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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:

Date	Communication	Main principles
13 October 2008	The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis **(Banking Communication)**	adapting certain principles of R&R guidelines to financial cases i.e. allowing capital injections, distinction between fundamentally sound and distressed institutions.
5 December 2008	Commission Communication Recapitalisation of financial institutions **(Recapitalisation Communication)**	• Guidance on pricing of capital injections based on ECB recommandation (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 **(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 " **(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

Aid received
  - £ 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

Main restruc-turing points
  - 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

Aid received
  - € 8.4 bn recapitalisation and asset relief and up to € 95-135 bn of State guarantees and liquidity assistance

Main restruc-turing points
  - 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.

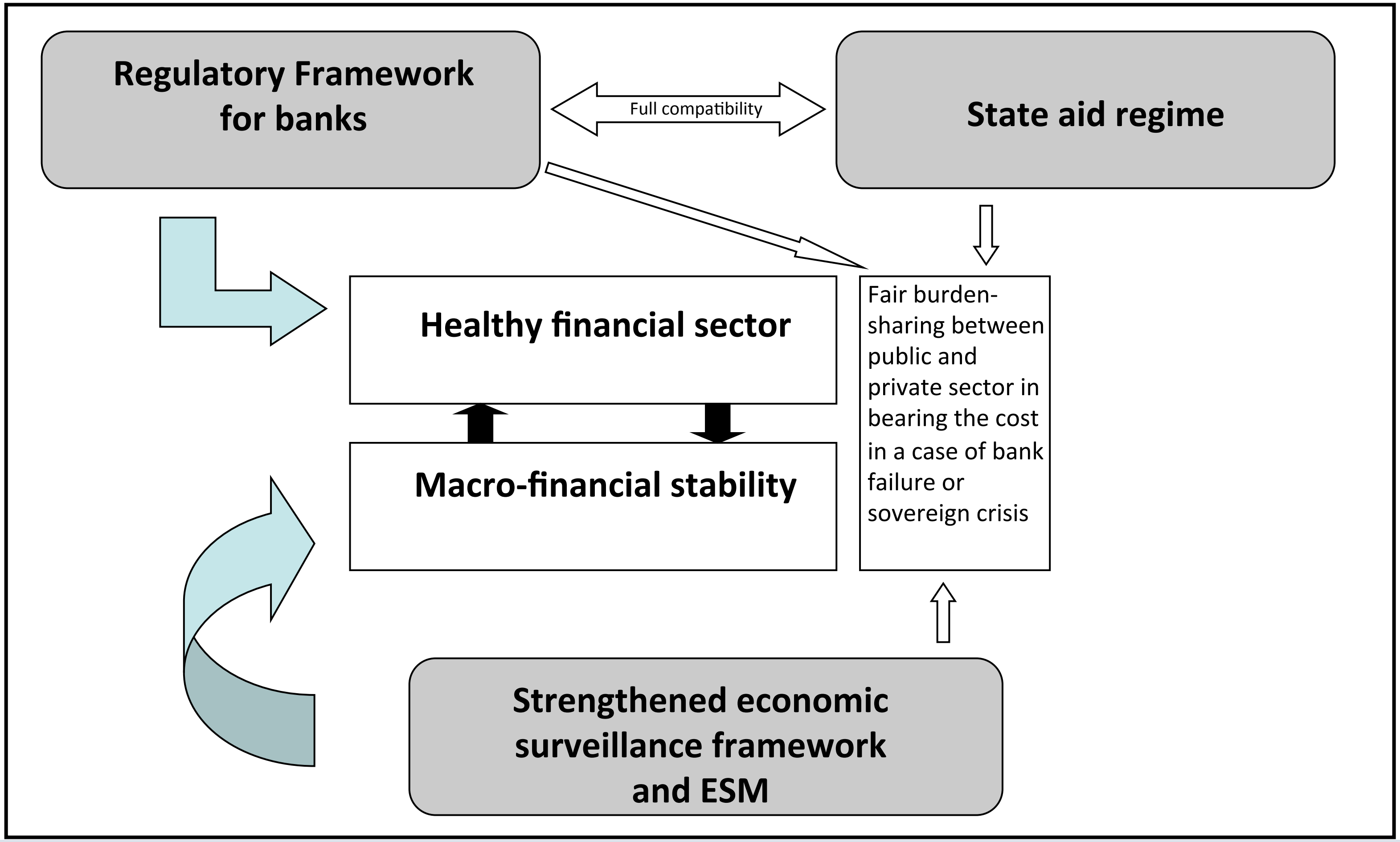
- Three initiatives to address the first two challenges
  - The EU-wide bank stress test to accelerate the financial repair;
  - New banking and financial sector regulation, inter alia to enhance bank capital requirements and put in place a new resolution regime;
  - The review of the State aid framework 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



