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PATH TO / TOWARDS THE EU BANKING UNION

The Role of State Aid in the Banking Union

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** The views expressed are those of the author and do not represent the views of the HDIGF*

I. **Introduction**

II. An Evaluation of the EU State Aid Institutional Framework

III. State Aid to the Financial Sector in the Crisis Context

IV. The Eurozone Framework

V. Changes in the Institutional Framework

VI. The Banking Union Arrangement

VII. Conclusions

State Aid Magnitude to the EU Banking Sector

Since the crisis erupted, State Aid was extended:

- by more than 22 EU governments to support the banking sector (in the form of guarantees, asset relief, recapitalization)
- to more than half of the banking sector by assets in seven (7) Eurozone countries
- to over than 110 banks standing for 30% of the EU banking sector by assets (12 of which included in the top 20 European banks)

Source: EU Commission

Banking Union Objectives

As a response to the crisis, the BU project aims to:

–Promote financial stability

–Preserve the integrity of the euro

–Eliminate the vicious circle between banks and sovereign risks

–Ensure a level playing field for all banking institutions and

–Curtail taxpayers participation

Considerations

– Are the instruments incorporated in BU legislation appropriate and effective in dealing with such challenges?

– What is required in the BU infrastructure to guarantee that the location of a bank (and not its assets) in the Eurozone does not influence either the public trust attached to it or its funding costs and that of the respective government?

– Does the potential of government intervention in the recapitalization/resolution process contribute to competition on borrowing costs among Member States?

I. Introduction

II. An Evaluation of the EU State Aid Institutional Framework

III. State Aid to the Financial Sector in the Crisis Context

IV. The Eurozone Framework

V. Changes in the Institutional Framework

VI. The Banking Union Arrangement

VII. Conclusions

State Aid Definition

Any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

Article 107 of the Treaty on the Functioning of the European Union (TFEU)

State Aid Features

A measure is considered as a State Aid when:

i. **Carried out by the State or through State resources**
   - direct monetary transfer or
   - indirect delivery of government funds (public control over aid)

ii. **Provides to the recipient an advantage on a selective basis**
   - not in the course of a "normal" business
   - selectivity focuses on specific companies or industry sectors, or companies located in specific regions
   - General measures which provide advantage to all companies are excluded

iii. **Competition has been or may be distorted**

iv. **The intervention may affect trade between Member States**

Compatibility with the Internal Market

Compatibility with the "Internal Market" framework is granted in case of certain policy objectives such as :

i. aid having a social character

ii. aid to recover the damage caused by natural disasters

iii. aid to support economically depressed areas

iv. aid to support projects of common European interest

v. aid to redress a serious shock in the economy of a Member State

vi. aid to assist culture and heritage conservation

vii. other categories specified by decision of the Council on a proposal from the Commission.

The EU Institutional Framework on State Aid: an Assessment

- The “flexible” definition of exceptions allows great potential for arbitrariness
- The EU State Aid policy, by allowing the Member States to intervene at micro level, may to some extent compensate for the loss of policy instruments and restore national autonomy.
- In this context national State Aid would emerge as a core issue in the process of European integration in the years to come.

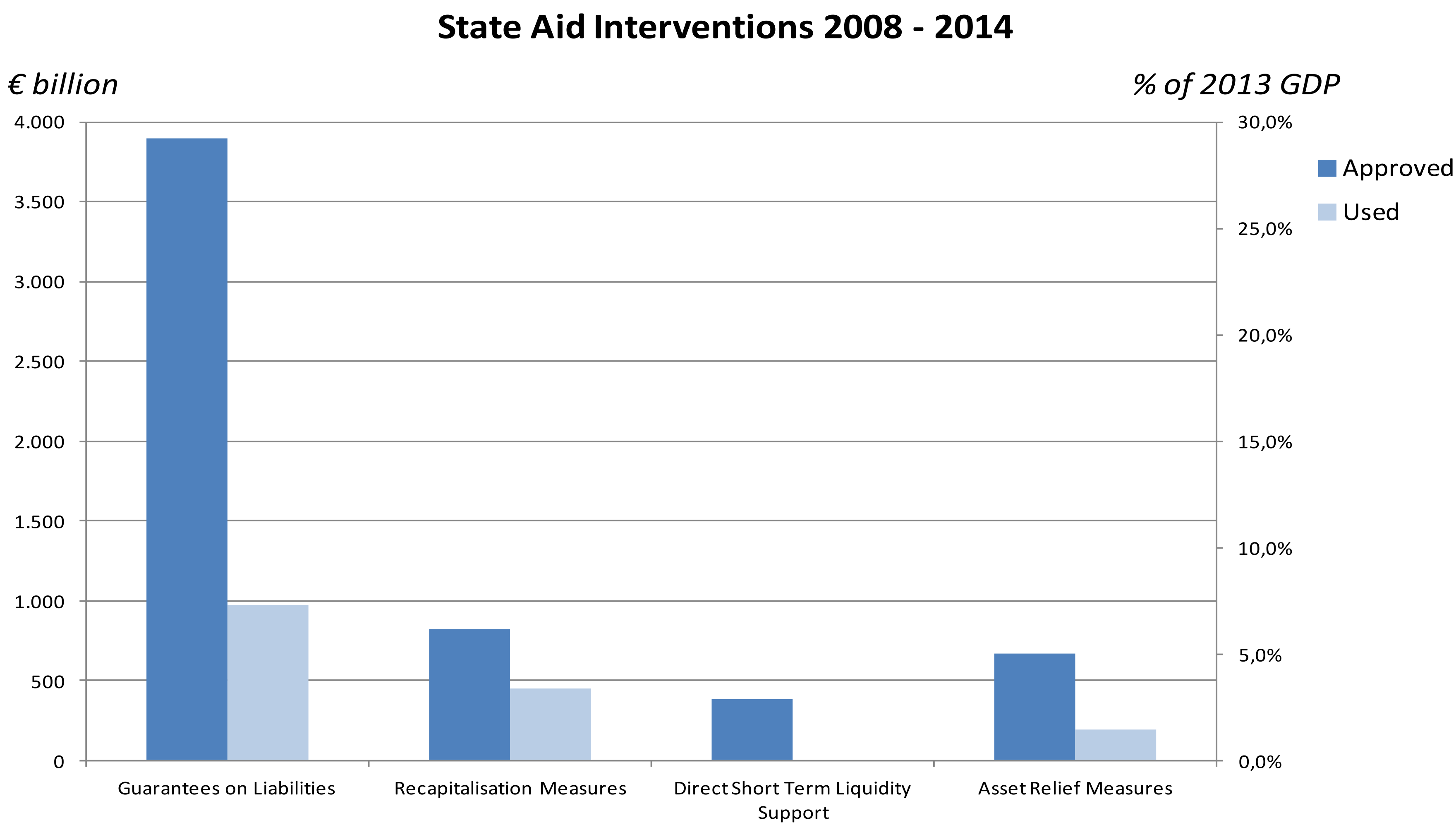
State Aid Interventions 2008-2014 (I)

