

**Presentation in Lisbon (25 January 2016): Banking Union and Competition**

**"From bail out to bail in: laying foundations for a restructured banking sector in Europe"**

**Speech**

**Check against delivery**

**1. Introduction**

Good morning.

First of all, I would like to thank the Universidade Católica Portuguesa for inviting me to participate in this seminar about the Banking Union which has an impressive line-up of speakers during the next couple of days.

The Banking Union is one of the most important initiatives from the European Union in response to the financial and economic crisis that emerged fully in 2008 with the collapse of Lehman Brothers and developed further over the subsequent years.

The crisis showed that when banks in Europe have problems the effects can reach far beyond the immediate threat to depositors and shareholders. This can easily undermine the foundations of a national financial system. And they almost inevitably have spill-over effects on other Member States or even beyond the EU.

When the crisis broke out in 2008, national, European and international authorities were only equipped with limited tools and means to face it. Since then, a comprehensive effort has been undertaken to strengthen the financial and economic rules, instruments and frameworks. The Banking Union is a centrepiece of this effort.

The main objective of the Banking Union is to break the vicious circle between bank debt and sovereign debt and to create a safer and sounder financial sector which is needed to restore the foundations for real growth of the economy.

During the last eight years, State aid control has played a major role in order to restructure the European banking sector while preserving the level playing field in the internal market...

... and it has also prepared the transition to the Banking Union, of which it remains an integral part.

As the Director-General of the European Commission's Competition Directorate-General, I naturally want to speak about the Banking Union and Competition.

Firstly, I will explain how, since the beginning of the crisis, in the absence of other instruments State aid control by the Commission has acted as a *de facto* resolution framework for the European financial sector in order to restructure and strengthen it.

Secondly, and looking at the present and future, I would like to speak about how State aid rules and the new Bank Recovery and Resolution Directive (the BRRD) will work together in the new scenario

of the Banking Union with the aim of breaking the vicious circle between bank debt and sovereign debt.

And to finalise my presentation, I would like to describe the outlook and key challenges we will face in 2016 and beyond, in particular within the framework of the Single Resolution Mechanism.

## **2. The role of State aid control in crisis: restructuring of banks and protection of taxpayer for level playing field in internal market**

In times of crisis, there may be a temptation to relax competition rules – if not rules generally – to accommodate short term problems that businesses face. However, experience shows that such relaxation more often than not actually prolongs and worsens the impact of the crisis and prevents healthy recovery.

In 2008, the European Union was in a very acute situation, and Member States were on the verge of giving in to that temptation. Fortunately, Member States have realised that such a route would have made everyone worse off. They have realised it because some of them suffered directly the consequence of negative spill-overs of "beggar thy neighbour" policies – remember what happened in the space of hours after the Irish government announced a blanket guarantee for its banking sector? Without the use of the State aid control the internal market would in all likelihood have collapsed, and there would have been no orderly way out of the crisis.

That is why the European Commission under the leadership of President José Manuel Durão Barroso made a step forward and took its responsibility. And for that reason, State aid control has played a key role as a *de facto* EU level resolution and coordination mechanism for the response of the Member States to the crisis. The successive Competition commissioners – Neelie Kroes until February 2010, Joaquín Almunia from February 2010 to October 2014 and Margrethe Vestager since then – have been working very hard shouldering this responsibility.

The insistence on a rules-based approach does not mean, however, that the Commission has not adapted its policy to the financial and economic crisis during these years.

Indeed, since the very beginning of the crisis, the Commission recognised the need for urgent action and decided to put in place very flexible procedures to assess urgently measures that were needed to safeguard the stability of the European financial system or to bring liquidity to the real economy.

State aid control is an essential element of the European Union, and it is so because it is fundamental for equity and fairness between Member States and companies, fundamental for the protection of taxpayers and key for the well-functioning of the economy.

State aid is an objective notion defined in the Treaty. Because of its distortive potential, it is prohibited as a matter of principle. But it can be authorised if certain conditions are met.

Focusing on the banking sector in particular, State aid can take a variety of forms, for example recapitalisations, asset protection schemes, interventions by resolution funds or deposit guarantee funds, state guarantees and even fiscal measures or tax rebates.

However, despite the general prohibition of State aid, in some circumstances these government interventions are necessary for a well-functioning and equitable economy or even to remedy a serious disturbance on the economy of a Member State.

In those cases, the Treaty leaves room for a number of policy objectives for which State aid can be considered compatible under the control of the Commission.

Therefore, I would like to stress that competition policy is essential to rebuilding the economy, and all players, from companies to employees and consumers are better off when competition exists in our markets. This is a matter of both efficiency and fairness.

As I have mentioned, in 2008, following the collapse of Lehman Brothers, the Commission proactively acted to coordinate the response of the Member States to the crisis as there was no other tool available at that time to deal with that situation. The Commission did not overstretch the State aid instruments; it took its responsibility.

