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Bank restructuring aid in the financial crisis

The financial crisis has triggered large-scale state interventions in the banking sector. Unlike in the rest of the world, the national measures taken by EU Member State governments are constrained by one complicating factor: state aid control by the European Commission. In this guest article, Christian Ahlborn and Daniel Piccinin of Linklaters take a critical look at the Commission's approach to state aid to banks in the financial crisis

The past 12 months have seen Europe (along with much of the rest of the world) suffer one of the most severe periods of financial and economic turbulence of the past 100 years. Although the causes of this crisis were complex, varied and are almost certainly not yet fully understood, governments around the world quickly realised that confidence in financial institutions was the key to restoring stability and they acted accordingly by providing unprecedented amounts of support to banks.

In Europe this support has taken a variety of forms, with measures aimed at combating the two key problems facing banks: special liquidity and credit guarantee aid measures designed to provide relief from the impact of the credit crunch on banks' funding needs; and capital injections and asset relief measures to improve banks' balance sheets in light of the impairments that they have or expect to suffer on their asset portfolios. In the period from October 2008 to July 2009, 16 European Member State governments granted to banks a total of €947 billion in credit guarantees, and €180 billion in recapitalisations. Together with other measures (including impaired asset schemes and liquidity measures), these have accounted for nearly 12% of EU GDP. This total is likely to rise significantly in late 2009 as approvals are expected to be given for a number of substantial impaired-asset measures in Germany, Ireland, the Netherlands and the UK.[1]

The measures deployed to date have in large part been successful in preventing the collapse of the European financial system, with markets having made significant progress towards normalisation in the past 12 months. This said, interbank lending remains tight and credit default swap spreads remain at an order of magnitude above their pre-crisis levels, suggesting that the markets remain fragile and that further measures may be required to maintain confidence in the system.

The Commission's state aid control

EU Member State governments' responses to the financial crisis have been constrained by a complicating factor that other governments (outside the EU) have not faced: state aid control by the European Commission. Articles 87 and 88 EC together provide that state aid is unlawful unless it falls within limited exceptions, and that it cannot be implemented without first obtaining clearance from the Commission on the basis of these exemptions.

Outside of the financial crisis, aid to firms in difficulty (referred to as 'rescue and restructuring aid') is examined under the exemption in Article 87(3)(c) EC and must satisfy three key criteria to receive approval: (i) the beneficiary needs to provide a restructuring plan demonstrating that it can return to viability; (ii) the beneficiary needs to make a significant contribution to the cost of that restructuring; and (iii) 'compensatory measures' need to be imposed to address potential distortions of competition.

The Commission assumes that restructuring aid always gives rise to significant distortions of competition because it allows a firm that would in the ordinary course of events have exited the market to remain in the market. This assumption is often reasonable because restructuring aid is generally given to firms in markets suffering from structural overcapacity, or to firms that are in difficulty because of their inefficiency or poor business decisions. The Commission therefore requires the divestment or closure of profitable

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businesses so as to reduce the recipient's presence in the market (and reduce overcapacity). Behavioural measures, such as market share caps or limiting the recipient's ability to offer competitive pricing, are often also imposed with the same objective. Although these remedies are somewhat counterintuitive from a competition perspective (since ordinarily they would harm consumers through increased prices), in many cases they will have only limited adverse effects on consumers (because, for instance, competition is intense due to the overcapacity) and will help remedy concerns about the effect of state aid on other firms' ability or incentive to compete—eg, because aid may otherwise be used to finance predatory pricing strategies or because other firms will reduce their competitive efforts over time because they know that firms that fail in the competitive process will always be rescued by the state.

When the financial crisis deepened in September/ October 2008 the Commission recognised the need for urgent action and adopted a new approach to aid to banks suffering the effects of the financial crisis. The Commission approved vast amounts of aid in a variety of forms, including capital injections of unprecedented size at record speed (in some cases over the course of a weekend) on the basis that the aid was necessary to 'remedy a serious disturbance in the economy', and so satisfied the exemption for state aid under Article 87(3)(b).

Although the Commission's flexible approach at the height of the crisis allowed for the extremely rapid approval of aid on an emergency basis, the Commission did not abandon the conditions for approval entirely. Rather, its new guidelines (the Banking Communication and the Recapitalisation Guidelines)[2] indicated that banks that were not 'fundamentally sound' would need to provide restructuring plans addressing the same criteria as had previously been required under Article 87(3)(c).