Between 2008 and 1.10.2014 the Commission authorized:

- Guarantees on liabilities
  - More than 3.8 trillion (30% of EU GDP in 2013)
  - Financial institutions used almost a quarter of the approved amount
- Recapitalisation measures
  - More than 820 billion euro (6.3% of EU GDP in 2013)
  - Actual amount granted: 450 billion euro (3.4% of EU GDP in 2013)
- Direct short term liquidity support by some Member States
  - Almost 400 billion euro (3% of EU GDP in 2013)
- Asset relief measures
  - Almost 670 billion euro (5% of EU GDP in 2013)
  - Actual amount provided: almost 190 billion euro (1.4% of EU GDP in 2013)

Source: EU Commission

State Aid Interventions 2008-2014 (II)



Source: EU Commission

State Aid Interventions 2008-2014 (III)

Financial Aid Approved by the EU Commission in Selected EU Countries, 2008 - 1/10/2014

	2008 - 30/09/2014							
	Recapitalisation measures		Guarantees		Asset relief interventions		Liquidity measures other than guarantees	
	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP
Belgium	23,32	6,1%	325,42	85%	28,22	7,4%	20,50	5,4%
Finland	4,00	2,1%	50,00	26%	0,00	0%	0,00	0%
France	29,24	1,4%	382,68	19%	4,70	0,2%	8,65	0%
Germany	114,61	4,2%	455,85	17%	82,78	3%	9,50	0%
Italy	22,00	1,4%	110,00	7%	0,00	0%	0,00	0%
Luxembourg	2,50	5,5%	7,05	16%	0,00	0%	0,32	0%
Netherlands	39,84	6,6%	200,00	33%	30,61	5,1%	54,00	0,2%
Ireland	111,39	67,9%	554,18	338%	122,26	74,5%	40,73	0%
Cyprus	1,80	10,9%	9,00	55%	0,00	0%	0,00	0%
Greece	48,97	26,9%	85,00	47%	0,00	0%	15,74	4,0%
Portugal	32,25	19,5%	44,27	27%	4,00	2,4%	6,06	0%
Spain	174,52	17,1%	321,05	31%	139,92	13,7%	32,65	0,08%
Czech Republic	0,00	0,0%	0,00	0%	0,00	0%	0,00	0%
Hungary	1,07	1,1%	5,35	5%	0,04	0%	3,87	0%
Poland	34,72	8,9%	33,89	9%	0,00	0%	0,00	0%
Romania	0,00	0,0%	0,00	0%	0,00	0%	0,00	0%
Sweden	5,03	1,2%	156,00	37%	0,00	0%	0,52	0%
United Kingdom	114,62	6,0%	458,75	24%	248,05	13,1%	51,93	0%
TOTAL EU-27	**821,13**	**6,3%**	**3892,57**	**29,8%**	**669,13**	**5,12%**	**379,91**	**2,9%**

Source: EU Commission

National State Aid to the Financial Sector: an Assessment (I)

- State Aid was provided far more extensively in the Eurozone than in non-Eurozone countries

- State Aid to some extent might have been used as a substitute to macroeconomic policy instruments (e.g. interest rate, exchange rate), eliminated by the introduction of the euro and as a device to pursue national interests and goals.
  - This issue requires further research.

