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Whether and how to evaluate effects

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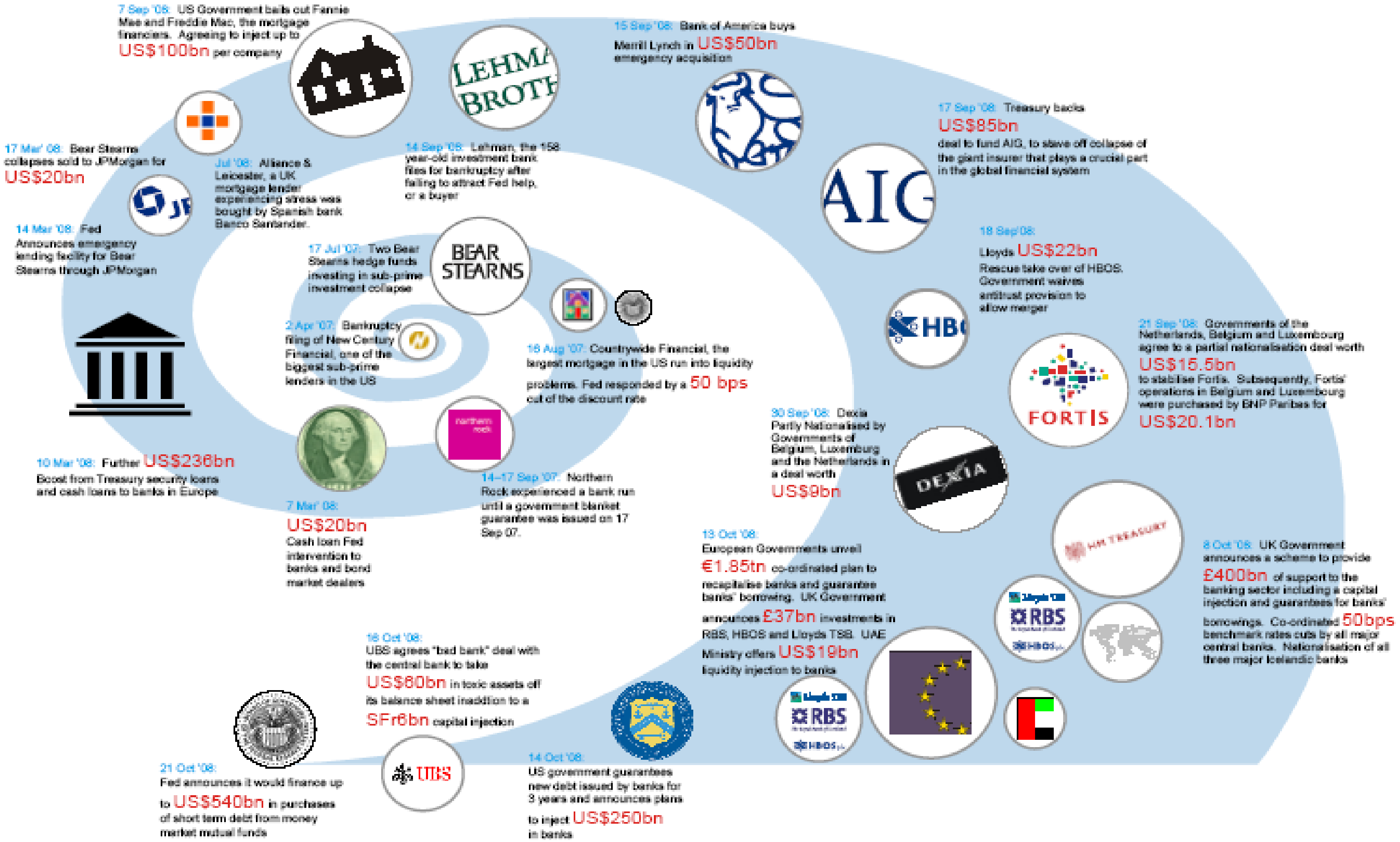
(*) Disclaimer: the views expressed in this presentation are those of the author and are not necessarily those of the European Commission.

