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State aid to banks and the real economy

Dirk Hudig of FIPRA examines the issue of state aid granted to failing banks in the aftermath of the recent financial crisis



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STATE AID TO BANKS AND THE REAL ECONOMY

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Background and the emergence of new risks

The European economy is slowly emerging from the deepest financial crisis in the last 100 years. In 2008, interbank lending almost came to a standstill with potentially catastrophic results, until immediate liquidity was injected into the banking system. The collapse of Lehman Brothers in September that year sent an alarm signal throughout the global banking system, freezing confidence and creating doubts about creditworthiness. Governments took various measures, issued guarantees, took over toxic assets, and injected capital. Ecofin, the ECB and the European Commission came into full action to deal with the crisis, agreeing to deal with the state aid aftermath later. It was a good demonstration of how well Europe can work in a crisis.

The dangers of economic collapse were staved off, and the banks that needed money from their respective governments continued to function. Subsequently the commission asked them to provide restructuring plans,¹ to avoid distortions of competition between the aided and unaided banks.

Since then the risks that were central to competition in the aftermath of the financial crisis have been replaced

by new challenges, a potential sovereign debt crisis, a threat to the euro, and potentially most threatening, the dangers of very low growth. If competition policy is a subset of overall economic policy, it is important to be mindful of the wider and the cumulative implications of the measures taken by the commission in more than 40 state aid cases to banks.²

The big question is: even if the commission's bank state aid decisions make sense case-by-case, is the cumulative effect the desired economic outcome?

Can rescues and restructuring be read across to financial services?

State aid control is unique to Europe, designed to maintain an even playing field between the large and small economies.

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The 1994 rescue and restructuring regime was originally designed to deal with sectoral overcapacity (e.g. chemicals, shipbuilding) created in large steps of new capacity building to benefit national champions, at the expense often of the smaller EU economies with less money to invest. In capital-intensive and cyclical businesses, over-capacity can distort the price structure of the entire sector and drive unaided firms out of business.³

To what extent is the original rescue and restructuring thinking also applicable to banks? What is different about banks?

- Banking capacity does not grow in large fixed capital steps like it would for a new truck or chemical factory. Defining capacity in banks is not a simple matter, since it covers a host of services ranging from deposit management, mortgage lending, foreign exchange and asset management.
- The balance sheet of a bank is largely the money of other people, such as depositors. The bank's own capital can be a little as six percent of the balance sheet. So balance-sheet reduction remedies to rebalance competitive relationships are decisions largely dealing with other people's money.
- The scope of international (non-retail) banking is often very important. This is demonstrated clearly in the context of the current sovereign debt problems. The exposure of banks cross-border is huge.⁴ The UK exposure to Spain alone is some 385 billion euros. A sovereign debt failure would precipitate a new banking crisis.
- Banking is a systemic business that facilitates the transfers between savers and borrowers. The systemic nature of banking puts everyone at risk, not only the banks' shareholders, but depositors and other stakeholders. When a bank fails it does not necessarily remove excess capacity from the banking system that is automatically made available to competitors.
- Financial services are necessary to provide capital and credit for growth of the real economy. This is particularly important in Europe, since many family firms, small and medium-sized enterprises are bank-financed. In the US, the stock market plays a much larger role in financing firms, and banks are therefore relatively less important for economic growth, and banks are smaller and the sector more fragmented.
- "Zombie banks" that are not viable should be allowed to go out of business, the viable portions sold to other operators, and then folded up. This is not a simple matter, but the alternative to be avoided is the experience in Japan, where the failure to clear unviable banks was one of the causes of years of very low growth and economic stagnation. The US has seen numerous banks go out of business in the aftermath of the financial crisis.⁷
- To get back to normal, the loans made by government should be repaid as a matter of priority. In cases where there are heavy sanctions for early repayment, the commission should seek to enable repayment at normal market rates for the cost of capital. Some banks are careful not to repay too soon lest they are drawn into new difficulties in the event of a sovereign debt default, which would again force them to borrow in distressed circumstances.
- The scale of the balance sheet reductions is more than 2.4 trillion euros.⁸ This is more than three times the US Troubled Asset Relief Program (TARP).
- The five-year period allowed by the commission to reduce balance sheets has contradictory effects. It extends the current uncertainty for a longer time before getting back to normal. On the other hand it helps avoid unnecessary capital destruction by forcing balance sheet disposals at