National State Aid to the Financial Sector: an Assessment (II)

- State Aid has largely been successful in restoring confidence and stability in the financial sectors
  - Most banks under State Aid Control pass the ECB stress test

- Nevertheless it has contributed significantly to two market failures:

  i. financial fragmentation in the Eurozone

  ii. increased moral hazard of both banks and governments obstructing the restructuring of the banking sectors

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II. An Evaluation of the EU State Aid Institutional Framework

III. State Aid to the Financial Sector in the Crisis Context

IV. The Eurozone Framework

V. Changes in the Institutional Framework

VI. The Banking Union Arrangement

VII. Conclusions

Eurozone’s Unique Elements

i. A common currency and payment infrastructure guaranteeing unrestricted capital flows

ii. National fiscal policies and backstops

iii. National resolution policies and instruments

iv. Absence of a common backstop in case of exhausted government funds

v. Tight banks’ political connections – strong links between banking and political actors

Government Incentives (I)

Within this framework governments have powerful incentives to:

I. Intervene to contain instability

which would lead to capital flights towards more secure jurisdictions and thus raise funding costs.

II. Refrain from inflicting domestic bank losses upon creditors and governments debt holders

due to fear of defaults, divestments, capital out flows, liquidity squeeze with severe repercussions on funding costs.

Government Incentives (II)

III. Compete on their own funding (borrowing)

IV. Delay the necessary adjustment of the domestic banking system postponing the appropriate management of losses derived from non-performing loans –the so called “legacy” assets

V. Avoid equity dilution by erecting or maintaining legal and fiscal obstacles to equity market integration

   The low market capitalization of several banks observed during the crisis did not generate any significant increase in cross-border equity ownership

Financial Integration / Fragmentation in the Eurozone (I)

Financial Integration Assessment

- Before the crisis: level of cross-border capital flows
- Since its beginning: Yield convergence/ divergence in financial markets
  - Procyclicality of capital flows

Following the introduction of euro, the close correlation between government bond yields gave way to wide divergences in interest rates since 2009

Financial Integration / Fragmentation in the Eurozone (II)

- The birth of euro and its payment infrastructure allowed unrestricted capital flows.
- Following the crisis, financial integration reversed.
  - Risk aversion has contributed to a retreat of capital flows (home bias).
  - National regulatory provisions (regulatory capital requirements, resolution procedures) have divided the euro area back into national boundaries.
  - Lack of harmonized resolution procedures generated uncertainty over the burden sharing and contributed to banks' risk aversion and thus liquidity ring-fencing at national level.

Financial Integration / Fragmentation in the Eurozone (III)

- State Aid was provided more extensively in the form of state guarantees, which generated significant distortions in credit risk pricing leading to credit market fragmentation.

- The fiscal capacity of a Eurozone member state, which is its ability to provide State Aid and credible guarantees to the banking sector, has emerged as a major determinant of its borrowing cost – i.e. its interest rate.

Financial Integration / Fragmentation in the Eurozone (IV)

Outcomes:

- Uneven playing field among national banks according to the States where they are legally headquartered
- Obstruction of the smooth operation of credit markets
  - distorts the appropriate channeling of credit
  - aggravate adverse selection
- Obstruction of the smooth transmission of monetary policy as pursued by the ECB
- Consequences on overall economic growth and welfare losses

Restructuring of the Banking Sectors – Moral Hazard (I)

State Aid provided in the form of guarantees:

- avoided the severe consequences of rising borrowing costs
- obstructed banking sector restructuring by:
  - requiring looser provisions than those of other forms of state support such as recapitalization
  - subsidizing national banks’ operations in the interbank market with merely limited requirements
  - deterring appropriate management of troubled assets derived as the legacy of the financial crisis.
- enhanced moral hazard of both banks and governments by avoiding the severe (though necessary) consequences of restructuring.

Restructuring of the Banking Sectors – Moral Hazard (II)

- A two speed adjustment in the banking sector of the Eurozone.
- The pace of adjustment proceeds more rapidly in the peripheral Eurozone countries
  - Implementation of recapitalization and reorganization procedures:
    - as prerequisites of external financial support or
    - by the prospects of falling under severe external funding provisions, which would carry even stricter restructuring plans

Restructuring of the Banking Sectors – Moral Hazard (III)