Indeed, the Commission acted in the best interest of Europe, the Member States and the economy. And I think it is fair to recognise the extraordinary efforts made by the College of Commissioners, but also by all the Commission staff that has been working on this issue during all these years very intensively including many nights and weekends.

The Commission, and in particular DG Competition, had to build up capacity very quickly. Given the dimensions of the challenges it even had to create a specialised Task Force for the Financial Crisis. All this without requesting extra resources from the budgetary authority.

In this period, the Commission adopted a comprehensive framework on the consequences of support to the financial sector, and generating the restructuring of those banks which needed State support through the application of Union State aid rules, adapting them to put in place an effective response to the crisis and acting as a *de facto* European resolution authority.

The seven “Crisis Communications” adopted by the Commission during the crisis have been progressively adapted and tightened in order to reflect the changing market conditions and the evolving nature of the crisis.

At every moment, we need to strike a careful and difficult balance: on one hand, to preserve financial stability and on the other hand, to minimise distortions of competition between banks and across Member States in the single market.

We also have to make sure that aided banks restructure and return to long term viability (and if not, exit the market in an orderly manner), because that is the only way for the sector to be able to resume its pivotal role in providing safe and stable deposits, payments and credit to the real economy.

When doing our job, our compatibility assessment of restructuring aid is based on three key pillars: viability, burden sharing and limiting distortions to competition.

Firstly, restoration of viability because zombie banks artificially kept alive distort competition and market prices, do not provide financial stability and cannot lend to the real economy. Therefore, aided banks must have the ability to generate a sustainable income and an appropriate return on equity in the medium/long term.

Secondly, the minimisation of aid and burden sharing because the Commission must preserve incentives for banks to generate resources internally to cover the cost of restructuring and protect the taxpayers who should pay only after shareholders and eligible creditors have done so.

And thirdly, the implementation of measures to limit distortions to competition because the Commission has the duty to establish a level playing field between aided and non-aided banks.

Only under these conditions, the restructuring aid can be made compatible, because – I emphasise this once again – a healthy banking sector with fair competition is the only way of financing real growth.

Now, please let me show you a few figures of what we have done during the crisis.

In the period 2007-2015, the Commission has taken almost 500 State aid decisions, determining the restructuring or orderly liquidation of 117 European banking institutions.

In other words, as a result of the crisis, around 30% of the European banking sector is or has been under State aid control.

In fact, during this period, out of the top 20 European banks, the Commission approved aid to 12 of them, of which six, were subsequently restructured, five received aid through approved aid schemes and one was orderly liquidated.

In total, we can say that State aid control has been the main driver for the restructuring of more than 60 banks in Europe.

Around 5 trillion euros of aid (including State guarantees) have been approved by the Commission of which 1.7 trillion were used at the peak of the crisis.

The aid provided in cash via direct capital injections or loans to the banks is around 700 billion euros, which represents more than 5% of the EU's GDP in 2008.

As a result of this, in quite a few countries (as you can see in this graph) more than half of the banking sector has been restructured on the back of State aid conditionality.

And what can we say about the outcome of all this process? Well, we can confidently say that all this State aid and control have worked for those banks whose business model could be turned around.

The restructuring plans of all these aided banks have forced changes in their operative management in order to become more efficient and profitable. The deleveraging process has pushed them to focus in their core activities and strengths while de-risking and cleaning-up their balance sheets at the same time. Thanks to this, many of these banks are back to their primary traditional banking business and have abandoned riskier and non-core activities.

This should also help them to avoid past mistakes like financing "anything" and growing just for the sake of growing.

Indeed, the aided and restructured banks are showing significant improvements in operational and risk indicators, and also in funding and solvency positions.

It is true that the recovery takes time, but (as you can see in these charts) towards the end of the restructuring period the performance of viable and restructured banks is converging towards the values of the peers that did not receive aid.

### **3. State aid in the Banking Union and the BRRD-world**

Looking at the present, the constitutive elements of the Banking Union are now in place (a single rule book, a Single Supervisory Mechanism and a Single Resolution Mechanism).

However, if the rules are not rigorously implemented, the risk is to erode the balance of the Banking Union as it is today.

As they say, those who do not learn from past mistakes are condemned to repeat them.

The year 2016 is going to be a key year for the credibility of the Banking Union.

Therefore, it is essential that once there are resolution cases under the new framework, the new resolution tools available to resolution authorities (an in particular the bail-in tool) are properly implemented.

In line with the law adopted by the co-legislators – the European Parliament and the Member States in the Council – all the institutions involved have to ensure that first and foremost shareholders and eligible creditors – and not resolution funds and taxpayers – will bear the cost for potential future bank failures before an institution can access any public backstop support.

