european school
of management
and technology

Financial Crisis and EC State Aid Control

Economic Issues

Dr. Hans W. Friederiszick
London, June 23, 2009

Overview

The Commission’s approach

Fundamentally sound vs. unsound banks

Restructuring plan & distortions of competition

The Commission's approach

- Commission Guidelines
  - Banking Communication: The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, Communication from the Commission, 13. 10. 2008 (OJ 25.10.2008)
  - Recap Communication: The recapitalization of financial institutions in the current financial crisis, Communication from the Commission, 5. 12. 2008
  - Impaired Assets Communication: The Treatment of Impaired Assets in the Community Banking Sector, Communication from the Commission, 25. 02. 2009
  - Restructuring Communication: planned

- The New (?) Approach of the Commission
  - Art. 87 3.b -> opening the floodgates temporarily, but keeping general principles intact
  - Distinction between fundamentally sound vs. unsound banks -> handled carefully; no black/ white approach
  - Restructuring and remedies -> and being tough at the end!

Fundamentally sound vs. unsound banks – the Commission's indicators

- Regulatory solvency requirements and prospective capital adequacy
- Pre-crisis and current CDS spreads
- Ratings
- Share prices
- Overdependence on short-term financing or abnormal leverage

Source: The recapitalization of financial institutions in the current financial crisis, Communication from the Commission, 5. 12. 2008, paragraph 12 to 15 and Annex

Fundamentally sound vs. unsound banks – the Commission's indicators (continued)

- Indicators put forward by the Commission are reasonable
- This does not lead to a simple tool set though
  - Standard indicators have proven unreliable in the past
  - Multiple indicators have to be applied (with potentially contradictory results)
  - Performance of banks will vary over the time horizon and under the actual stress test put on them under the current crisis

Significant degree of discretions for the Commission to decide on whether a bank is structurally sound or not

Restructuring plan & distortions of competition

- Long-term viability key focus for restructuring
- Downsizing in core markets
- May require divestments representing up to 50% of balance sheet

- How severely will the Commission intervene into the internal organization of banks, e.g. incentive schemes?
- What is the benchmark against which banks viability will be assessed?

Restructuring plan & distortions of competition (continued)

- Remedies shall restore undistorted competition
- Recent cases comprises the following remedies:
  - Significant additional divestments (beyond what is required for long-term viability)
  - 3 year prohibition of external growth
  - Behavioral remedy not to under cut prices in markets with significant market share
- Market Opening Measures?

Commission shows willingness to impose significant restraints on aid beneficiary

Restructuring plan & distortions of competition (continued)

- Immediate effect on competitors
- Dynamic distortions
- Distortion of trade

- Conflicting goals – viability vs. restoring competition vs. European integration
- Link to regulation?

Analysis of one Indicator - Credit Default Swap spreads (“CDS spreads”)

- Buyer of a CDS makes periodic payments to seller
- Buyer receives payoff if the underlying financial instrument defaults

➲can be considered an insurance against default (higher spread means higher default risk)

➲in theory CDS spreads reflect rating, stock price change and volatility, and leverage (see Kool 2006)

Remark: In general, a multiple indicator approach is superior, as the relationship between the various variables is not always positive and might be non-linear, e.g. CDS spread might decrease in parallel with stock prices as creditors’ and shareholders’ perspectives do not coincide

Structurally healthy banks – alternative approaches

- Simple indicators vs. multiple regression analysis
  - Predictability vs. accuracy