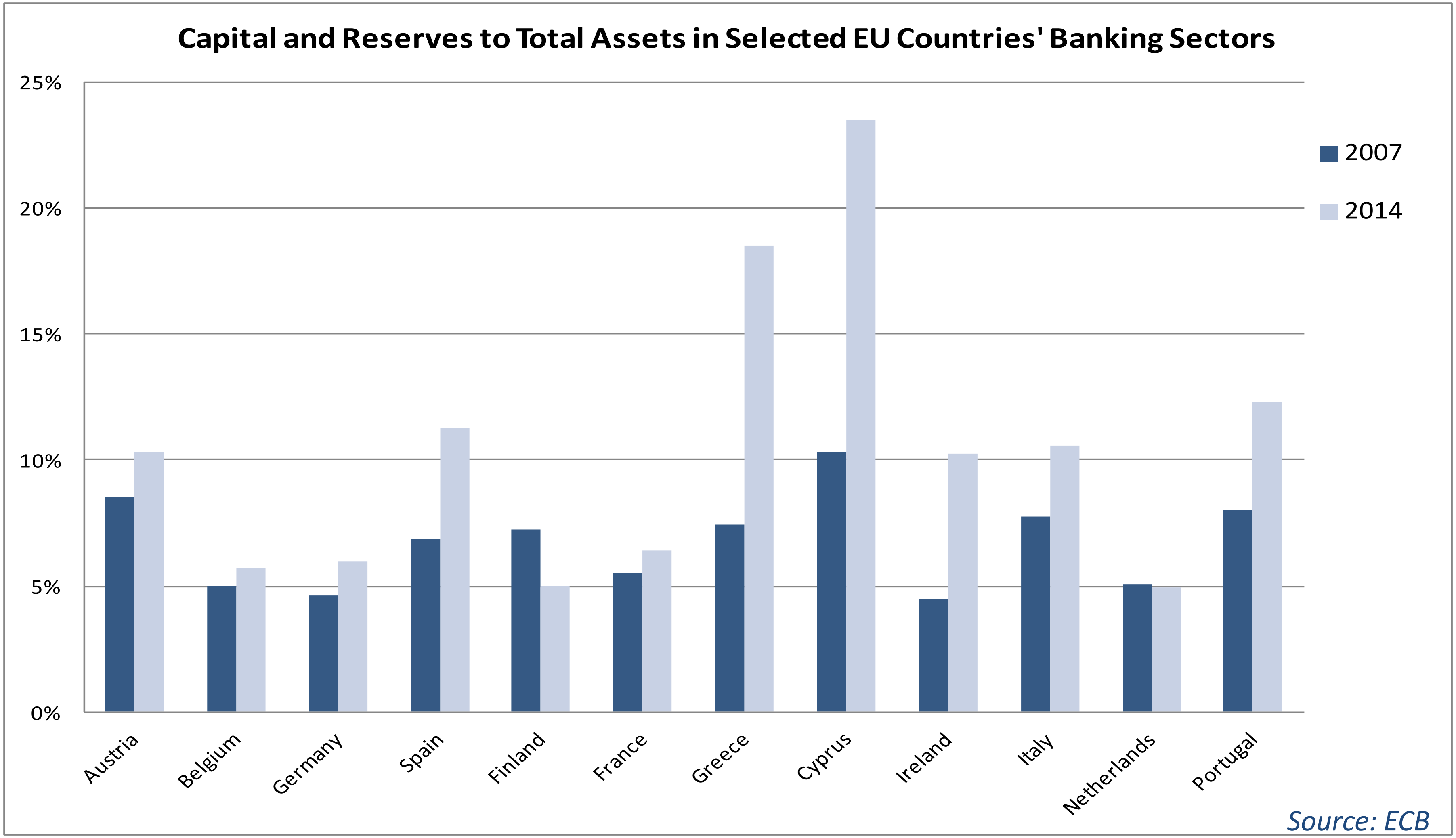
Countries with banking systems supported by national governments, either directly via subsidization, or indirectly by the fiscal status of the respective governments, demonstrated delays in the adjustment process.

- Existing equity holdings and interests were preserved – no equity dilution.

Restructuring of the Banking Sectors – Moral Hazard(IV)

The following Diagram presents the developments in capital and reserves over total assets in selected EU countries' banking sectors since the outset of the crisis. It clearly reveals that the process of adjustment has been particularly evident in peripheral countries.

Restructuring of the Banking Sectors – Moral Hazard(V)