Indeed, the paradigm change from bail-out to bail-in has to become a reality for the Banking Union to become a success.

We have to remember that a key issue to enter into the Banking Union was the vicious circle between banks and the debt of their sovereigns.

As the financial crisis evolved and turned into the sovereign debt crisis in 2010/2011, it became clear that, for those countries which shared a currency and were even more interdependent, more had to

be done, in particular to break this vicious circle between bank debt and their national public finances.

The weak position of many banks (as a result of the excesses and mistakes committed in the previous years) required support from their national governments and this had a negative impact on the fiscal positions of those countries that in turn led to higher refinancing costs for those countries and also for those entities.

That is why the Commission under José Manuel Durão Barroso launched its proposal for a Banking Union (even against some resistance) , and in June 2012, the Heads of State and Government of the Eurozone agreed to create it, with the objectives of breaking this vicious circle, restoring financial stability and also completing the economic and monetary union.

This was really necessary, even more for programme countries as their sovereigns would never regain market access with the financial sector being a burden for the public purse. But we should not forget that being in a programme did not mean that the responsibility was shifted to the European and international institutions; the ultimate responsibility of the programme, including fiscal decisions or the prudential supervision of banks, always rested with the Member State, in dialogue with these institutions.

The decision to create the Banking Union was a great step, and I truly believe that the completion of the Banking Union will help to break the vicious circle and to reinforce financial stability by restoring confidence in the European banking sector.

Under the Banking Union, the European financial sector will be in a better position because:

- first, banks will be stronger and more immune to shocks,
- second, failing banks will be resolved normally without taxpayers money, limiting negative effects on the fiscal positions of the governments,
- third, the systemic banks will supervised at the European level and resolution ensured, when necessary, by a truly European mechanism,
- The one element on which further decisions are needed is the proposal for depositors to have the same level of protection across the whole Banking Union through a European Deposit Insurance Scheme.

As I just said, the Banking Union will help to create a safer European banking sector, something that it is essential for restoring the foundations for real growth in Europe.

In the Banking Union, there is a Single Supervisory Mechanism and a Single Resolution Mechanism. There are sufficient new tools to try to prevent crisis, but also to intervene early when problems arise or to manage a crisis in an effective way when necessary. All this should increase the confidence in all banks.

The market credibility of the banks will therefore depend on their specific risk profile and less and less on the financial strength of the Member States where they are based. This should make it easier for banks in all Member States to access funding on equal terms which in turn makes it easier for them to start lending once again to families and businesses across the European Union.

A key element of the Banking Union is the change from bail-out to bail-in.

It is true that sometimes this can be a tough way out. But someone has to pay for the losses when banks make mistakes. This may be an inconvenient truth, but it is a mathematical truth.

The options would be sovereigns (which can't be the first one if we want to break the vicious circle and reinforce protection of taxpayers), shareholders and creditors (which means bail-in) or other the financial sector as a whole (which lead us to resolution funds).

In this new scenario, State aid control will remain a central element of the Banking Union as State aid rules will continue applying alongside the Bank Recovery and Resolution Directive (the BRRD), also to assure a level playing field between Banking Union ins and outs.

In addition, we strongly believe that State aid control is a key element for successfully achieving the paradigm change from bail-out to bail-in.

Indeed, any kind of public financial support (including the use of deposit guarantee schemes or resolution funds) is subject to State aid control and will have to comply with these rules, both within and outside resolution...

... and any State aid measure or resolution scheme that implies the use of the resolution fund will need a prior approval from the Commission under State aid rules before it can be granted or the scheme adopted.

It is also important to remind that under the BRRD, i.e. because the co-legislators decided so, any State aid support will imply that an institution is deemed as *failing or likely to fail* and would therefore be an automatic trigger for resolution of the entity.

The law is the law, and we all have to comply with it. Therefore, provision of State aid to a bank will lead to its resolution. But it is for the respective supervisor or resolution authority, and not for the Commission, to apply this EU law and put a bank in resolution. The responsibility of the Commission is to ensure that State aid used in resolution does not unduly distort competition.

There are just three narrow exceptions to this general "resolution" rule of the BRRD, and these are State guarantees to emergency liquidity assistance from central banks, State guarantees of newly issued liabilities, and the exception of precautionary recapitalisations.

Note that the exception of precautionary recapitalisations has to be interpreted in a very narrow way (because the general rule is resolution) which means that precautionary recapitalisation can only be used to cover capital shortfalls arising under adverse scenario of a stress test. In these cases, only State aid rules apply.

In summary, under the BRRD, State aid can only be given in resolution (with the exceptions I just mentioned).

When we speak about aid and the Banking Union another key element is the Single Resolution Fund, which has been established at a supranational level to provide support to banks in resolution after all the other options, including the bail-in tool, have been exhausted.