Outline

- Two seemingly unrelated issues
- Support to distressed firms in the presence of contagion effects
- Distortions of competition by object and effect
- A common theme : when to evaluate effects?

Tsunami of SA cases



Competition enforcement for financial institutions

- Balancing
  - Market failure
  - Distortions of competition
- Market failure
  - Systemic effects from bank failures –an externality such the social cost much exceeds the private cost
  - Crisis of confidence - a coordination failure
- Distortions of competition
  - Moral hazard (update beliefs about future interventions)
  - Competitors with sound banking practices : incentives to compete are affected because rents are allocated ex post by the state

Competition enforcement for financial institutions

- Across member states
  - Banks compete across national jurisdictions
  - Member states do not internalise effects beyond their own jurisdictions
  - Different ability and willingness to support banks
- Instruments
  - Ex ante guidance
  - Assessment of schemes and individual cases
- Fits naturally with the general framework

Individual restructuring plans

- Three components:
  - private (“own”) contribution to the coverage of the restructuring costs (aid to the minimum)
  - compensatory measures
  - long-term viability
- Calibrating own contribution and compensatory measures

Own contribution : financial restructuring (liabilities)

- In principle, losses and restructuring costs should be borne by the owners, creditors, and managers of the entity receiving support
- Conversion of unsecured debt/hybrid capital into common equity and/or the write-down of (part of) the unsecured debt.
- But systemic concerns
- Commitments during rescues

Compensatory measures (assets)

- For non-financial institutions, compensatory measures typically consist of asset disposals and/or capacity reductions that attempt to approximate what would have happened in the absence of support
- With systemic effects, what is the counterfactual ?
  - What would have happened in the absence of support ? The distressed sale of banks would probably often have hurt competitors
  - What would have happened in the absence of excessive risk taking (and regulatory failures)
- Simply not feasible to simulate such (aggregate) counterfactual.

Compensatory measures (assets)

- Added concern : few buyers and many sellers
- Ensure consistency
- Identify markets in which conditions of competition can be improved
- Avoid the fragmentation of the internal market

Next crisis

- Avoid too stark a choice between financial instability and massive bail outs at the tax payer’s expense. Could we do better ?
- Reduce systemic risks. Make sure that banks internalise some of the risks
- Anticipate drastic restructuring
- Bankruptcy procedures
  - Do not allow for systemic effects
  - No public policy objectives
  - Triggered by insolvency
  - Not well suited to ensure the continuity of business

Next crisis

- Special resolution regimes grant special powers. Allows to deal with systemically important institutions without endangering financial stability. It also prevents minority stakeholders from impeding prompt and orderly restructuring of the distressed institution (living wills)
- US regimes. About 100 failures in 2009. Dealt with sizeable banks (around 400 bn)
- Special Resolution Regimes (SRR) and Prompt Corrective Action (PCA) have been created, but so far, little used.
- « Banks are international in life but national in death » Need for an ex ante arrangements across countries

Object and effect

Object and effect

Ex ante probability that a practice is unlawful (OFT, 2009)

1 ←→ 0

Per se | Object | Effect | De Minimis | Block exempted

- What determines whether a practice is characterised as giving rise to a distrortion of competition by object ?
- How can a restriction by object be integrated with efficiencies ?

Object and effect

- Rationale behind different “boxes” : different probability that the practice leads to anti-competitive effects
  - From accumulated experience
  - From economic theory
- Is the distinction discrete ? Is there a threshold in the ex ante probability that a practice lead to anti-competitive effects ?
- Few practices (straightforward horizontal price fixing ?) for which the probability is unquestionably high
- For others, there is rather a sliding scale. For instance, information exchange are very likely to be harmful only in some circumstances. See also RPM (OFT)

