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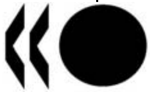

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ROUNDTABLE ON EXIT STRATEGIES

-- Note by Prof.Thorsten Beck et al. --

The attached document includes the introduction of the report "Bailing out the Banks: Reconciling Stability and Competition" by Thorsten Beck, Diane Coyle, Mathias Dewatripont, Xavier Freixas and Paul Seabright which is circulated to Competition delegates FOR INFORMATION. The full report, including section 7 on "Preventing future crisis" is available at http://www.cepr.org/pubs/other/bailing_out_the_banks.htm. Prof. T. Beck will participate as panelist to the roundtable on Exit Strategies.

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Bailing out the Banks: Reconciling Stability and Competition

An analysis of state-supported schemes for financial institutions

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Bailing out the Banks: Reconciling Stability and Competition

An analysis of state-supported schemes for financial institutions

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Glossary

ABS	Asset Backed Security
AMC	Asset Management Corporation
BCM	Bank Crisis Management
BIS	Bank for International Settlements
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
EBA	European Banking Authority
EDIC	European Deposit Insurance Corporation
ECB	European Central Bank
EFC	Economic and Financial Committee
ESA	European Supervisory Authorities
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
ESRC	European Systemic Risk Council
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
LCFI	Large Complex Financial Institution
MoU	Memorandum of Understanding
OTC	Over the Counter
OFT	Office of Fair Trading
PCA	Prompt Corrective Action
RBS	Royal Bank of Scotland
SIV	Special Investment Vehicle / Structured Investment Vehicle

Introduction

The continuing crisis has been exceptional in its intensity and global reach. It began as a financial crisis and it became an all-out economic crisis, requiring a wide range of globally-coordinated policy responses: monetary and fiscal as well as regulatory responses, not to mention steps to avoid the trap of protectionism.

Much has already been written on the subject,[1] and this report will not try to address the current crisis in its entirety. Since its main focus is on bank bailout plans, we will not discuss trade and macroeconomic aspects (except to emphasise that bailout plans should not threaten the sustainability of public finances).

This report will concentrate on two specific aspects of policy: financial regulation and competition policy. These are inevitably intertwined. Since the Great Depression policymakers have struggled to define the right mix of competition rules and regulations specific to the banking sector. The Great Depression led to the discontinuation of most standard competition policies in banking in order to foster financial stability. This objective was clearly achieved, but at the cost, over succeeding decades, of stifling innovation and imposing a high burden on consumers. This led in turn, from the 1970s, to a swing of the pendulum towards deregulation, with more competition and innovation but also with many banking crises (e.g. in the US in the 1980s and in Scandinavia and Japan in the 1990s, in addition to the many emerging-market crises). Each time, regulation did try and adapt, in a global fashion, leading in particular to the Basel I and II regulatory frameworks.

Obviously, this has not prevented the massive crisis that exploded in 2008, leading to the two unavoidable questions that accompany every such episode: (1) how to deal with the current crisis; and (2) what lessons the experience offers for reducing the likelihood of another crisis and mitigating its impact? This report will address these two questions, with special emphasis on competition policy, and in particular on state aid control. It is important, furthermore, to put these policy responses in the context of the overarching architecture of regulatory policies, because the question of the link between competition and stability in the banking industry depends on the ability of the various levers of prudential regulation to prevent excessively risky behaviour by bank managers and shareholders.

The crisis has provoked two common but quite different reactions concerning the role of competition policy in the banking sector. One reaction has been to consider

1 Just to focus on CEPR/VoxEU outputs, see for example the recent ebooks edited by Baldwin (2009), Dewatripont et al. (2009) and by Baldwin and Evenett (2009), as well as the two ebooks collecting Vox columns on the crisis edited by Felton and Reinhart (2008, 2009). VoxEU.org has published two other relevant ebooks, both edited by Baldwin and Eichengreen (2008a, b).

that financial stability should take priority over all other concerns, including those of traditional competition policy; and therefore, that the 'business as usual' preoccupations of competition regulators should be put on hold, and the normal rules suspended for the duration. Another reaction has been to fear that intervention to restore financial stability will lead to massive distortions of competition in the banking sector, and therefore to conclude that competition rules should be applied even more vigorously than usual, with the receipt of state aid being considered presumptive grounds for suspecting the bank in question of anti-competitive behaviour. As will be seen, in this report we endorse neither of these points of view. We reject the idea that the crisis requires the suspension of normal competition policy rules; in times of crisis they are more important than ever. However, we also believe that the competition rules appropriate to the banking sector are not the same as those that should apply to most other sectors. The reasons are set out in detail below, and result from the fact that bailing out one bank in an episode of crisis helps its competitors. State-aided banks have a different relation to the rest of the economy than state-aided firms in other sectors, and the rules of state aid policy should reflect these differences. However, this is not equivalent to saying that competition policy in banking does not matter in a crisis. On the contrary, there should be a thorough competitive assessment of the banking sector following the bailouts.