This Fund has a target level of around 55 billion euros that should be built up over a period of 8 years with the contributions from the banking sector.

As I said before, under the Banking Union, the losses arising from failing banks have to be paid by their own shareholders and creditors (that is the bail-in) or by the industry itself, with the contributions to the resolution fund.

This Fund will be owned and administered by the Single Resolution Board.

One issue I wanted to explain is the functioning of the Single Resolution Fund, in particular the mutualisation of the resources that come from each Member State.

During the transitional period of 8 years, the Fund will consist of "national compartments" for every participating Member State. But these "national compartments" will be gradually mutualised becoming common resources that could be used to finance the resolution of any banks in the Banking Union.

This means that at the end of the transitional period there will be no "national compartments" anymore but just a single fund.

Finally, on this issue, I would like to reiterate that the Single Resolution Fund can only be used after all the other options, including the bail-in tool, have been exhausted.

This means that, as established by the BRRD, the Fund can only be used after the minimum bail-in of not less than 8% of the total liabilities of the bank under resolution has been done.

Then, after the 8% bail-in has been done, the Fund could be used to cover capital needs that do not exceed 5% of the total liabilities of the bank.

If this use of the fund is not enough to cover the resolution costs, then the resolution authority should continue bailing-in all the remaining liabilities (excluding eligible deposits) before the Fund can be used again.

As I mentioned before, public support is still available under the Banking Union, but clearly as the last resort. The use of the resolution fund, including the Single Resolution Fund, must comply with State aid rules.



#### **4. Outlook for 2016 and beyond**

To finalise my presentation today I would like to explain how we see the outlook and key challenges we will face in 2016 and beyond, in particular within the framework of the Single Resolution Mechanism and the relation with the State aid control from the Commission.

This last point is very important, as from the 1<sup>st</sup> of January 2016, the Single Resolution Board has taken over its responsibility for bank resolution within the Banking Union, but at the same time State aid control will remain an integral part of this Banking Union.

Under this new scenario, i.e. where State aid leads to resolution of the aided entity we will have to face new challenges as in every banking crisis, the boundaries of the definition of State aid are tested.

As an alternative to state aid and resolution, instruments like SPV's, funding mechanisms, capital instruments and derivatives or a combination of some or all of them might be devised.

The question will be whether such measures are state aid or not: is the Market Economy Operator Principle applicable, is the measure non-imputable or is it non-selective?

In response to that, the Commission will continue applying a clear and consistent definition of State aid to preserve equality of treatment and a level playing field between all member States.

If we don't do that rigorous examination, then the whole system of resolution, and consequently the whole Banking Union, will be undermined, to the detriment of all.

Note that when the co-legislators, the European Parliament and the Council, were discussing the SRM regulation, they wanted to make sure that the resolution of banks would take place at the same terms for ins and outs of the Banking Union, and that means that all European banks must be treated in the same way.

For that purpose, Article 19 of this regulation establishes that the Commission will assess whether the use of the Single Resolution Fund is in line with State aid rules, and that it will do it in the form of a Decision.

And when doing this assessment, the Commission will use the same substantive and procedural rules that will apply to the use of all resolution aid.

This means that the Single Resolution Board will become the main interlocutor of the Commission in many resolution cases, in particular on those State aid procedures in which there is a use of the Single Resolution Fund.

As a consequence, the SRB and the Commission will have to work together and very closely as any draft resolution scheme that includes the use of the Fund cannot be adopted by the SRB until the Commission had adopted a State aid decision on it.

Allow me a few closing remarks.

As I have said, we have just started a key year for the implementation and the credibility of the Banking Union.

We have now a fully applicable new scenario with new rules (like the BRRD) and new players (like the SSM and the SRB) that will be involved in the resolution of troubled banks in Europe. But State aid rules will continue to apply.

It is true that we have done a lot in the last few years. But there are still pockets of the European Banking sector that need to be restructured. If those banks can return to viability they can be restructured, but if not, they should orderly exit from the market.

Therefore, it is essential that all the involved institutions learn to cooperate and work together to ensure the orderly resolution of failing banks with the minimum impact on the real economy and on the public finances of the participating Member States....

... which means that someone, either shareholders, eligible creditors or the industry as a whole, will have to pay for the losses.

And knowing this, they will hopefully have the necessary prudence which was lacking before the outbreak of the financial crisis.

We cannot afford that the European Banking sector goes back to the previous situation and commits the same mistakes of the past, in particular the "growth for the sake of growth".

Europe needs a healthier and safer banking sector, to break the vicious circle between bank debt and sovereign debt, to protect taxpayers and also very importantly, to restore the foundations for real growth of the economy.

And I honestly believe that the Banking Union, properly implemented, is the right framework to achieve all these objectives.

Thank you very much for your attention.