SPEECH/09/

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State aid and the banking sector

– the European banking sector's futures

Unico Round Table on Risk Management 2009

KEYNOTE ADDRESS

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Ladies and Gentlemen,

Let me first thank the organisers for giving me the opportunity to address you at the opening of this management round table[1]. Austria is an important financial actor both in its own right and in its role for Central and Eastern Europe. We have important banking institutions from other European countries around the table. Cooperative banking is representing a major strand of European finance. And one lesson to be learnt from this present financial crisis is without doubt that central importance has to be attributed to risk management. I am therefore sure that this cooperative banks' management round table on risk management will provide a forum for a highly topical discussion on this issue.

I have been asked to give a more general outlook at the European Commission's current State aid policy in the banking sector. It has been now about eight months since the financial crisis has hit our economies in a systemic manner. Many European Union governments have taken unprecedented measures to support financial stability, to restore confidence in the financial markets and to minimize the risk of a serious credit crunch—as has Austria.

Let me discuss with you today the role that the European Commission has played in the field of competition policy, and EU State aid control in particular, when it was faced with the current crisis.

[1] The statements made in this paper represent the personal opinions of the author

[The role of State aid control in the financial crisis]

The European Commission has addressed the crisis in a broad policy framework, as set forth in the European Recovery Plan submitted to the European Council in November of last year. Given the distribution of roles and competences concerning fiscal and economic policy management between the European Institutions and the Member States, major measures fall inevitably to Member States. However, Member States' aid measures addressing specific banks or other enterprises will generally fall under Article 87 of the Treaty which entrusts the Commission with the task of reviewing Member States action in these fields. For this reason the application of EU State aid rules has played a pivotal role in crisis management in the European Union from the start.

Since the beginning of the crisis, financial stability and restoration of market confidence were crucial concerns for the application of state aid rules to the banking bail outs.   We have applied competition policy with **flexibility** to accommodate financial stability concerns.

We must not forget that in normal circumstances State-financed bail-outs can have severe negative effects:

- State interference can go against competition on merits between banks,
- it can reinforce the market power of the aid recipient
- it can affect negatively dynamic incentives of non-aided competitors

- it can encourage moral hazard and excessive risk-taking, and
- it has a high potential of undermining the EU's internal market

Banks and Member States across Europe have been hit by the crisis to a varying degree. In a situation of financial, economic and budgetary crisis, **differences between Member States** in terms of resources available for State intervention become even more pronounced. And those banks which today need to undertake a far-reaching restructuring, have in recent years often engaged in **expansionary strategies** to the detriment of their competitors.

National interventions in the current economic crisis are by their very nature prone to promote focus on the national markets. There is a serious risk of promoting **retrenchment into national boundaries and retreat from the European single market**. Market concentration and a decrease of incentives for cross-border activities are not beneficial for European businesses and consumers.

Therefore, where we have to provide flexibility for State intervention in the banking sector in order to support financial stability, we must also keep in mind the return to normal market conditions.

One may submit that in the current situation ***non-aided*** banks benefit indirectly from State aid to their competitors—in the form of a rise of overall confidence in the financial markets and therefore stability. But we must not forget that at the very root of the problems we are facing today, have been unsustainable and sometimes speculative business strategies of a number of large market players. We therefore have to balance carefully the concerns for financial stability which must prevail at the moment, and the requirement to ensure a return to a normal market situation and a competitive future.

[The rules for State aid for the banking sector during the crisis]

Since last autumn the European Commission has adopted three communications setting out a clear framework for the application of State aid rules to the measures undertaken—setting rules for **guarantees** by Member State to their banks; for **re-capitalisation**; and for the **cleaning up of Impaired Assets**; and it is about to adopt a forth one on the restructuring of distressed banks that have received State aids. In establishing this policy framework, we have worked in close coordination with the EU's Economic and Financial Committee composed of the Member States, the ECB, and the Commission.

Within this framework the Commission has adopted, in rapid sequence, a large number of decisions dealing with aid in the banking sector—both concerning schemes like the guarantee and recapitalisation scheme in this country, and individual decisions with regard to a number of large banks in Member States. With efficient State aid teams and substantial know-how in place—provided both in-house and by external experts—we have now built a capability in State aid control in Brussels that can handle highly complex banking cases within weeks, and where required, days.

Since October 2008 we have adopted more than **seventy State aid decisions** in the context of the financial crisis—comprising inter alia twelve comprehensive guarantee schemes, five major recapitalisation schemes, five framework schemes comprising a combination of these measures and a substantial number of ad-hoc measures concerning certain banks. Taken together the total schemes and measures approved stood by end May at 3.7 trillion EUR or nearly 30% of the total GDP of the European Union, out of which 2.9 trillion for guarantees alone. It must be understood that these figures represent the upper level of possible risk shields, rescue and restructuring packages and other measures that Member States have been authorised to put in place, normally in the context of national schemes—the actual aid element will be substantially lower and it will have to be seen how far guarantees will be drawn. Banks have taken up the State protection and recapitalisations massively—the take up rate stands at more than 50% for recapitalisations and 30% for State guarantees.