Nevertheless, it initially appeared that even for banks that were not sound, the Commission's state aid review of these criteria would be more lenient than in standard restructuring aid cases, with the restoration of financial stability being the primary objective and addressing competition concerns being, at most, of second-order concern. Thus the Commission, in December 2008, provided final clearance for an extremely complex aid package involving tens of billions of Euros in aid to Fortis Bank following only a two-month preliminary investigation and with only minimal compensatory measures. (The main compensatory measure was the separation of Fortis Netherlands from Fortis Bank, which left the bank's market position in each of the national markets unaffected.)[3]

As time has passed and conditions in financial markets have stabilised to some extent, however, the Commission's stance has hardened significantly. It has essentially abandoned the sharp distinction between 'fundamentally sound' and 'unsound' banks, requiring restructuring plans with substantial compensatory measures for almost all banks that receive a significant amount of aid. Thus the Commission's approval of aid to Commerzbank and West LB imposed conditions that the banks reduce the size of their balance sheets by 45% and 50% respectively. These conditions are comparable to those imposed by the Commission on banks receiving aid under Article 87(3)(c) before the Commission recognised that there was a 'serious disturbance' in the economy sufficient to warrant aid under Article 87(3)(b). Moreover, it has also imposed behavioural constraints such as prohibitions on price leadership.

In July 2009 the Commission published its Financial Crisis Restructuring Guidelines,[4] which set out its analysis of the competitive distortions that are likely to arise in financial crisis state aid cases and the remedies that it proposes to impose to address those distortions. Although these guidelines appear to suggest that the Commission may take a more detailed approach to identifying competitive distortions in future and imposing only 'tailor made' remedies, the guidelines also envisage significantly more extensive and ambitious remedies than those imposed to date.

In particular, the Commission now intends to require the divestment of core assets and businesses (or parts thereof) with a view to reducing market shares or fostering new entry in markets with high barriers to entry. This is in sharp contrast to the Commission's approach in the Fortis case, where the Commission was prepared to overlook the bank's high market share in Belgian banking markets because it had not pursued aggressive expansionary or predatory pricing strategies in those markets. The Commission has thus shifted from a position where its primary concern was facilitating the rapid flow of aid to restore financial stability to one where it now proposes to use banks' restructuring plans to pursue industrial policy objectives of artificially creating new entrants in banking markets in the name of addressing the distortive effects of state aid.

Economic assessment of the Commission's approach

The shift away from a policy primarily concerned about financial stability towards a policy which largely applies the principles developed in 'normal' restructuring cases (possibly applied with increasing severity) would be justified if the circumstances of the banking sector in the financial crisis were similar to those in other industries where one or more firms are in difficulties.

In this case the same underlying assumptions would be justified; namely, that financial crisis restructuring aid had only a weak social policy rationale and could be expected to give rise to significant distortions of competition in most cases that could be remedied by imposing compensatory measures that are largely net beneficial for competition (eg, because the market features overcapacity). However, there are three key respects in which state aid in the financial crisis differs fundamentally from standard restructuring aid cases:

- aid to the banking sector during the financial crisis brings overwhelming social benefits;
- aid in the financial crisis does not give rise to significant moral hazard;
- the under-capacity caused by the credit crunch prevents other significant distortions from arising.

The combined effect of these factors is that the benefits of aid to banks in the financial crisis clearly outweigh any costs, and distortions of competition are likely to be small and of second-order concern, to the extent that they arise at all.

Social benefits of the aid

Despite the devastating effect of the financial crisis on the world economy to date, there is general agreement that the various state aid measures provided by Member State governments have helped stabilise the banking system and economy, avoiding what was a real danger of the complete collapse of the financial system. In particular, it is clear that the competitors of those banks receiving aid have benefited from the aid to the recipients as calm has been restored to financial markets. The improvement in financial stability has also benefited a number of economies, with France and Germany already returning to economic growth and a number of other countries' economic contractions slowing.

Given that state aid to banks in the financial crisis has been necessary to avoid the total collapse of the financial system and to reduce the likelihood of a prolonged and deep economic recession, it is clear that aid to banks in the financial crisis provides large enough social benefits to outweigh any competition distortions that may arise. These significant social benefits should make any regulator think twice about imposing 'compensatory measures' that could in any way limit the effectiveness of the granting of state aid.

Absence of moral hazard

One of the most important competition concerns raised by the Commission in the Financial Crisis Restructuring Guidelines is the potential for moral hazard. The Commission's concern is that if state aid were to be granted without accompanying compensatory measures, all banks would infer that they were effectively benefiting from a free insurance policy against financial crises. They would then be more willing to engage in risky strategies that would make a future financial crisis more likely.

However, moral hazard is unlikely to play a significant role in financial crisis state aid cases. The Commission has made clear that Article 87(3)(b) only applies in the context of a severe financial crisis where aid is needed to 'remedy a serious disturbance in the economy of a Member State'. Given that such crises are (mercifully) extremely rare (as illustrated by the fact that the European Commission state aid regime has never had to deal with such a crisis before), the expectation that in such circumstances banks would receive aid free of conditions is unlikely to have much impact on the profitability or otherwise of any given business strategy.

