management of firms, that may be complacent to restructuring needed	Highly distortionary	Medium. It is equal to probability of bankrupcy times average loss	Very difficult and complex to administer. Needs to define criteria for access. Needs to analyze and monitor restructuring plan	Long
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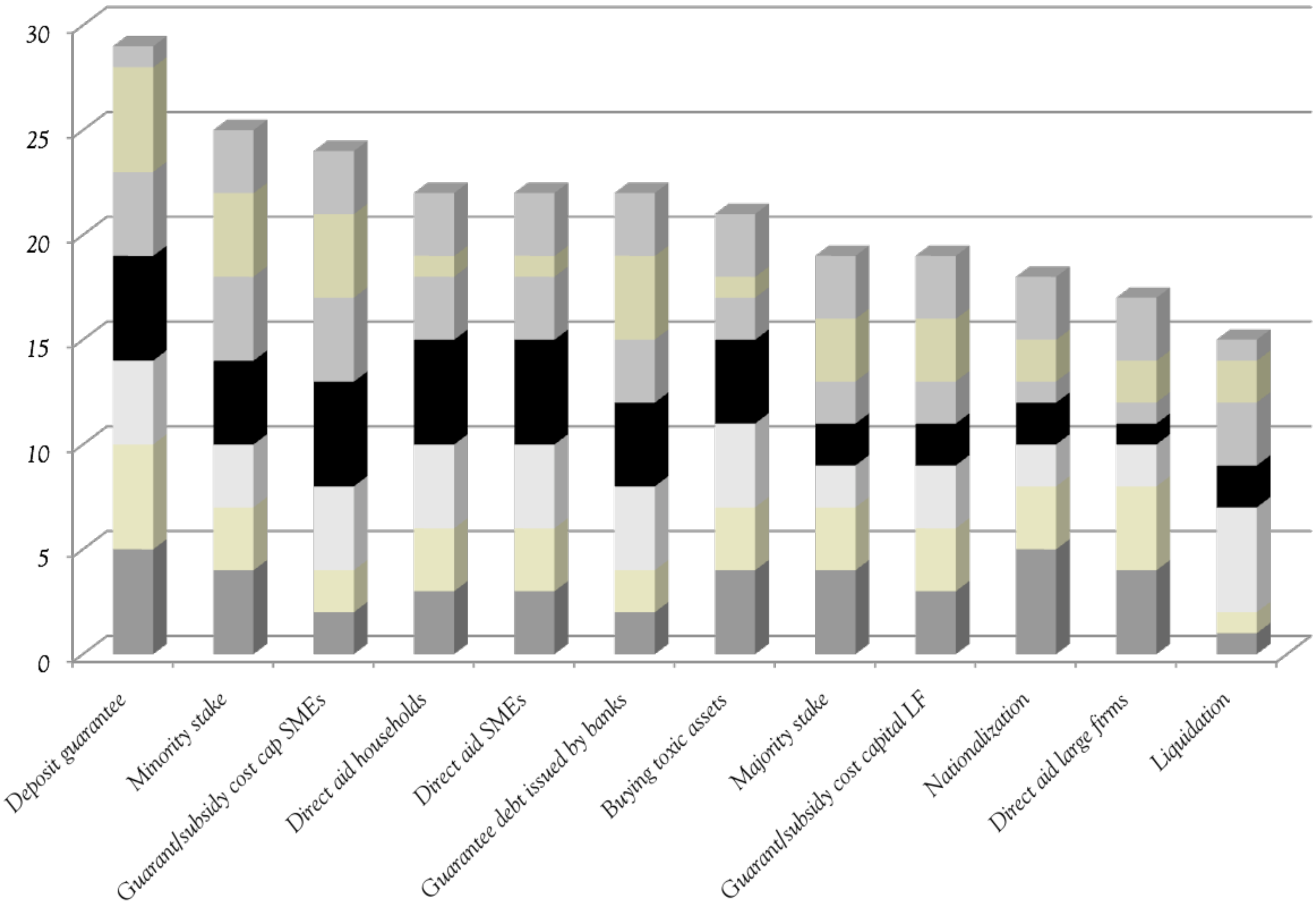
Scoring different measures on CBA