[State guarantees and recapitalisation]

Looking back at what could be called the **first phase** of the crisis, from September 2007 onwards the sub-prime crisis in the US started taking its toll on some European banks. These were normally banks which had relied on extreme business models and had therefore run into substantial difficulties. UK's Northern Rock, and Germany's WestLB and SachsenLB are cases in point in Europe. At this stage, the crisis was not systemic yet—and we dealt with these cases using the standard approach based on the EU State aid rescue and restructuring guidelines, our general framework for companies in difficulties.

The situation changed dramatically for us as for everybody else, after Lehman Brothers defaulted, when a sudden drop in confidence restrained inter-bank lending worldwide and threatened to lead to a financial meltdown in Europe as in the US. One could call this the **second phase of the crisis**. Within days, the Commission adopted the **banking**

communication[2]. We provided guidance on a number of types of State intervention, in particular on State guarantees for bank liabilities which were the most widespread response to the crisis in this phase, when the re-launching of the inter-bank markets was the main target.

A main objective of Commission intervention was to prevent subsidy races between Member States that could undermine financial stability at the EU level instead of promoting it—as measures taken initially in certain Member States would have done if left unchanged.

It is important to note that in order to approve these measures, we had to use broadly the concept of State aid "to remedy a serious disturbance of the economy", as provided for in Article 87(3)(b) of the EU Treaty for crisis situations—a concept never used extensively before. This just emphasises the dramatic situation that the Union and the Member States were facing.

In a **third phase** it became apparent that lending to the real economy was drying up, as banks were attempting to restore or enhance their capital ratios. Member States sought to inject capital into banks to ensure that banks continued to lend. In December of last year the Commission therefore issued guidance on the compatibility of these measures with State aid rules. The main principles for the assessment of such measures

[2] 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, OJ C 270, 25.10.2008, p. 8 ("the Banking Communication")

under EU State aid rules were set out in **the recapitalization communication**[3] **of 5 December 2008.**

Both the guarantee and the recapitalisation communications are still dominating the design, and now prolongation, of the national schemes that were put in place, as well as key decisions with regard to individual banks taken by the European Commission. We believe that on the basis of the communications we were able to provide for the necessary coordination between Member States and the necessary coherence of measures, in order to achieve the intended stabilisation effect for the whole of the Union.

However, whilst the measures implemented by Member States according to these frameworks have avoided the worst—a meltdown of the financial system or a complete halt of lending—we continued to witness a high sense of uncertainty and lack of confidence in the markets. Many banks are still faced with an array of impaired assets on their books creating persistent uncertainty.

[Impaired assets and "bad banks"]

The Commission addressed this problem by providing **guidance for the treatment of impaired assets** on 25 February 2009[4] which now gains central importance, as Member States start with the establishment of "bad bank" schemes—or equivalent insurance against loss schemes—for unloading those assets.

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[3] 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, OJ C 10, 15.01.2009 ("the Recapitalisation Communication")

[4] Communication from the Commission on the Treatment of Impaired assets in the Community Banking Sector, OJ C 72, 26.03.2009 ("the Impaired Assets Communication")

The **Impaired Asset Communication** sets out principles for Member States to follow in providing State aid for the cleaning up of balance sheets and the removal of toxic and other impaired assets.

This third communication addressed the implications of the introduction of such asset relief measures whilst leaving it to Member States what instrument they choose for the asset relief. The purchase of such assets or their guarantee against further losses by the Member States, asset swaps and hybrid solutions are treated in a manner that should ensure consistency across instruments and across Member States.

The communication applies the basic principles developed in the guarantee and recapitalisation communications to State aid for impaired asset relief: requirement for **transparency and openness**; **limitation of the aid** to the minimum and **burden sharing** between the State and the owners; **containment of market distortions.**

Transparency

The Commission's approach to impaired assets and "bad banks" is based on the **principles of transparency and disclosure**. Banks to benefit from State aided asset relief will need to disclose prior to the intervention fully the types of assets and their impairments.

Equally important is identification of assets eligible for asset relief measures through development of eligible categories of assets or so called baskets. The communication provides for a coordinated approach to valuation of assets ex-ante, based on their real economic value assessed by independent experts and certified by the Bank Supervisory Authorities of the Member States.

We acknowledge that markets currently price the value of certain assets too low—or are simply not functioning for certain categories of assets at all. This is the very market failure that State aid should address—allowing the transfer or insurance of assets at real economic value. This means that the difference between real economic value and a lower market price is in principle considered as compatible aid where covered by Member States in the context of a "bad bank" scheme.