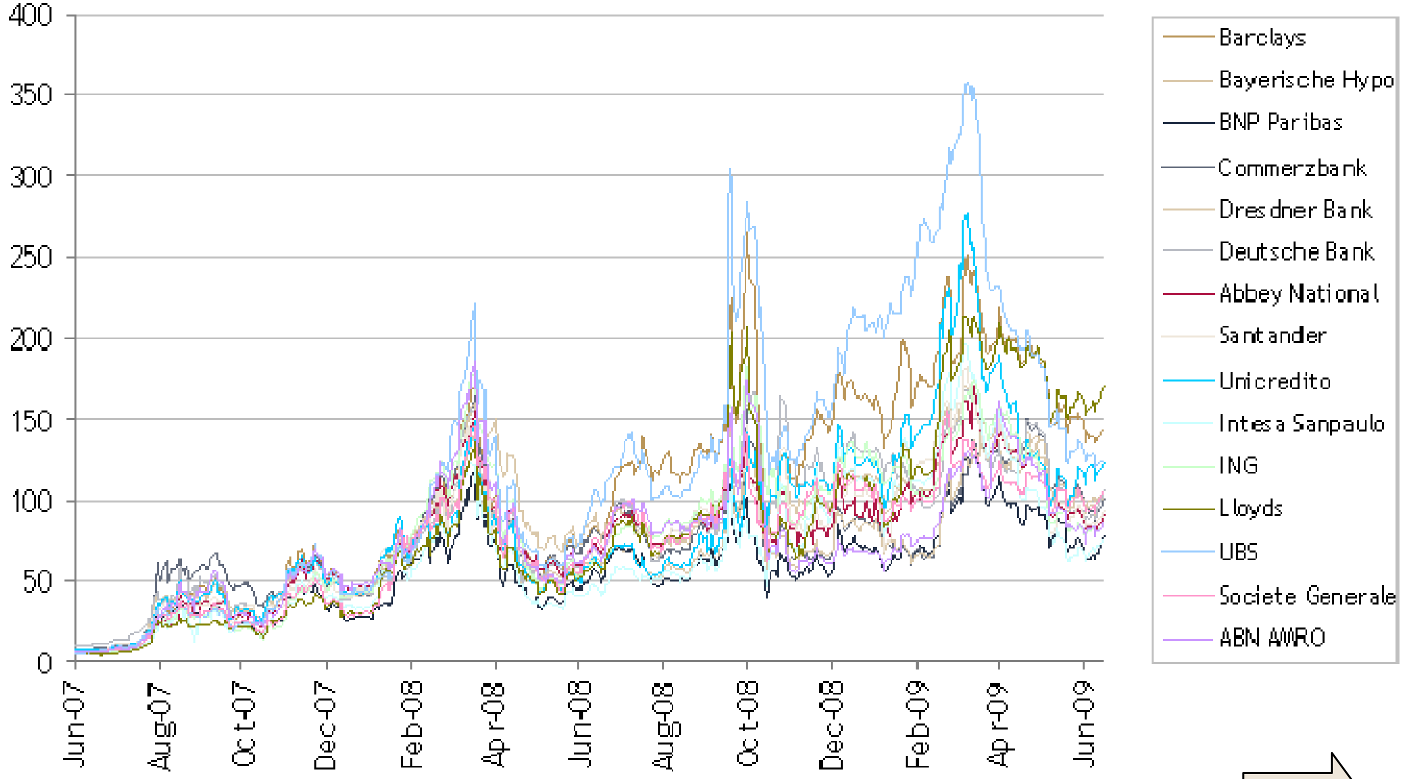
- Performance before the crisis vs. performance during the crisis
  - Only the crisis may reveal healthiness of a bank
  - May result in circularity if implemented wrongly