The commission has, in its four communications on rescue and restructuring,⁵ sought to deal with the specificity of banking, and focus on what is necessary to bring troubled banks back to a healthy state. The question is whether this is enough to facilitate the return to normal conditions, and avoid the consequences of the exceptional circumstances provoked by the financial crisis.

Exit from the special regimes to deal with the crisis

The commission has recently rolled over the special measures for banks for another year.⁶ The main objective is "exit," which means getting the banking system into a normal mode of operation as soon as possible. What are the main impediments?

Figure 1: State aid remedies – sample of 11 balance sheet reductions

Institution	2009 balance sheet total (EUR bln)	Business reduction – balance sheet (%)	State aid remedies (EUR bln)
Commerzbank	844	45	380
Dexia	580	35	203
ING	1,164	45	582
KBC	324	20	65
Lloyds	1,200	20	240
RBS	2,019	25	505
IKB	50	47	24
Fortis	199	40	60
WestLB	242	50	121
BayernLB	416	50	208
Northern Rock (2007)	150	20	30
TOTAL	5,988	N/A	2,418

Source: FIPRA

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low prices – not because the assets are without value, but because there are not enough buyers and too many assets that have to be sold at about the same time.

- The banks should resume lending to help the real economy function normally. However, many banks have to rebuild their own balance sheets and are therefore more restrictive in their lending, especially to SMEs – from which more employment growth comes. Lower employment leads to lower growth, which undermines the commission's own 2020 objectives.
- Basel III requirements are also expected to require both larger reserves and less risk exposure by lending less to SMEs, with wider macro-economic impacts on employment and growth.

The combined effects of commission measures and other regulatory developments need to be taken into account. The risk/risk choice between stronger balance sheets or lower growth is not an easy one.

What is needed is an integrated exit strategy that brings together the policy strands of competition policy, regulatory policy, monetary policy and social policy. A coherent exit strategy needs to take into account all these various policy dimensions.

In what ways should EU competition policy take more account of the macro-economic impact of its state aid policy?

Since banks play an important role in financing the real economy in Europe (compared to stock markets), it is not surprising that European banks are among the largest.⁹ The competitiveness of European banks is therefore important for the economy as a whole.

The US is probably the only reference point against which the EU can evaluate its exit policy, even though the US has no state aid control. The initial costs of TARP were 700 billion dollars, and won reluctant approval from Congress.¹⁰ The cost to date is roughly 25 billion dollars, and the US still has AIG assets it can sell. The exit in the US is likely to be faster and cheaper than that in the EU. One of the contributing factors to the US exit could be that smaller non-systemic banks have been allowed to fail, which in the EU is more difficult to do – the extreme case is Ireland, where the huge losses of the banks were fully guaranteed by the state and by taxpayers.

EU competition policy as implemented by the state aid to banks is based on a number of fundamental assumptions that

may be true on a narrow case by case basis, but are not in the public interest as a whole when the exception becomes the general rule.

- Is the aim of state aid control mainly about the interests of competitors and distortions of competition? There are increasingly strong voices that say competition policy is fundamentally about economic growth, and not only competitors or even consumers.
- The uncertainty about the value of banking assets caused by massive enforced disposals has not benefited competitors. To the contrary, all bank share values have suffered. What may have seemed a good idea at the time when unaided complainants made their powerful appeals has backfired.

Is the aim of state aid control mainly about the interests of competitors and distortions of competition?