Burden sharing

However, State aid cannot come for free. Transfer must be at a price that ensures adequate burden-sharing of the costs related to impaired asset between the shareholders, the creditors and the State. As in guarantees and recapitalisation the setting of a **market oriented price** must be the focus of our attention—it is the very guarantee that deep distortions are avoided and an ultimate return to market conditions remains possible. In the guarantee and recapitalisation fields we base ourselves on our close cooperation with the European Central Bank and the EU's Economic and Financial Committee, and the recommendations worked out by the ECB. In asset relief the principles will still have to be developed further in case practice but must remain within the logic of the system—this will mean that we will consider the regulatory capital relief effect that the beneficiary will receive as a direct consequence of an impaired asset relief scheme.

Containing distortions of competition

Banks will always have to proof future viability when they draw on State aid—the very purpose of allowing State aid in the first place. Where banks are in a distress situation and are saved by State aid from exiting the market altogether—or for situations of similar gravity—we require the submission of a **restructuring plan** within a six month period. The European Commission is still considering more formal guidance on the principles it will apply to restructuring to take account of the situation of the sector. However, as a number of recent decisions taken by the Commission show, deep restructuring will often include substantial balance sheet reductions and divestments of non-core activities where justified. **Future viability** will have to be proven on the basis of stringent stress testing which must show that the bank will be **viable without State aid** also under current unfavourable market conditions. In no case State aid can be used to expand to the disadvantage of competitors. In recent decisions such as Commerz Bank and WestLb the Commission has imposed bans on acquisitions for the period of the restructuring and limitations on aggressive market strategies.

[Turning point – The banking sector's futures]

Ladies and Gentlemen,

We are **at a turning point in this crisis. Our** main aim was to preserve financial stability by giving legal certainty to the measures taken by EU Member States in rapid sequence and in difficult circumstances whilst maintaining a level playing field and ensuring that national measures would not simply export problems to other Member States.

We have opened the gates for State aid widely, in order to allow Member States to contain the crisis. But as a consequence we have now a huge aid volume out there. The main task now must therefore be to come back to a more normal market situation before this huge aid volume leads to major market and monetary disruptions.

As you all know the European Commission has announced a fundamental overhaul of the regulatory system of the financial sector as a consequence of the crisis. With the backing of the de Larosiere report by the Heads of States in Spring and the adoption of the subsequent May communication of the Commission by the European Council last week, the legislative proposals for a new regulatory structure for managing risk in the financial markets of the European Union are now up for this Autumn. The proposals for a **European Systemic Risk Council** chaired by the ECB at the macro-prudential level and for a new system of microprudential supervision of the individual financial institutions through the creation of a **European System of Financial Supervisors**—as well as other related measures—will establish a new regulatory framework for banking operations in the European Union. At the same time, the global system will undergo substantial change, subsequent to both the European and US developments and the discussions in the G20 framework.

The application of State aid rules to the banking sector must be seen in this broader context.

The Commission has approved the State aid measures in favour of banks so far under the condition that aid beneficiaries are to demonstrate the ability to operate on the market in the long term without State support. We are still not out of the crisis. Banks in a number of Member States continue to suffer from impaired assets on their balance sheets resulting from the profound disturbance of the global financial markets caused originally by the subprime crisis. Other Member States now experience follow-on disturbances due to the degradation of their loan portfolios subsequent to the crisis of the real economy that followed the financial crisis—particularly also with regard to operations in Central and Eastern Europe where many banks have taken important positions, such as banks in this country. As a consequence, we will see the need for a prolongation of the current guarantee and recapitalisation schemes, and we are likely to see a major role for "bad bank" schemes, as they are now about to emerge in certain Member States.

But the **main topic** of the future should be **medium- to long-term strategies** for exit from State aid. The **right pricing** of guarantees and recapitalisations and other State aid measures will help. We had to withstand sometimes bitter criticisms about the firmness with which we stood in our decisions on ensuring market oriented pricing. I believe that we will ultimately earn the returns of this firmness, as banks will turn back to normality—in a new regulatory framework.

The European banking sector's futures **cannot be more and more concentration and more and more State aid**. Market structures will have to adjust and to rationalise but the issue of risk generated by size and market power will have to be kept in mind.   Increasing concentration substantially and leaving competition aside on the way, **would increase—and not diminish**—the risk of another "too big to fail" syndrome, with all the disastrous systemic effects which we have seen. The future is in maintaining competition in the banking sector and bringing the sector back to sound market conditions—the very purpose of EU State aid control. One task ahead will be major restructuring of basically distressed banks. Restructuring will be often a painful process and will only be acceptable by all if all banks and Member States are treated on equal terms. Another task will be allowing fundamentally sound banks an acceptable return path to normal market conditions. One catch word of the next months will therefore be sound **exit strategies** from State aid. The other one will be **risk management,** by the banks, by the micro-prudential, and the macro-prudential level—the very topic of this conference. The future for the financial sector is not the State economy. It is competition and risk management in a sounder regulatory environment for banks, be they privately or publicly owned—in Europe, as in the US and in global markets.