Object and effect

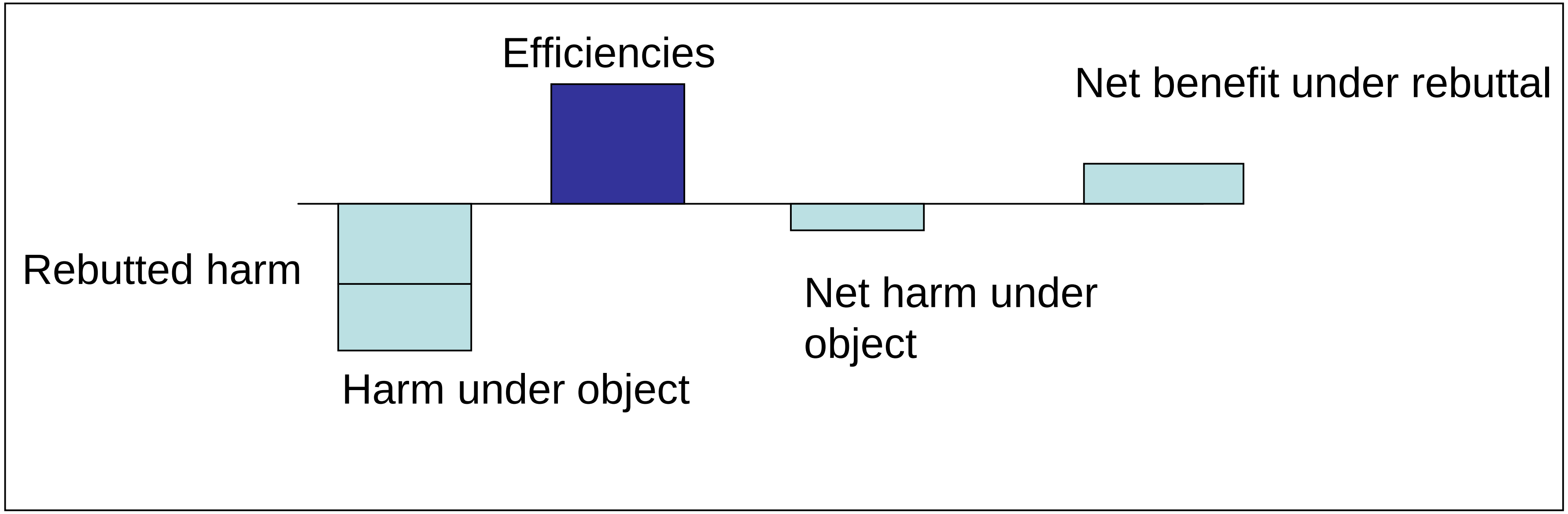
- Hence, the evidence that is required from the authority can also be seen in terms of a sliding scale
  - For instance, to identify the mechanism leading to harm in terms of economic theory, to qualify its generality
  - To prove that the circumstance in which the practice can be expected to lead to harm are actually met
  - For instance, show that the information exchange concerns (confidential) detailed prices ex ante.
  - Show (OFT) that the resale price maintenance act as mechanism of coordination (in a concentrated industry)
- In any event, even a pure restriction by object is by reference to a counterfactual
- Comparison with Art 82 (and priorities for enforcement)

Object : a matter of magnitude ?

- Is a restriction of competition by object one for which
  - there is a high likelihood of harm or one for which
  - the expected value of harm is high enough ? (ie that the harm is not only probable but also sizeable)
- It has to be the latter in order to make Art 81(3) operational
- Otherwise, there is no metric to compare the consumer harm and the efficiencies (if it is only a high presumption of harm, how could one assess whether efficiencies compensate for the harm ?)

Object : a rebuttable presumption ?