This report focuses on general economic principles that should be kept in mind when facing crisis-induced bank bailouts. It then discusses the reaction by competition authorities to the current crisis. It is fair to say in this respect that they tried to strike a balance between the insistence on competition concerns and the need for urgent action to respond to the financial crisis. Nevertheless, the specific characteristics of banking need to be acknowledged more explicitly, in particular because the crisis has had sector-wide competition implications which measures targeting the individual recipients of aid are not well suited to address.

Main conclusions of the report

The various methods of helping banks, such as purchasing toxic assets (perhaps to be put in a bad bank), recapitalisation or providing guarantees, should have three objectives in mind: (i) the need to stabilise the financial system; (ii) the need to restart lending; and (iii) the need to avoid distortions of competition. Although in some respects there is a balance to be struck between these objectives, there is no fundamental trade-off between the aims of financial stability and competition: in our view, reformed prudential regulation should take care of potentially excessive risk-taking, which means competition policy rules can then apply in banking as in other sectors of the economy, once the crisis has subsided.

Our conclusions on *general economic principles* fall under three main headings.

- **State aid principles *are* different for banks**

Bank bailouts can help competitors

It is important to recognise that in the banking industry, in times of crisis, the fact that one firm is being helped could well imply a positive externality for its

competitors, either because it prevents systemic problems, or because these competitors are themselves its creditors, and so are indirectly also bailout recipients. This means that bank bailouts do not necessarily require 'compensation' for competitors, in contrast to the normal assessment of state assistance in other industries. This does not detract from the fact that in the medium- to long-term, the survival of less efficient banks can hurt their competitors and the whole banking system.

New lending needs to be supported

In periods of generalised bailouts, remedies that will tend to contract new lending must be avoided, although the economic crisis means the desired amount of lending will decline and the credit-worthiness of some borrowers will have declined.

- **Competition policy should apply, but conditions on bailouts must reflect the specifics of banking**

Standard competition policy should apply to banks

There is no case for applying weaker competition policy criteria to banks, because competition and stability are not incompatible. The data show that the share of profits of financial institutions, in GDP, had been growing steadily over time until 2008. Even if some of this was an unsustainable bubble, it was not a situation in which trouble would have been unavoidable whatever the design of regulation. The problem was clearly not one of competition leading inevitably to banking fragility. Proper prudential regulation should therefore be sufficient to allow standard competition policy principles (Articles 81 and 82 and merger regulations) to be applied: there is no need to weaken standard competition policy for banks. Nor should competition policy be applied more strictly in a crisis; it should be applied with sensitivity to the circumstances that distinguish banks from other kinds of state-aided firms.

Behavioural restrictions may distort competition

Standard competition policy imposes both structural and behavioural restrictions on firms, and there are no grounds for applying these less vigorously to banks in a crisis: leniency in merger approval or greater tolerance of predatory behaviour are no more justified for weak banks than for any other financial or non-financial firm. However, the opposite tendency also needs to be avoided: in particular, there is no case for specific behavioural restrictions following bailouts that would put the rescued bank at a competitive disadvantage with respect to competitors, such as caps on the compensation of new hires (when banks need fresh talent to clean up the mess created by previous executives), or limitations on their pricing strategies relative to competitors.

Moreover, in periods where many banks have received bailouts, there are good reasons to avoid imposing conditions on the receipt of state aid that require generalised balance sheet reductions. These are sometimes justified by analogy with other sectors (such as manufacturing), where the crisis conditions that lead to bailouts are often an indicator of structural overcapacity in the sector. In banking, by contrast, bailouts have been provided due to the fear of a credit crunch – that is, of

inadequate activity in the sector due to the efforts of weak banks to recapitalise. Imposing balance sheet reductions as an automatic condition of state aid therefore does not have the rationale that it often has in other sectors of the economy.

This does not imply that concerns about balance sheet growth are unjustified: on the contrary, limiting growth through acquisitions does make sense as a way to prevent the recipients of a bailout gaining an unfair advantage. And, in fact, there is a case for requiring balance sheet reduction in the case of banks whose prior overexpansion was the reason for their needing a bailout. This being said, a lot of restructuring in the sector will be desirable following the crisis, and there is no reason to prevent acquisitions which are compensated by divestitures and therefore avoid net growth of balance sheets. This should, however, be accompanied by an assessment of the competitive situation in the sector taken as a whole.