Moreover, as the present crisis has demonstrated, even without compensatory measures, the impact of the financial crisis on all banks—especially those that have received aid—has been devastating. Shareholders, bondholders, management and employees alike have suffered greatly. For instance, the UK banking sector has seen average shareholder losses of approximately 50% since 2007, and the aid-recipient banks have suffered even more. It is difficult to see how, if losses of this scale are insufficient to deter banks from undertaking risky activities in the future, imposing compensatory measures could make any difference to banks' strategies.

Furthermore, any effort to address moral hazard by 'punishing' aid-recipient banks is likely to be relatively ineffective unless the Commission has a method for distinguishing between those banks whose activities contributed to the extent of the losses suffered in the crisis (eg, through risky business strategies) and those who followed prudent strategies but were nevertheless severely affected by the crisis.

Although the Commission attempted to draw such a distinction in the early stages of the financial crisis, it has since retreated from this approach, probably because of the difficulty of the task. In practice, therefore, the Commission has imposed these 'punishments' on all banks that have received significant amounts of aid.

Finally, if the Commission's concern is to ensure that banks do not repeat the mistakes that led to the present financial crisis, state aid control must be among the weakest of policy instruments for addressing that concern. In light of the efforts being made towards financial market regulatory reform at the national, Community and global levels, it is hard to believe that state aid control in addressing moral hazard concerns could have any noticeable effect on the frequency or severity of financial crises in the future.

Effect of under-capacity

Any potential concern that state aid to banks could 'crowd out' or otherwise harm competitors or that it could provide the aid recipient with a competitive advantage needs to take account of the severe effects of the credit crunch on lending capacity in banking markets. Following the collapse of wholesale funding markets and the reversal of the large capital inflows that fuelled much of the pre-crisis lending in developed economies, there is now a large amount of unmet demand for borrowing. Accordingly, there is no prospect of aid-recipient banks 'crowding out' their competitors, and since these competitors cannot or will not meet existing demand, it is hard to see how they are otherwise harmed by state aid in any sense that is relevant to competitive outcomes for consumers.

The dangers of compensatory measures

Against this background, one would want to be very careful to ensure that any remedies imposed to address these competition concerns at the very least 'do no harm'. However, as we will explain, many of the remedies imposed by the Commission to date have the potential to cause serious harm to competition and financial stability while in many cases serving no obvious purpose.

Balance sheet reductions and behavioural constraints

The Commission's remedies aimed at reducing the presence of aid-recipient banks can cause a number of significant problems in the context of the financial crisis. First, behavioural constraints have the immediate effect of restricting static competition among banks in the market. Although the same is true when similar remedies are imposed in Article 87(3)(c) cases, in the context of a financial crisis the effect is potentially much more serious because there could be a number of aid recipients in the same market.

Moreover, given that the banking system is presently suffering from a severe shortage of lending capacity, remedies designed to limit banks' ability to lend (either directly or through limiting their access to deposits) could potentially have very serious adverse impacts on consumers and the wider economy. Output is already limited—to restrict it further artificially and to increase prices further would only make matters worse. It is also not entirely obvious what competition distortions market presence remedies of either kind are designed to address. The Commission appears to have recognised the issues associated with behavioural constraints (if not balance sheet reductions). Paragraph 44 of the Financial Crisis Restructuring Guidelines notes the potential for behavioural remedies to limit competition, and states that where this is a significant issue, alternative remedies should be found.

Divestment of non-core assets

The divestment obligations imposed by the Commission to date have focused on non-core divestments. Remedies of this kind tend to have no direct effect on competition. At best it could be argued that the divestment of non-core assets represents an 'own contribution' from the recipient bank, which limits the amount of necessary aid and hence indirectly contributes to a reduction of competitive distortions. However, given the Commission's approach of negotiating divestment obligations (up to six months) after the aid has been granted, it is hard to imagine how these obligations could in practice reduce the amount of aid to the bank.

While imposing obligations to divest non-core assets is unlikely to have any noticeable impact on distortions of competition, these obligations have drawn stinging criticism from officials and regulators in the financial sector. Bundesbank President, Axel Weber, engaged in a public dispute with the Commission through the *Financial Times*, claimed that the Commission's insistence on banks divesting foreign assets and withdrawing to their home markets would have the effect of undermining the Single Market.[5] The Commission's Financial Crisis Restructuring Guidelines reflect this criticism, however, noting that restructuring measures may threaten the Single Market and that the Commission 'will view positively measures that contribute to national markets remaining open and contestable'. It remains to be seen, however, whether current criticism leads to a change in the Commission's decisional practice.