Bank sample analyzed

Name	Country	Date	Aid	Amount (mio. €)	Short description	European rank (total assets)	National rank (total assets)
UBS AG	Switzerland	10. Feb 09	x	30,100	Swiss state aid package	1	1
		16. Okt 08		48,000	Swiss state aid package		
		28. Feb 08			Capital injection		
DEUTSCHE BANK AG	Germany	05. Feb 09			No government assistance	2	1
BNP PARIBAS SA	France	19. Jan 09	x		Second bailout plan	3	1
		21. Okt 08		2,550	State cash injection		
BAYERISCHE HYPO-UND VEREINSBANK AG	Germany	12. Nov 08			No government assistance	4	2
BARCLAYS BANK PLC	United Kingdom	10. Feb 09			No government assistance	5	1
ABN AMRO BANK NV	Netherlands	03. Okt 08	x		Full nationalization of Dutch activities	6	1
		29. Sep 08		(11,200 for Fortis)	Indirect government assistance, via Fortis		
SOCIETE GENERALE	France	24. Jan 09	x		No further government assistance	7	4
		21. Okt 08		1,700	State cash injection		
ING BANK NV	Netherlands	26. Jan 09	x	28,100	Back-up facility	8	2
		19. Okt 08		10,000	State cash injection		
COMMERZBANK AG	Germany	08. Jan 09	x	10,000	State takes 25% stake	9	3
		11. Dez 08		8,000	State cash injection		
		07. Nov 08		15,000	Financial guarantees		
DRESDNER BANK AG	Germany	31. Aug 08	x	(Through CMZB)	Commerzbank takes over Dresdner	10	4
LLOYDS TSB BANK PLC	United Kingdom	20. Okt 08	x		Debt guarantee	15	4
BANCO SANTANDER CENTRAL HISPANO SA	Spain	06. Feb 09			No government assistance	16	1
INTESABCI SPA	Italy	25. Feb 09	x		Bank bond package	18	1
		16. Okt 08			No government assistance		
BANCO BILBAO VIZCAYA ARGENTARIA SA	Spain	30. Jan 09			No government assistance	21	2
CREDIT LYONNAIS (now LCL)	France	21. Okt 08	x	(3,000 for CA)	Indirect government assistance, via Crédit Agricole	24	8
UNICREDITO ITALIANO SPA	Italy	09. Dez 08			No government assistance	32	2
SANPAOLO IMI SPA	Italy	16. Dez 08			No government assistance	35	3
ABBEY NATIONAL PLC	United Kingdom	06. Feb 09			No government assistance	41	6

Annotation: Sample like in Kool et al. (2006) / Source: CA press recherché

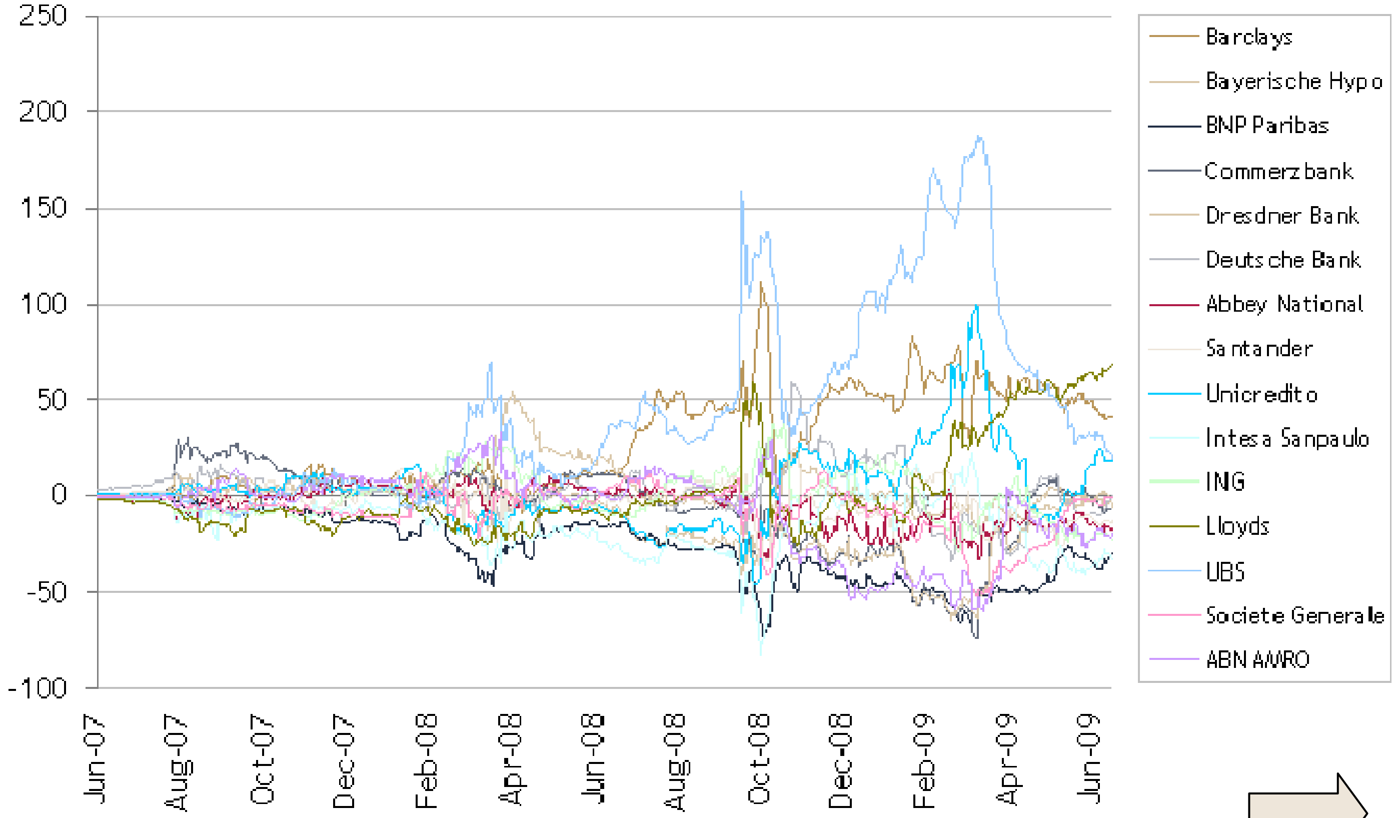
CDS spreads show strong common trend plus bank specific effects