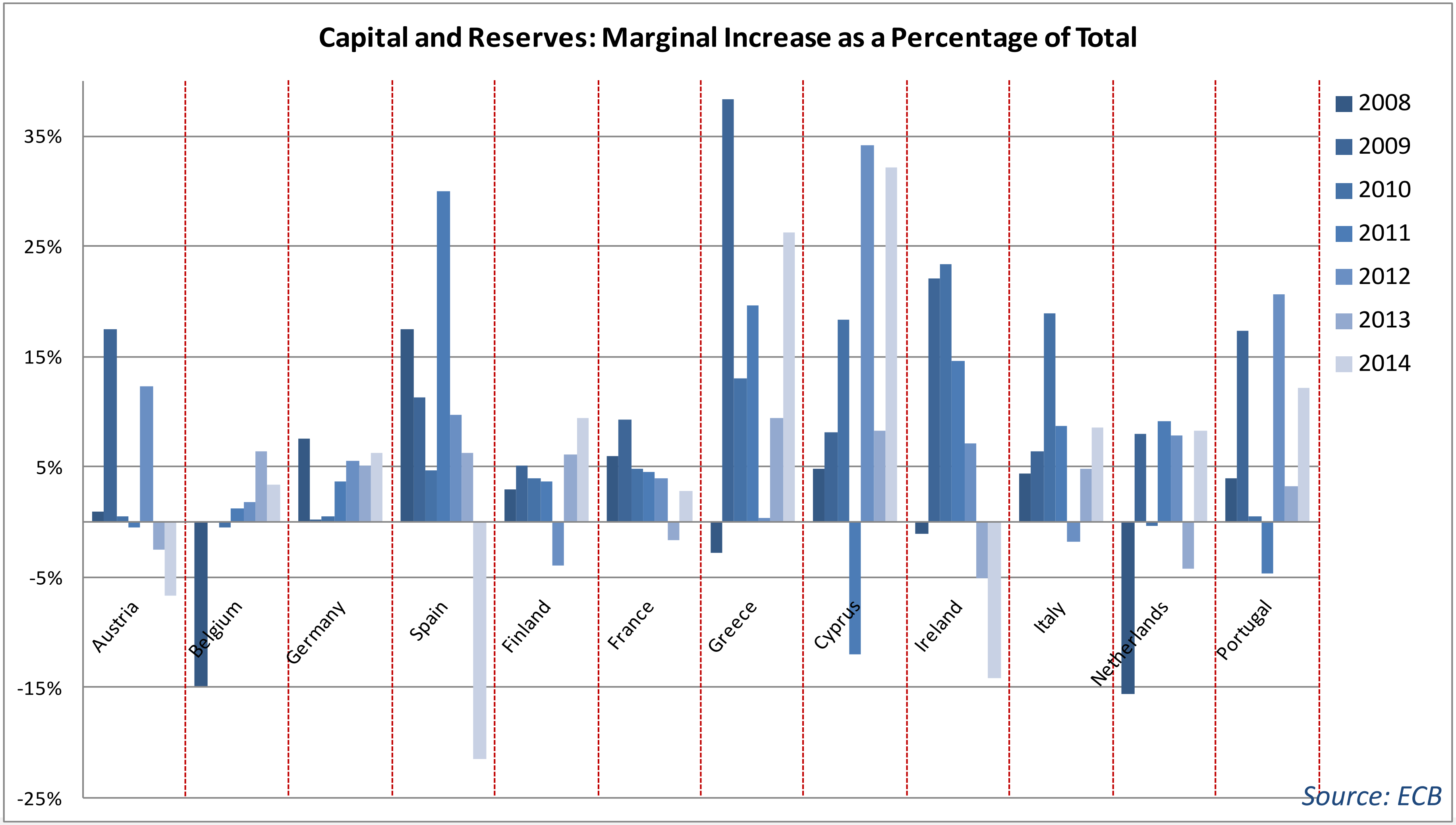


Source: ECB

Restructuring of the Banking Sectors – Moral Hazard(VI)

- Countries performance on banks recapitalization could better be assessed by the annual marginal increase in capital and reserve as a percentage of the total capital and reserve
- This indicator substantially eliminates any disparities in the definition of capital amongst Member States
- The results are revealing: the level of adjustment was more extensive in the peripheral countries

Restructuring of the Banking Sectors – Moral Hazard(VII)



Restructuring of the Banking Sectors – Moral Hazard(VIII)

According to the European Central Bank (2014):

- The process of rationalization and resizing appears a common trend in the euro-area banking system since the outset of the crisis as an attempt towards more efficient use of resources.
- However, this is especially evident in the peripheral EU countries that were participating in EU/IMF financial adjustment programmes.
  - Such process becomes visible in the increase of key banking capacity indicators, for instance population per branch and population per bank employee.

Restructuring of the Banking Sectors – Moral Hazard(IX)

In a nutshell:

•Governments fiscal standing holds back banking restructuring

•External funding arrangements (e.g. ESM) promoted recapitalization and reorganization.

•The current framework amplifies governments' moral hazard in competing on their own funding and consequently generates financial fragmentation alongside national boundaries.

•Governments' fiscal status play fundamental role in pricing domestic credit risk and determine the funding costs (i.e. the interest rate) of both domestic banking systems and governments.

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V. Changes in the Institutional Framework

VI. The Banking Union Arrangement

VII. Conclusions

Strengthening of EU State Aid Rules

Since 2013 EU State Aid rules were strengthened with the application of two core principles :

•**Burden sharing** - ailing banks before being subject to public recapitalization should bail-in equity and subordinated debt

•**Commission assessment of comprehensive bank restructuring plans** – based on two appraisals:

–Long term viability is restored without further need for state support

–Competitive distortions are limited through proportionate measures (e.g. behavior measures such as constrains to acquisitions)

DGS Actions under State Aid Control

Core DGS interventions

–Payout

–Financing resolution measures up to covered deposits

➢**Not subject to State Aid**

Other DGS interventions

–Early intervention

–Financing measures in the context of national insolvency proceedings

➢**Subject to State Aid**

National Resolution Financing under State Aid Control

- National resolution financing arrangements involve State Aid since it fulfills almost all State Aid assessment criteria:
  - the intervention is carried out by the state or through state resources
  - the intervention provides to the recipient an advantage on a selective basis
  - competition may be distorted
  - intervention may affect trade between Member States, etc.

- Thus, national resolution financing triggers the Commission intervention.

SRM Resolution Aid under State Aid Control

- The SRM resolution financing arrangements will be assessed on equivalent terms to the national resolution financing arrangements (SRM regulation Art. 19 (1) and (3)).

- The Board cannot utilize the SRF ahead of a relevant Commissions' decision.

Interaction between the State Aid rules and the BRRD

	Capital Instruments (Common Equity Tier 1, Common Equity Tier 2)	Subordinated Debt	Senior Debt & Corporate Deposits over € 100,000	SMEs & Household Deposits over €100,000	Covered Deposits / DGS (deposits ≤ €100,000)
State Aid Rules	Burden Sharing				
BRRD Transitional Provisions until end - 2015	Loss Absorption				
BRRD 1.1.2016 onwards	Loss Absorption		+	Bail-in Tool *(Minimum 8% of liabilities)*	

Exceptions

State Aid:
- Financial Stability
- Disproportionate Results

BRRD:
- Exceptional exclusion of liabilities (Art. 44 (3))

Burden Sharing

<u>EU Institutional Framework</u>

- ➢ Attains a certain degree of integration

A fully integrated structure on burden sharing is lacking

– Member States may still strike different balances on burden sharing

I. Introduction

II. An Evaluation of the EU State Aid Institutional Framework

III. State Aid to the Financial Sector in the Crisis Context

IV. The Eurozone Framework

V. Changes in the Institutional Framework

VI. The Banking Union Arrangement

VII. Conclusions

The Current Banking Union Framework (I)

- The new arrangements of the BU provide for:
  - a Single Supervisory Mechanism
  - reorganization 'bail-in' procedures to contain moral hazard
  - a limited common financial backstop financed by banks contributions
- However such arrangements are incomplete:
  - National governments may still intervene by providing their own financial assistance if common financial resources fall short of the respective losses
  - Such intervention distorts borrowing costs for domestic versus non-domestic banks

The Current Banking Union Framework (II)

- According to BRRD, Government Financial Stabilization Tools (GFSTs - Public Equity Support Tool and Temporary Public Ownership Tool) can only be used until the end of 2015.