Divestment of core assets

The key change in the Commission's approach, as set out in the Financial Crisis Restructuring Guidelines, has been its calls for the divestment of core businesses or parts thereof in order to increase competition in banking markets. Indeed, the Commission indicated that measures should seek to foster new entry in markets featuring high barriers to entry, 'including on the domestic retail market of the aid beneficiary'.[6] At first glance, this could be an attractive remedy from a competition perspective. Although, as discussed above, there may not be any serious distortions of competition for the remedy to address, unlike other remedies it could at least have the benefit of increasing competition (which could eventually lead to an increase in lending to the economy). On closer inspection, however, these remedies are potentially quite dangerous. If they were applied to a large number of banks across Europe simultaneously, the effect would be that a large number of banking businesses would be sold in 'fire sales' at approximately the same time. Uncertainty as to how and at what prices these sales could be achieved would threaten the stability of the fragile financial system today, even though the Commission generally provides divestment periods of up to five years.

These remedies would also be value-destructive in many cases as they often require assets to be carved out of existing businesses, with associated dis-synergies. Moreover, the long divestment periods would also be likely to cause serious damage to the divestment businesses. This is why in merger control cases the Commission generally allows only six months for divestments to be made. This timescale would be impossible in the present climate for financial stability (as the Financial Crisis Restructuring Guidelines acknowledge), but if a business were earmarked now for divestment in up to five years' time, it is unlikely that even the appointment of a powerful monitoring trustee could prevent the loss of morale, staff and customers as a result of the uncertainty over the future.

There is also a real danger that the new entry could have unintended consequences for competitors who have not received aid. First, it is clear that the new entrant would reduce the profitability of all existing banks through increased competition. There is no rationale for harming banks that do not require aid. More significantly, however, there is a serious risk that the new entrant would—once the credit crunch has abated—negatively affect existing smaller financial institutions that have not received aid.

Conclusions

The Commission's approach to state aid to banks in the financial crisis has to date been remarkably successful in ensuring that aid can be delivered to avert catastrophe, even if this is achieved by leaving the hard questions about restructuring until later. There is a danger now, however, that the Commission's remedies applied to aid-recipient banks to mitigate distortions of competition will do more harm than good, both to competition and to financial stability. This is especially concerning since the social benefits from state aid in these circumstances so clearly outweigh the costs of any distortions of competition.

Against this context, a key question is whether state aid control is really the best policy instrument to address some of the Commission's concerns. In particular, the Commission's concerns about moral hazard could almost certainly be more effectively addressed through better financial regulation than by imposing harsh compensatory remedies on aid recipients. Given the potential for remedies for moral hazard to cause serious harm to competition, it is likely that the incremental effect of imposing these remedies alongside better regulation is small if it is positive at all.

What is left for the Commission's control of state aid to banks under Article 87(3)(b) is a more limited role based on three key functions: (i) acting as a gatekeeper for Article 87(3)(b) by ensuring that aid is only given to remedy a serious disturbance in the economy (ie, a sufficiently serious systemic crisis) rather than just a few isolated bank failures; (ii) ensuring that aid recipients commit to restructuring plans that ensure their swift return to viability; and (iii) ensuring that aid measures are structured so as to provide adequate remuneration to the state, and burden sharing with the bank's stakeholders to the extent that this does not interfere with the bank's return to viability.

Christian Ahlborn and Daniel Piccinin

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[1]Moreover, Member States have a large amount of approved aid that has not yet been implemented. The total amount of financial crisis banking state aid approved by the Commission between October 2008 and mid-July 2009 accounted for approximately 31% of EU GDP.

[2] European Commission (2008), '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', the 'Banking Communication', OJ C270/02, October 25th; European Commission (2009), 'Communication from the Commission—the Recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition', the 'Recapitalisation Communication', OJ C10/03, January 15th.

[3] Commission decision in case NN-42/200: European Commission (2009), 'Authorisation for State Aid Pursuant to Articles 87 and 88 of the EC Treaty: Cases Where the Commission Raises no Objections', OJ C80/7, April 3rd.

[4] European Commission (2009), 'The Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis Under the State Aid Rules', the 'Restructuring Communication', OJ C195, August 19th.

[5] *Financial Times* (2009), 'Bundesbank Chief Hits Out at Brussels', April 21st. See also Commissioner Kroes' response, *Financial Times* (2009), 'European Commission Responds to Axel Weber', April 22nd.

[6] European Commission (2009), 'The Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis Under the State Aid Rules', OJ C195, August 19th, para 35.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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