Bailouts should not favour banks' domestic assets

Bailouts should not be permitted to lead to any move away from the single market, either through national governments directing their own banks towards domestic lending, or through the imposition of remedies that would lead banks to spin off foreign rather than domestic activities.

- **The need for stability justifies 'real' but not over-generous aid**

Accounting changes are dangerous

In cases of bank insolvency, such as those we are experiencing in current conditions, 'real' bailouts are needed. Changing accounting rules in order to pretend things are fine is inappropriate: this just means allowing insolvent banks to go on rather than cleaning them up, which would result in inefficient lending – ie, leading either to a credit crunch (as in Japan in the 1990s), or to 'zombie lending' (as in the US Savings and Loans Crisis in the 1980s).

The amount of the bailout should be the minimum necessary

While 'real' bailouts are needed, Governments must avoid being 'overly generous' in bank rescues; they should avoid plans that give such banks extra funds that would, for example as discussed above, allow them to start buying other financial institutions that are in trouble.

Equity holders must bear as much of the bailout burden as possible

Minimising aid means in particular that, to the extent possible, bailout plans should wipe out initial equity holders, in order to reduce potential moral hazard. However, this can be overstated, as the regulatory environment will clearly change after the crisis, and as there is a danger of negative externalities (including between member states) if a government treats shareholders too harshly. The key criterion for European authorities should be to insist that the sustainability of public finances is not threatened.

More of the burden should be placed on 'junior creditors'

Moral hazard and fiscal considerations also point to imposing losses on junior creditors, something which has been too much overlooked in the 2008-2009

bailouts.[2] This may be because of the fear of causing panic among creditors – but this fear is overrated: separating out the claims of junior creditors from those of senior ones may well encourage the latter to lend more, rather than less freely. Of course, one should be careful about second-round effects: if junior creditors are financial institutions too, such liability re-evaluations may simply transfer the problem; and European authorities may want to give careful attention to this argument in the case of foreign junior creditors, whose interests would naturally be neglected by member states.

Sunset clauses/exit strategies are needed

The difficulty of monitoring and enforcing behavioural restrictions on the assisted banks, and of designing restrictions which do not distort competition, make it imperative to include an end date or exit strategy in bailout plans.

Governance of banks needs strengthening

For the same reason, certainly for the duration of the state aid and in many cases permanently, stricter governance of the banks rescued is needed. The prior standard corporate governance framework proved inadequate.

Other implications for regulation

We also make a number of recommendations in terms of the over-arching regulatory architecture:

Regulation is needed for non-deposit-taking institutions

While it is true that deposit-taking institutions deserve special attention, other types of institutions also need regulation if they are 'too big to fail' or 'too interconnected to fail'. Otherwise, this can quickly lead to the rapid development of more lightly regulated entities, leading to distortions of competition and inefficiencies. In this respect, the tax treatment of financial institutions has important prudential and competition implications, and dangerous loopholes that currently favour the shadow banking sector, encouraging leverage and risk taking, must be closed. There should also be a review of the capital charges that apply to lending by banks to the shadow banking sector.

No need to prevent universal banking

There is no need to try to prevent universal banking, but the right capital charges are needed for various business lines or products. What is dangerous is not financial innovation *per se*, but 'excessively' risky uses of such innovation. This means higher capital charges are needed on structured finance products and other off-balance-sheet transactions, and these should no longer be linked to the ratings they receive (since ratings are particularly inflated for non-transparent products). Further consideration

2 Note that we use the generic term 'junior creditors' here to include the various financial instruments that are 'in-between' equity and senior debt in terms of priority were the bank to go bankrupt, from 'hybrids' until subordinated debt.

should be given to the idea of having very high charges beyond some threshold volume for each bank offering new financial products, at least until their properties are understood.

No direct limits on bank size needed – but growth should be made more costly

There are risks associated with big banks, in particular the danger that they are too big to fail, and the moral hazard to which this gives rise. This is all the stronger because bigger banks have more lobbying muscle. However, there is value in having a single market in banking just as in other sectors. Of course, this should be accompanied by proper centralised regulatory, supervisory and burden-sharing arrangements. The way to deal with the risks of size is not to impose arbitrary limits, but to apply deposit insurance premia or capital charges that increase in percentage terms when banks get bigger.

Macro-prudential regulation should supplement the current Basel regulatory system.

It is crucial to limit the procyclical effect of the current regulation, for example by introducing procyclical capital ratios, in order to limit the need for banks to deleverage during recessions. This could take the form of dynamic provisioning (as already done in Spain), capital ratios indexed on macroeconomic variables (see Repullo et al. (2009) for an example using GDP), or capital insurance (along the lines of Kashyap et al. (2008)). Using the options provided by Pillar 2 of Basel II, which leaves it to each country to set an additional layer of capital, has proved inadequate, due to competition amongst regulators limiting this additional capital.