- If a presumption cannot be rebutted, there is a risk of type I error because in the circumstances the practice does not lead to consumer harm
- But also a risk of type I error because some efficiencies will not be be considered :



Conclusion

Back up slides

Implementation

	EU public interventions in the banking sector							
	Capital injections		Liability guarantees		Asset relief		TOTAL	
	Committed	Effective	Committed	Effective	Committed	Effective	**Total committed**	**Total effective**
EA (€bn)	241	156	1.849	725	103	89	2.193	969
EA (% GDP)	**3%**	**2%**	**21%**	**8%**	**1%**	**1%**	**24%**	**11%**
EU (€bn)	315	202	2.913	937	103	89	3.331	1.228
EU (% GDP)	**3%**	**2%**	**25%**	**8%**	**1%**	**1%**	**28%**	**10%**

Source: EC Services (Cutoff date August 31 2009)

The response

- Reduced liquidity
  - Interbank market and wholesale funding evaporated
  - Ability to securitize assets seriously impaired
  - Cost of funding increased sharply
  - Committed credit lines drawn upon
- Deteriorating solvency
  - Write-downs
  - Increasing capital requirements
- Main forms of State aid to banks:
  - Recapitalisations
  - Guarantees on newly issued bank liabilities
  - Impaired asset relief (purchase or insurance)
  - Liquidity provision

Ex ante guidance

- Impaired asset (February 25 2009)
  - Asset purchase or guarantees
  - Transparency
  - Incentives to participate
  - Asset valuation by independent experts
  - Market value, book value and real economic value
  - Remuneration in accordance with guidance on recapitalisation
- Bank restructuring paper (August 2009)
- EU-wide stress testing using common criteria

Ex ante guidance

- Banking communication (October 2008)
  - General principles
  - Pricing of guarantees (ECB)
- Recapitalisation (December 5 2008)
  - Distinction between banks in distress because of contagion and banks that are not fundamentally sound
  - Ex ante indicators
  - Pricing of recapitalisation that reflect the instruments, the risk profile, exit incentives
  - Sliding scale for restructuring and reporting requirements

Banking Communication (1/3) (13 Oct 2008)

- General principles:
  - Co-ordination and overall coherence
  - No protectionism, no discrimination
  - No softening of substantive rules
  - Inbuilt-flexibility to allow for different types of measures
  - Ex ante « benchmarks » and tailor-made conditions (e.g. duration of guarantees)
- Euro-system recommendations
  - Pricing

Recapitalisation Communication (5 Dec 2008) (2/3)

- Ensure lending to the real economy
- Differentiation in treatment of fundamentally sound and distressed banks in relation to price, safeguards, and the extent of future restructuring
- Which banks are fundamentally sound?
  - Assessment by the MS ex ante when deciding about the eligibility
  - COMP will monitor ex post when reviewing the schemes on the basis of MS's reports
  - Set of indicators (Annex 1) and a role for national supervisory authorities: capital adequacy, size of recap, current CDS spreads, rating & its outlook

Recapitalisation Communication: Fundamentally sound banks (2/3)

- Remuneration to reflect:
  - Banks' risk profile
  - Type of capital (subordination)
  - Exit incentives and safeguards against abuse
  - Risk-free rate benchmark
- Entry price:
  - Euro-system methodology (20 Nov 2008)
- Exit incentives:
  - Increasing remuneration, redemption clauses, link with dividends distribution
- Safeguards:
  - Ban on aggressive commercial strategies, M&As by competitive tendering, use of capital for lending
- Reporting & follow-up after 6 months:
  - soundness of the banks, individual recaps conditions, use of capital for lending, path towards exit

Recapitalisation Communication: Banks not fundamentally sound

- Higher risk – higher remuneration
- Stricter safeguards (e.g. limitations on executive remuneration and bonus, maintenance of higher solvency ratio)
- Follow-up: far-reaching restructuring (restructuring or liquidation plan to be assessed according to principles of the rescue and restructuring Guidelines)

Impaired asset communication (3/3)

- Need for a consistent EU approach:
  - avoiding a “race to the top” triggered by the first-mover effect (public finance implications)
  - avoid arbitrage for cross-border banks
  - avoid protectionism in an internal market
- State aid rules for a coordinated action
- Balancing immediate financial stability and return to normal market functioning
- Cater for different situations across the EU