Conditionality

- Guarantees to deposits: only a temporary "all deposits guarantee". After crisis it should be subject to a maximum by depositor and bank, to limit moral hazard. Assumes large depositors have enough information on risk of the bank.
- Require that funds to back-up guarantees be financed by contribution from banks, which decreases cost to taxpayers.
- Government have to require that shareholders do not profit from the recapitalization, by preconditioning write-down of capital, and avoiding payment of dividends and large bonus to management while bank benefits from aid
- Nationalization and liquidation should be only a last resort measure

Preventing regulation failure

- Subject all measures in a country to a periodic review of capabilities of national bank supervision (jointly with IMF?)
- Subject to an assessment of bank regulation
  - Improve regulatory prudential rules, in cooperation with other for a (Basel Committee, FFS), and subject each country to an annual review of measures implemented
- Subject to monitoring of bank restructuring and system recovery

Commission guidance

- Priority of guarantees to bank deposits
- If guarantees extended to other liabilities (like subordinated debt) restrictions have to be imposed
- Recapitalization of banks are also appropriate, but
  - Only to sound institutions
  - Should be done at market prices
  - Must be preferred shares with adequate remuneration, or
  - With claw-back mechanisms or better fortune clauses
- Liquidation as a second-step, if guarantee did not work
- Liquidity provision by the CB is not considered state aid if open to all institutions
- Liquidity provision to individual institutions not state aid if the bank is sound and CB charges penalty rate
- Non-discrimination should apply to all schemes

Lessons learned

- Systemic solutions to “shore-up” the financial system, based on guarantees, are always preferable, and should be a precondition for any specific intervention (e.g. deposits guarantees)
- Minority stakes in bank recapitalization are the least costly intervention to taxpayers, if appropriate measures avoiding the leaking of the aid are imposed (need to write-off losses to capital)
- State officials are not good bank managers and Governments may be tempted to use banks for “other purposes” than commercial oriented operations (profit at minimum risk). Thus they should avoid be involved in bank management and privatize as soon as possible
- Recapitalization does not solve the problem of jump starting the monetary and credit markets
- Buying toxic assets from banks requires “reverse repos” and the set-up of a specialized agency for collecting the bad debts, which may take a long time

- Direct intervention at household level may be required in a prolonged recession, to decrease the rate of foreclosure, but it is administratively more complex (is seen as more equitable, than saving directly the banks)
  - UK: state pays interest for up to 2 years to unemployed
  - PT: state plus bank fund to allow substitution from homeowner to tenant
- Direct intervention at SMEs level may also be required in a prolonged recession (is also seen as more equitable, may be important for employment support)
  - Fund for guarantees to loans or mutual guarantees system
- Another problem:
  - What cost should be borne by the minority shareholders?
    - In Sweden they were compensated
    - Prohibition of dividends should be to all? Problem of pension funds

Fundamental role of the Commission

- To avoid cross-border effects
  - Even in a Union of separate national supervision systems (the French proposal of a Community bailout opposed by Germany did not make sense)
- Commission needs to take “hard line” on state aid
  - National governments have a commitment problem: they are not able to commit to clear rules and a fixed budget ex-ante (Kornai problem of soft budget constraint)
    - Problem of agent to ask for a renegotiation of conditions
    - Regulatory, administrative and political capture at national level
  - Dynamic commitment problems create intertemporal inefficiencies
- But at the same time promote a more aggressive and transparent approach by MS to solve crisis (remember the Japanese case)