(Articles 56-58 of Directive 2014/59/EC)

- However, in the context of the SRF, if ex-ante and ex-post contributions are insufficient to meet the SRF's obligations, there is access to further financial arrangements, including public financial arrangements (Article 74 of Regulation 806/2014).

The Current Banking Union Framework (III)

The BU lacks an efficient Single Resolution Fund (SRF).

A privately financed SRF is efficient only if:

•It is linked to a potentially unlimited resource and hence inexhaustible even in cases of severe systemic crises.

> –<u>The case of the US and UK</u>
> The backstop is officially limited, but *de facto* unlimited, as governments can essentially request central bank funding when private resources prove insufficient

•It is neutral to prevent discrimination in terms of the nationality of a bank

The Current Banking Union Framework (IV)

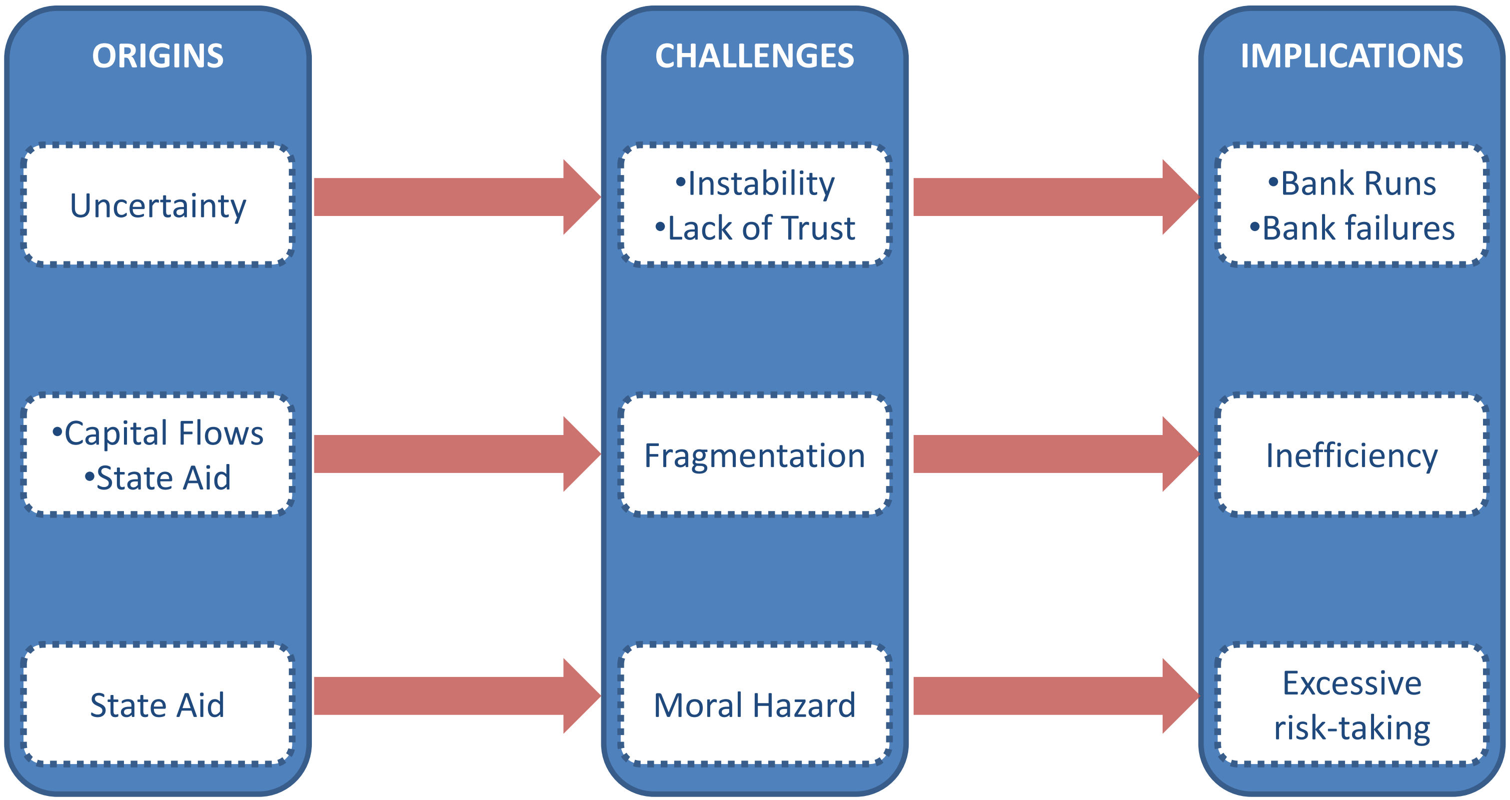
Lack of an efficient common fiscal backstop implies:

- A significant government role in the process of bank resolution, which:
  - preserves moral hazard for both banks and governments,
  - holds back appropriate settlement of banks' legacy losses
  - promotes competition amongst governments for funds and financial fragmentation
- Sustainable uncertainty and financial instability

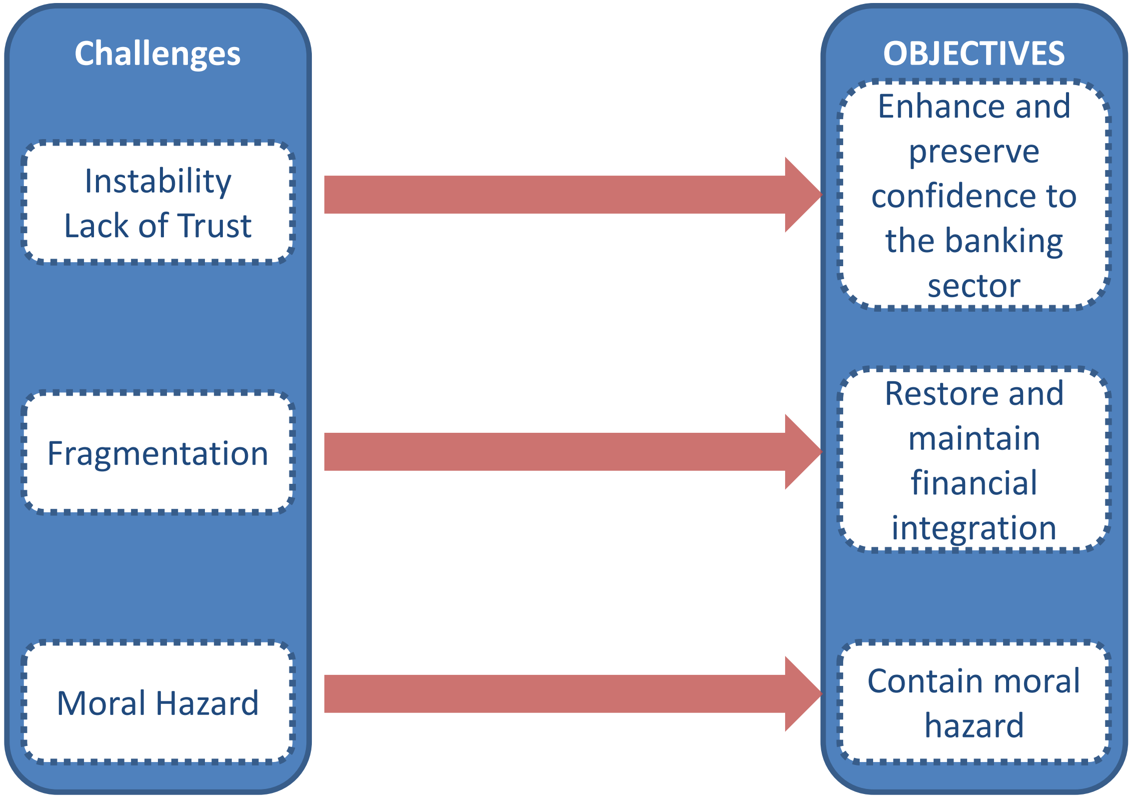
The Current Banking Union Framework (V)

- As long as national governments preserve their option to support domestic banks when private financed sources were exhausted, the stability of the domestic banking system would be based on unfunded government guarantees
- The credibility of such guarantees depends on the **respective governments' fiscal status** which ultimately determines the pricing of credit
- Borrowing costs (i.e. interest rates) would be influenced by a bank's location rather than by the ECB's monetary policy
- The financial markets play the game and remain fragmented

