

State Aid after the financial crisis: Bank bailouts and State Aid control

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Punchline

- Three main aims of aid to banks:
 - *Need to stabilize financial system*
 - *Need to restart lending*
 - *Need to avoid distortions of competition*
- No fundamental tension between competition and stability: apply Articles 81 and 82 and merger regulation; prudential regulation should ensure stability ‘in normal times’, not the relaxation of competition policy

Punchline (2)

- *State aid principles are different for banks*
 - Bank bailouts help competitors
 - Bank lending needs to be supported in times of crisis
- *How much to bail out ?*
 - Real money is needed, accounting changes are dangerous
 - This being said, equityholders and junior creditors should take their share of the burden
 - This should be done with minimum harm to competition

How is banking different from other sectors?

- Because of the role of liquidity, in a crisis the supply of banking services falls much faster than demand (unlike for, say, cars)
- When banks are bailed out most competitors benefit (unlike cars)
- Bank assets are typically much harder to value, and solvency/illiquidity harder to distinguish
- Banks' leverage responds much faster to their economic conditions than that of other firms
- The social costs of bank bankruptcies can be much higher and much harder to calculate

Competition and banking stability

- Contrary to much journalistic comment, “excessive competition” in banks’ core businesses doesn’t seem to have been at the root of the crisis
- Nor does pre-crisis evidence suggest a clear relation between extent of competition and bank fragility
- Nor has any particular business model (eg universal banking) been at the root of the problems
- Regulatory responses should therefore not try to force a particular model but should tax (i.e. impose capital ratios on) activities that create high risk (which was not adequately done before)

Implications for policy

- State aid principles *are* different for banks – in a crisis they are doing too little, not too much, and their activity favors, not hurts their competitors
- But that doesn't mean competition policy (especially Art 81, 82, mergers) should not apply!
- It needs to work hand-in hand-with regulatory reform
- And consider burden-sharing: shareholders, creditors, taxpayers
- No justification *either* for suspending competition policy during a crisis *or* for applying « state aid procedures as usual ».

Banking bailouts: purpose, risks and implications for burden-sharing (I)

- 4 main problems bailouts try to address: (i) Financial instability; (ii) the Asset Management Problem; (iii) the Loan Freeze Problem; (iv) the Zombie Lending Problem
- Public interventions for recapitalization can be done via: (i) asset revaluation by guarantees/purchases/cash injections; (ii) downward valuation of liabilities; (iii) good bank/bad bank schemes to quarantine the uncertainty.
- The choices affect national and international burden-sharing

Banking bailouts: purpose, risks and implications for burden-sharing (II)

- Need for stability, and thus real money, to ‘restart’ the system does not justify over-generous aid – ie a disproportionate share of the burden borne by taxpayers
- Amount of bailout should be the minimum necessary: wipe out shareholders if possible, and have junior creditors share the burden
- Sunset clauses/exit strategies are needed (this being said, bailouts do give authorities bargaining power for re-regulation)

Competition implications of bailouts

1. Bailouts could be distortionary by: (i) reducing marginal cost below true social cost; (ii) encouraging excessive risk-taking
2. Even though all bailouts have moral hazard component, guarantees are more worrisome than 'simple' recapitalizations in this respect
3. Distorsions can also result from restrictions on pricing, advertising or employee/manager compensation tied to bailouts

Competition implications of bailouts II

1. On the issue of growth, while bailouts should not be an opportunity for a bank to take advantage of 'bargain acquisitions' in the crisis, forcing significant generalized divestitures is unrealistic given the prevalence of bailouts in Europe
2. Since moreover reallocations of assets may be efficient, better to focus on constraining the *net* growth of the aggregate bank size (on and off-balance) rather than freeze its portfolio of assets
3. Remember that a key danger is the fragmentation of the banking landscape along national borders!

Competition implications of bailouts III

- Of course, relevant question is whether the bailed-out bank is viable. For example, were there indicators of problems even before 2007, for reasons not related to systemic fragility?
- Then, there is a case for ordering shrinkage. Remember however: (i) the desirability of just constraining the growth of banks; (ii) the risk of internal market fragmentation; and (iii) the distortions resulting from restrictions on bank conduct.
- Ideal recipe probably: shrinkage + recapitalization, which will correct distortions in lending/borrowing.

Conclusion

- EU competition policy rightly recognized that banks are different in their general application of State Aid control.
- It is good however to push for exit strategies.
- The focus on the ‘worst cases’ is a useful attempt to keep emphasizing competition concerns in banking.
- The remedies should promote a ‘level-playing field’ of viable players, with appropriate capitalization for all.
- One should avoid the re-fragmentation of the banking landscape along national borders.
- Of course, much help needed here from regulatory reform !

For more details:

Forthcoming CEPR Report written together
with Thorsten Beck, Diane Coyle,
Xavier Freixas and Paul Seabright