3. The way forward

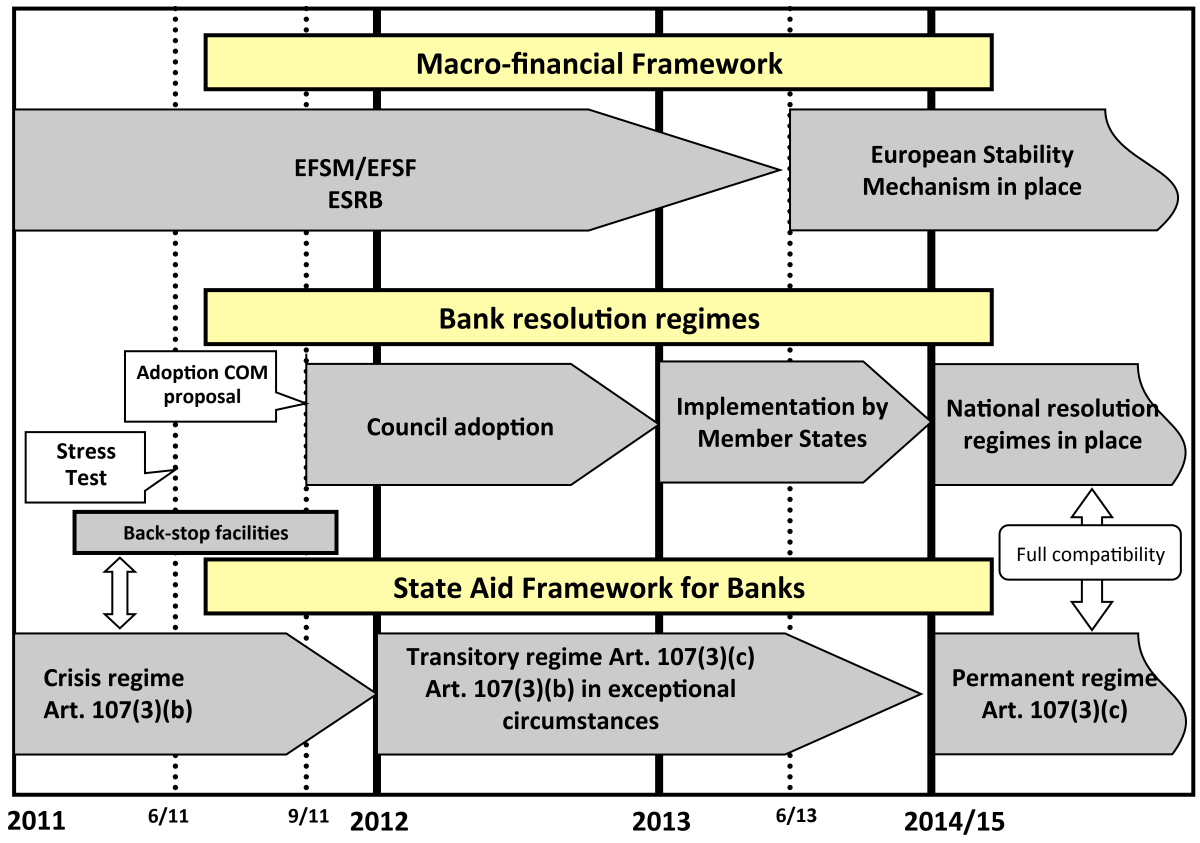
- As far as State aid is concerned, the work going forward consists in:

- 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.

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