Simpler fixed rules are needed to protect regulators

Regulation should seriously and explicitly take into account the gaming between regulators and private actors, which takes place either through potential lobbying and capture, or through financial innovation that aims at regulatory arbitrage.

More centralised supervision and resolution capacity is needed in Europe

To address cross-border bank failures, there is a need for more centralised regulation and supervision and in particular ex ante burden-sharing agreements in Europe.

Assessment of the policy responses so far

State aid control

DG Competition has been very active since the Autumn of 2008. As stressed earlier, it has struck a balance between the insistence on competition concerns and the acknowledgement of the specificities of banking. We agree with its general approach, in particular, its general 'permissiveness' towards broad-based plans (as of December 17, 2009, it had adopted without objections all 66 of the 67 temporary sector-wide aid schemes), and its focus on only those banks that received significant individual help. (As of December 17, 2009, it had adopted 81 decisions on individual cases related to the financial crisis, of which 75 raised no objections to the aid). It does not mean, however, that its potential concerns, detailed in its Communications, did not

have an impact on the many plans and cases being put forward. In particular, it was very useful for DG Competition to insist on avoiding overgenerous help, and on encouraging exit strategies.

As far as those cases where remedies were imposed, we understand the desire to counter moral hazard by insisting on balance sheet reductions. This being said, we want to stress again the fact that the implications of bailouts on competitors can be quite ambiguous in the banking sector. Our feeling is that the key concern of competition authorities should be the restoration of a 'level playing field' among banking competitors, with sufficiently dynamic competition. In this respect, it is important that the insistence on minimum aid and on exit strategies do not lead to undercapitalised banks. Similarly, it is important that balance sheet reductions do not lead to a retreat of banks within their national borders, thereby contradicting the goal of a single market in this sector. Finally, our biggest worry concerns behavioural restrictions imposed on bailout recipients. While it makes sense to avoid the unfair advantages that public money would give to such recipients, 'tying their hands', for example by preventing them from being 'price leaders', seems to us to be both hard to enforce and misguided: it is much better to ensure that these banks are adequately capitalised and then enforce competition on all players in the market.

Of course, this criticism has to be mitigated by the fact that competition authorities do not live in a first-best world: while we strongly feel that financial stability, and in particular the prevention of moral hazard, is mainly the job of prudential regulation and not of competition authorities, the latter have to live with whatever prudential regulation exists at present times. Erring to some extent in the direction of moral-hazard prevention in competition policy can therefore be justified partially (but not fully) by the excessively slow reform of prudential regulation, a topic we now turn to.

Prudential regulation reform

Let us start with a note of caution here. Regulatory reform is currently only 'work in progress', some of which requires complicated international negotiations – that is, for example, as far as macro-prudential regulation, accounting conventions, or the treatment of the shadow banking sector, are concerned. Our assessment can therefore only be partial.

This being said, the recent European Banking Authority (EBA) proposal and Bank Crisis Management (BCM) Communication constitute a step forward in the design of a post-crisis financial regulatory regime that better coordinates supervision in Europe, a key requirement to preserve a single market in banking. Still, the loss of supervisory authority will presumably be aggressively opposed by some countries, such as the UK, for which the financial industry is a strategic one. This could lead to weak European regulation dominated by national regulators. So, although moving in the right direction, there are some reasons for concern. First, the key issue in terms of efficiency is the need to define a European bankruptcy regime, which is only vaguely invoked at the end of the BCM Communication. Second, the issue of burden sharing, also mentioned in the BCM Communication, will be a permanent source of disagreements among countries, precisely because the European bankruptcy regime has not been harmonised. Indeed, why would one country's taxpayers provide capital for an institution in another country that has been badly managed, badly supervised and

badly regulated, especially if the main beneficiaries are the distressed institution's shareholders, or even subordinated debt holders? Third, the EBA proposal pursues two objectives at the same time: European consistency and integration on the one hand, and the creation of a new post-crisis financial regulation on the other. Although they are not incompatible, there is a risk that, as the European economies emerge from the crisis, the first objective ends up dominating the second, and regulatory reform is postponed until the next crisis.

Structure of the report

This report falls into four parts. The first (in sections 1-2) will set the stage by discussing why banks are special and how competition interacts with bank stability. The report will then discuss (in sections 3-4) the characteristics of the crisis and outline European bank rescue plans and the European Commission response so far (as summarised by the Communications which are meant to set the stage for its planned evaluation, according to state aid control rules, of the bank bailouts that have taken place since autumn 2008). Sections 5 and 6 turn to two key aspects of resolving the current crisis, namely burden sharing and competition issues. Finally, section 7 will discuss the necessary changes to prudential regulation in order to minimise the danger of future crises.