The banking sector as a whole has been devalued, because the aided-bank exception became the rule. Investors have lost confidence in the banking sector, exacerbated by exposure to sovereign debt of even the strongest banks.

- Is it a good idea to weaken banks that have benefited from state aid? Massive reduction of balance sheets will certainly weaken even viable banks, but is that in the public interest and that of the real economy? The real economy needs strong, viable banks.
- Is the scale of the balance-sheet reduction proportionate to the aid received? For instance, Commerzbank and ING received roughly 20 billion euros and some asset relief, and are compelled to reduce their balance sheets by about 500 billion euros. Even taking account of the RWA and toxic asset relief packages, the remedies are a factor of 10 of the aid received: is this proportionate? Is it desirable for economic growth and competitiveness to reduce major viable banks in this way?
- Forced assets sales would provide access to other new entrants and lead to more competition. Is this assumption true? It needs to be tested. It can be argued that a market such as Switzerland, where three very strong highly competitive retail banks control each other, is a much more competitive and also more innovative market than a fragmented market like the US. The idea that breaking up larger banks will lead to more competition could be a major error, with considerable unintended consequences.
- The theory of new entrants bringing more competition is also likely to be false in terms of innovation and therefore growth. Large banks have the economies of scale and the benefits of computer systems that are scalable, and

provide innovative lower-cost services than small banks. An industrial policy engineering of the banking market into smaller units could have the unintended consequence of reducing innovation and competitiveness, and raising consumer costs.

- The forced disposal will probably lead to banks divesting their operations outside their home markets, and therefore lead to retrenchment within national borders. This process of renationalisation of banking is against the spirit of the internal market.¹¹
- Price leadership bans are intended to prevent aided banks from going on spending sprees to the disadvantage of unaided banks. However, the notion of a price leadership ban is fundamentally opposed to the notion of competition. One of the keys of competition is prices, and not allowing aided banks from developing new lower-cost services,

and passing those advantages on to consumers in lower prices, is not in the interest of consumers. What would happen when a price-leadership ban becomes a general measure, such as in the Netherlands, where 70 percent of the banks offering mortgages are denied the right to compete on price? Home-ownership associations have complained to the Dutch competition authority, which is now investigating their claim that mortgage rates in the Netherlands are higher than in surrounding countries because of the EU price-leadership ban.

- The ECB is providing massive support to banks, especially in countries where the markets have lost faith in the economic performance of the state. The scale of this aid dwarfs the aid that banks have received in the depths of the financial crisis. Yet this is regarded, for understandable reasons, as monetary policy not state aid. Given the huge disparity between the treatment on the one hand of banks

Figure 2: World's biggest banks in 2010 by assets

Rank	Bank	Country	Total assets (USD bln)	Statement date
1	BNP	France	2,964	31 Dec. 2009
2	Royal Bank of Scotland Group	United Kingdom	2,747	31 Dec. 2009
3	HSBC Holdings	United Kingdom	2,364	31 Dec. 2009
4	Crédit Agricole	France	2,243	31 Dec. 2009
5	Barclays	United Kingdom	2,233	31 Dec. 2009
6	Bank of America	United States	2,223	31 Dec. 2009
7	Mitsubishi UFJ Financial Group	Japan	2,196	31 March 2010
8	Deutsche Bank	Germany	2,162	31 Dec. 2009
9	JPMorgan Chase	United States	2,032	31 Dec. 2009
10	Citigroup	United States	1,857	31 Dec. 2009
11	Industrial and Commercial Bank of China (ICBC)	China	1,726	31 Dec. 2009
12	ING Group	Netherlands	1,676	31 Dec. 2009
13	Lloyds Banking Group	United Kingdom	1,664	31 Dec. 2009
14	Mizuho Financial Group	Japan	1,637	31 March 2010
15	Banco Santander	Spain	1,600	31 Dec. 2009
16	Group BPCE	France	1,482	31 Dec. 2009
17	Société Générale	France	1,475	31 Dec. 2009
18	China Construction Bank China	China	1,409	31 Dec. 2009
19	UniCredit	Italy	1,338	31 Dec. 2009
20	Agricultural Bank of China	China	1,301	31 Dec. 2009