Annotation: CDS for 5 years senior dept; Sample like in Kool et al. (2006)
Source: Bloomberg

Common trend shows high level of systemic risk

CDS difference show strong firm specific effects; variation between CDS differences vary strongly over time



Annotation: CDS for 5 year senior dept; Differences to non-weighted average
Source: Bloomberg

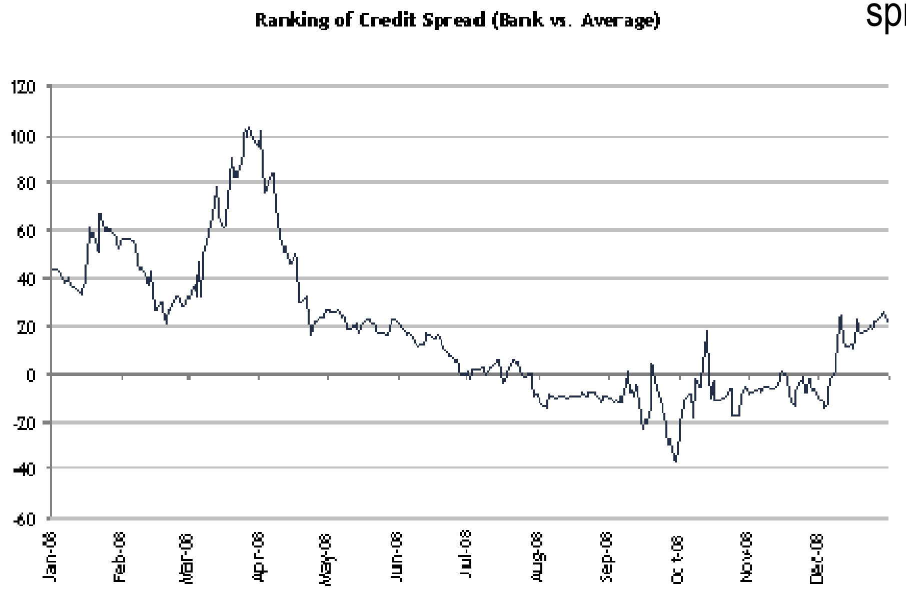
Market seems to exaggerate difference between individual banks during periods of turmoil