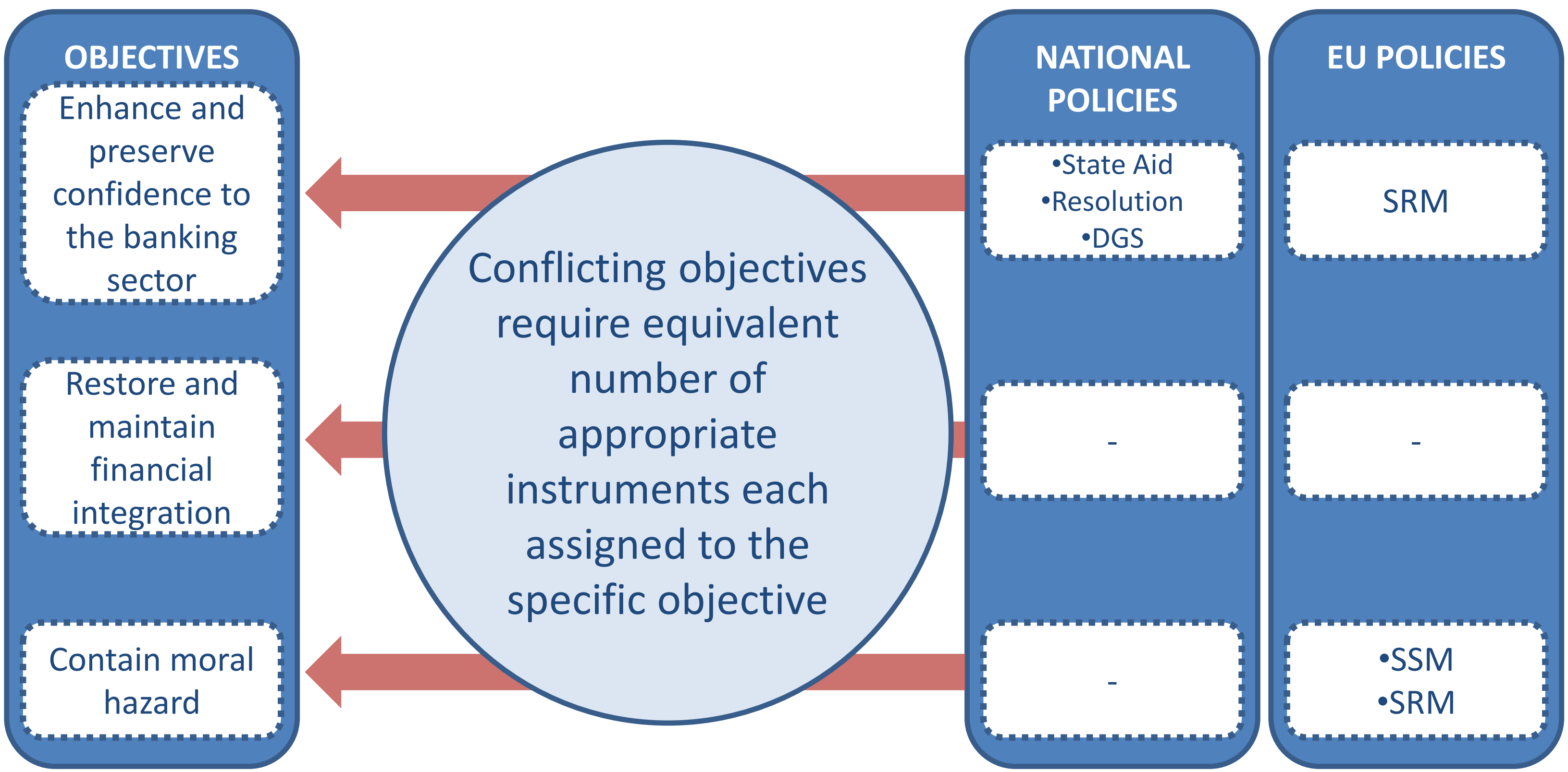
Challenges of the Banking Union (I)



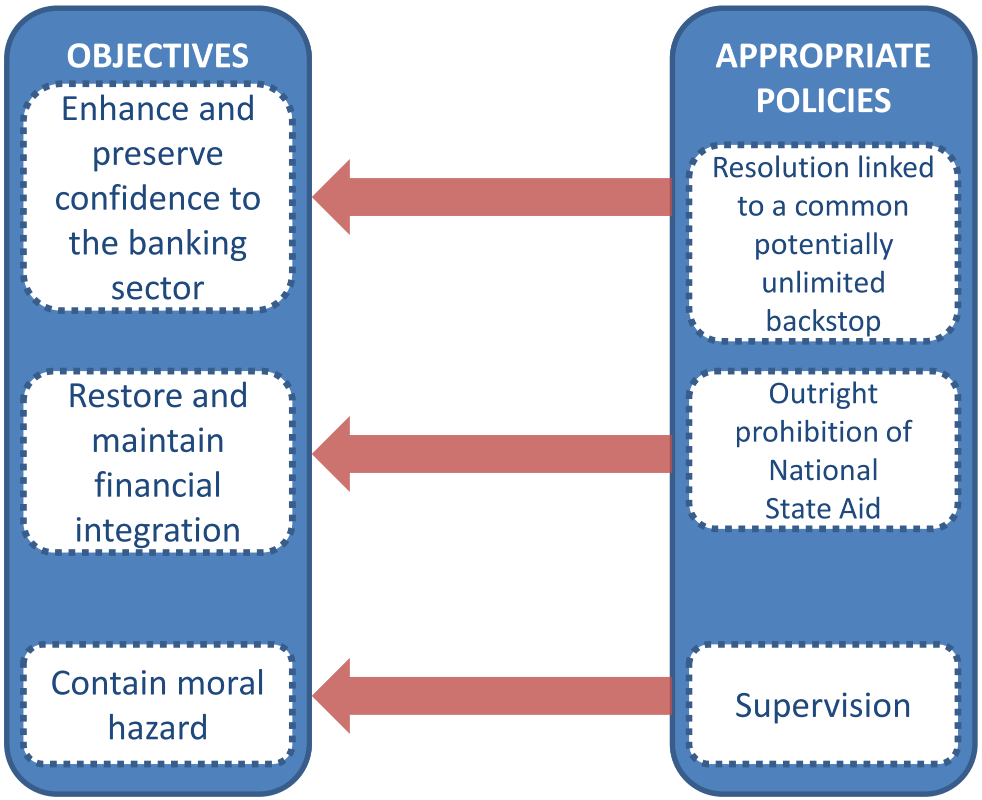
Challenges of the Banking Union (II)



Challenges of the Banking Union (III)



Challenges of the Banking Union (IV)



Conclusion

- A genuine Banking Union is essential

- A system of fragmented Banking Sectors and unrestricted capital flows is unsustainable

Thank You!