Source: Global Finance, Annual ranking of the world's 50 biggest banks, as measured by total assets (published September 2010)

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receiving money from the ECB, and on the other those that received aid from the member states, the commission should seek to be as consistent as possible in the penalties imposed on recipients of aid from governments. This problem may become even larger, as for instance Spain addresses the rationalisation of the savings banks.

Are there spillover effects of the new crises for EU state aid policy?

State aid control is no simple matter, and it is important that a competitive structure is maintained. Seen from the perspective of the broader economy, however, a number of wider considerations need to be taken into account:

- 1 The need to avoid unintended consequences, such as a price-leadership ban in markets where most of the market is covered by the ban.
- 2 Weigh carefully the competing demands of competitors and the consumer. There is a risk that the demands of competitors are at the expense of the consumer – which is contrary to the very principles of competition policy.
- 3 Europe is not an island; the way the policy is implemented should not lead to a weakening of the EU as such. (Of the world's top 10 banks by assets, six are European, but in terms of market cap, only three.)
- 4 The remedies should not lead to a renationalisation of the EU banking sector through forced disposals of all assets

outside the home market. That would be contrary to the objective of greater market integration in the EU.

- 5 The exit scenario needs to be more comprehensive. Rolling over the special rules for bank aid for another year does not go far enough. A wider assessment of the economic impact and cumulative effects of the state aid policy is required, but in the overall context of economic growth.
- 6 Weakening banks that are rebuilding their balance sheets after the financial crisis should not be a policy objective, even as a remedy. We will need strong banks more than ever to face new challenges such as sovereign debt risk.
- 7 The commission should use its powers to deal with the “zombie” banks that can have a long-term distortion of competition, and drag economic growth down.

One may answer by saying, “state aid control is complicated enough, so please do not add other levels of complexity.” However, the real economy is no simple matter, and the sweeping remedies that have been applied also need to take account of structural consequences for the banking sector as one of the motors for European growth and competitiveness. ■

Dirk Hudig is head of the Brussels office of FIPRA, and is advising a number of financial institutions in matters of state aid. The views expressed in this article are personal and do not represent those of FIPRA or any other organisation.

Footnotes

- 1 “Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty”: http://ec.europa.eu/competition/state_aid/legislation/temporary.html
- 2 “State aid: Overview of national measures adopted as a response to the financial/economic crisis”: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/656&format=HTML&aged=0&language=EN&guiLanguage=en>
- 3 The Commission adopted its original Community Guidelines on State aid for rescuing and restructuring firms in difficulty in 1994 (1994/C368/02). New versions of the guidelines were adopted in 1999 (1999/C288/02) and 2004 (2004/C 244/02)
- 4 Sources: “Bank Exposure: The Euro zone risk”, Financial Times 1 December 2010
- 5 “Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty”: http://ec.europa.eu/competition/state_aid/legislation/temporary.html
- 6 “Communication from the Commission on the application, after 1 January 2011, of State aid rules of support measures in favour of banks in the context of the financial crisis”: http://ec.europa.eu/competition/state_aid/legislation/banks_en.pdf
- 7 List of Bank Failures, Federal Deposit Insurance Corporation: <http://www.fdic.gov/bank/historical/bank/index.html>
- 8 See Figure 1, State Aid remedies: Sample of 11 balance sheet reductions
- 9 See Figure 2, The world's biggest banks in 2010
- 10 USA, Department of the Treasury, Trouble Asset Relief program-Two Year Retrospective: http://www.financialstability.gov/latest/pr_10052010.html
- 11 “Bank State Aid in the Financial crisis - Fragmentation or level of playing field” CEPS Task Force Report