Development of CDS differences over 2008 - two examples

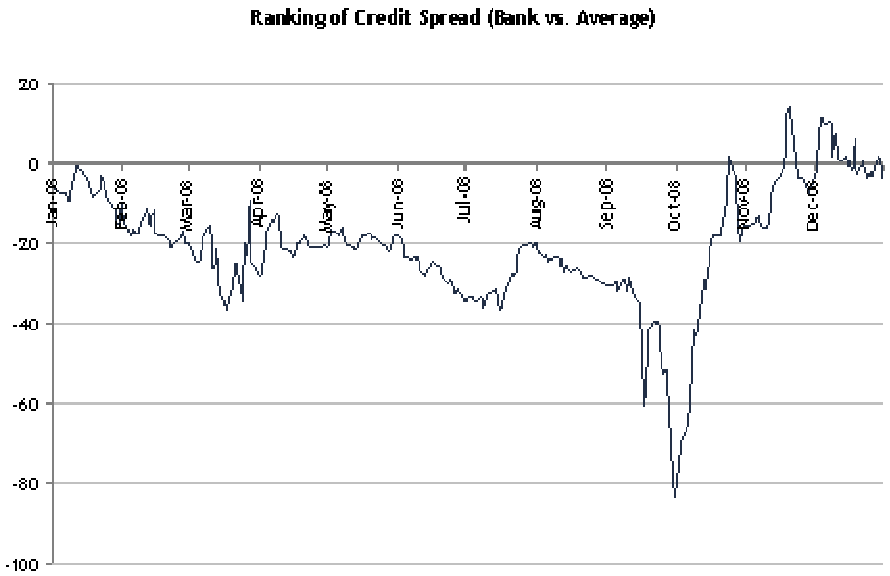
Before August 2008 WestLB realized an above average CDS spread; Intesa Sanpaulo a below average spread

However, during the crisis both observe more or less the same CDS spread

WestLB



Intesa Sanpaulo



Banks relative performance varies over different market phases

- One observes different events influencing the CDS spreads
- These relate to different risks
- Which ones are considered systemic? Which are considered individual business risk?

Bank	**Ranking Credit Spread**
UBS*	**100.6**
Barclays	**94.5**
Dresdner Bank*	**89.4**
ABN AMRO*	**85.3**
ING*	**83.6**
Commerzbank*	**81.2**
Abbey National	**80.8**
Santander	**78.8**
Average	*78.5*
Deutsche Bank	**78.1**
Societe Generale*	**77.9**
Bayerische Hypo	**71.2**
Unicredito	**70.0**
Lloyds*	**69.7**
Intesa Sanpaulo	**58.7**
BNP Paribas*	**57.3**
Period	*Jan 2008 - Aug 2008*

Bank	**Ranking Credit Spread**
UBS*	**206.5**
Barclays	**172.1**
Lloyds*	**144.2**
Unicredito	**142.2**
Average	*121.5*
Deutsche Bank	**121.0**
Bayerische Hypo	**118.1**
ING*	**117.6**
Santander	**113.6**
Intesa Sanpaulo	**111.4**
Societe Generale*	**107.0**
Abbey National	**106.5**
Commerzbank*	**96.4**
Dresdner Bank*	**96.0**
ABN AMRO*	**90.1**
BNP Paribas*	**79.3**
Period	*Nov 2008 - Jun 2009*