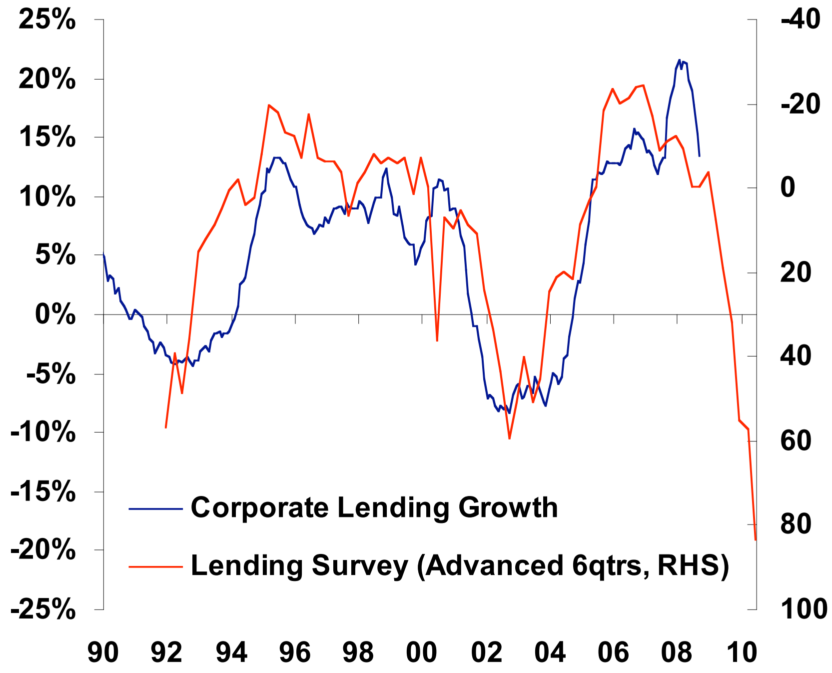
Need for new guidance from Commission

- We are in broad agreement with Commission Guidance on the bank crisis. It has sound principles. However, needs to be revised
- More comprehensive,
  - Should address all the instruments and measures referred above
  - Prioritize and establish rules for its use in a more rigorous way
- Consider measures for jump-starting the credit markets (so far there is still a paralysis)
- Need to extend measures to households and firms in distress
- Recognize the need for complementary measures (state aid is not all…)
  - Fight deflation (reflate the economy)
  - Deleverage orderly financial institutions
  - Fiscal stimulus to stimulate demand

Bank lending

US Lending Survey Leads Loan Growth

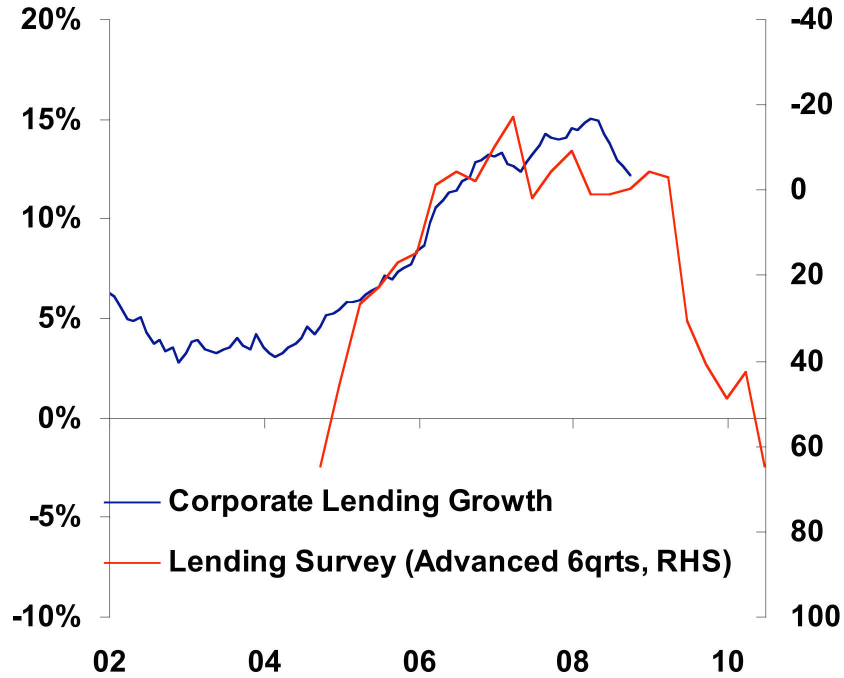
US Corporate Loan Growth in Percent



Source: Citi, EcoWin, Federal Reserve Senior Loan Officers' survey.

Does the European?

Eurozone Corporate Loan Growth in Percent



Source: IMF WEO, October 2008, p. 130.

Lending is still falling – and sharply

Main problems and what lays ahead

- To jump start the economy CBs and SPCs may need to start buying toxic assets (Spanish proposal)
  - Using reverse repo auctions
  - Commission reluctant to accept
  - Setting-up a collection agency (bad bank) for recuperating credits
- Moral hazard has not been squarely addressed: how to punish management and stockholders for taking excess risk (moral hazard)
  - Question of dividends
  - Remuneration of management
- Presently, no direct aid to the real economy is contemplated, although Commission has recognized the plight of SMEs (and households in distress?):
- Fed and Freddy Mac already using some unorthodox measures (buying toxic assets directly from banks, money creation)
- Nationalizations and remuneration to stockholders has also to be clarified