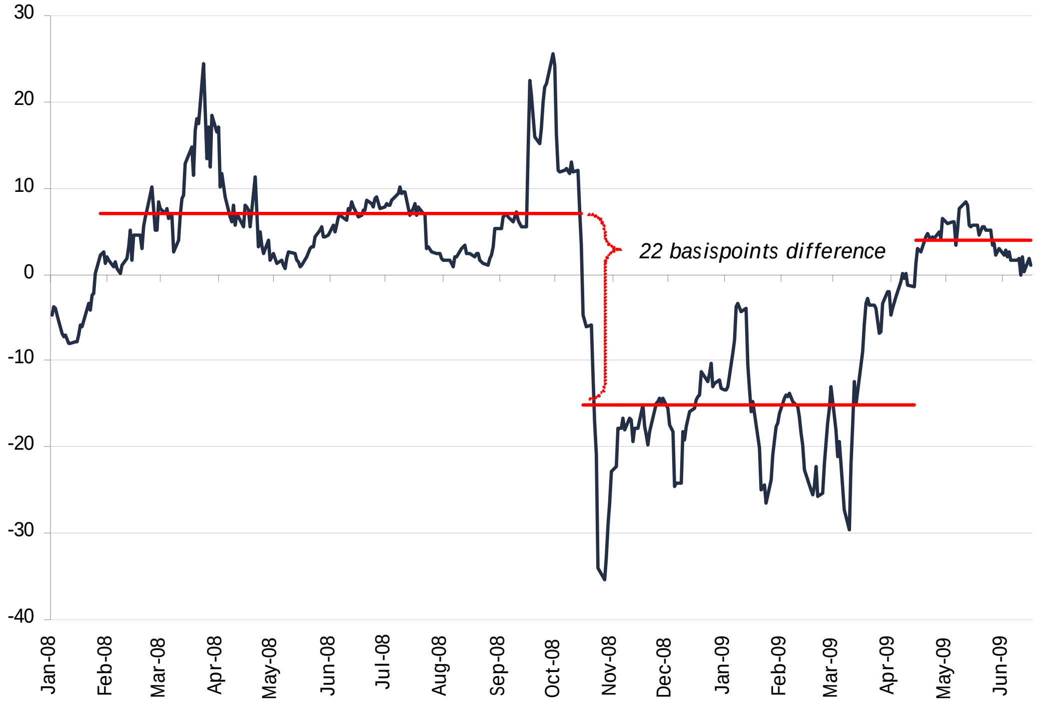
** Bank received State aid*

Lloyds and Unicredito show up only in the second time window

In conclusion, banks seem to perform differently well with respect to default risk in various market phases

Effectiveness of State intervention

CDS spread of Banks with aid minus
spread of Banks without aid



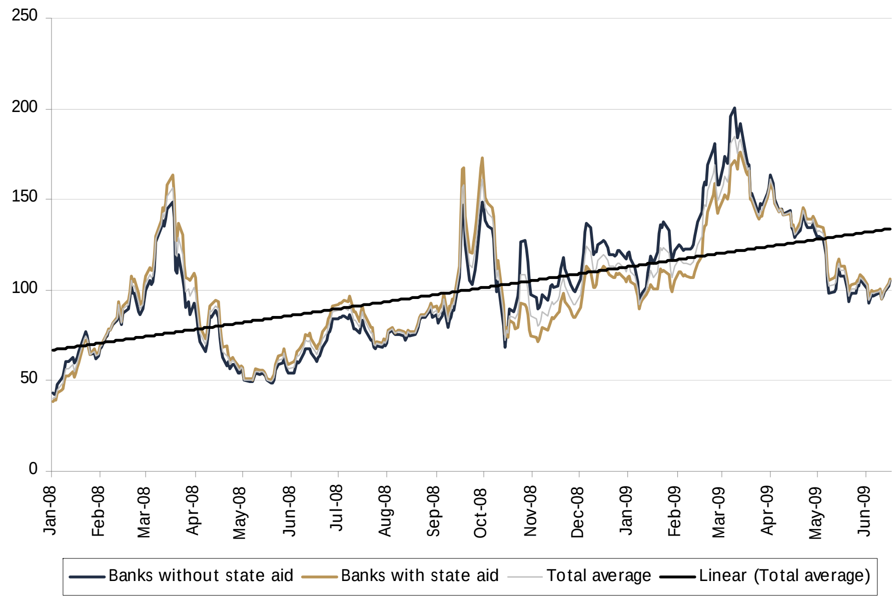
1. Did the aid go to the right group of banks?
2. Was the aid effective?
3. Do we observe overcompensation?
4. Is the effect persisting?

Effectiveness of State intervention - persistence

CDS spread of Banks with aid minus spread of Banks without aid

Roughly 20 basis points reduction

CDS spread average January 2008 to June 2009



But unbroken positive trend!

Conclusion

- Indicators to delineate fundamentally healthy and unhealthy banks are reasonable
- This does not lead to a simple tool set though
  - Standard indicators have proven unreliable in the past
  - Multiple indicators have to be applied (with potentially contradictory results)
  - Performance of banks will vary over the time horizon and under the actual stress test put on them under the current crisis
- CDS analysis indicates effectiveness of State interventions, and no clear cut evidence of overcompensation

Only Risk Is Sure

Thank you!

Dr. Hans W. Friederiszick

Managing Director
friederiszick@esmt.org
+49 30 21231 - 7010

ESMT
European School of Management
and Technology

Schlossplatz 1
10178 Berlin

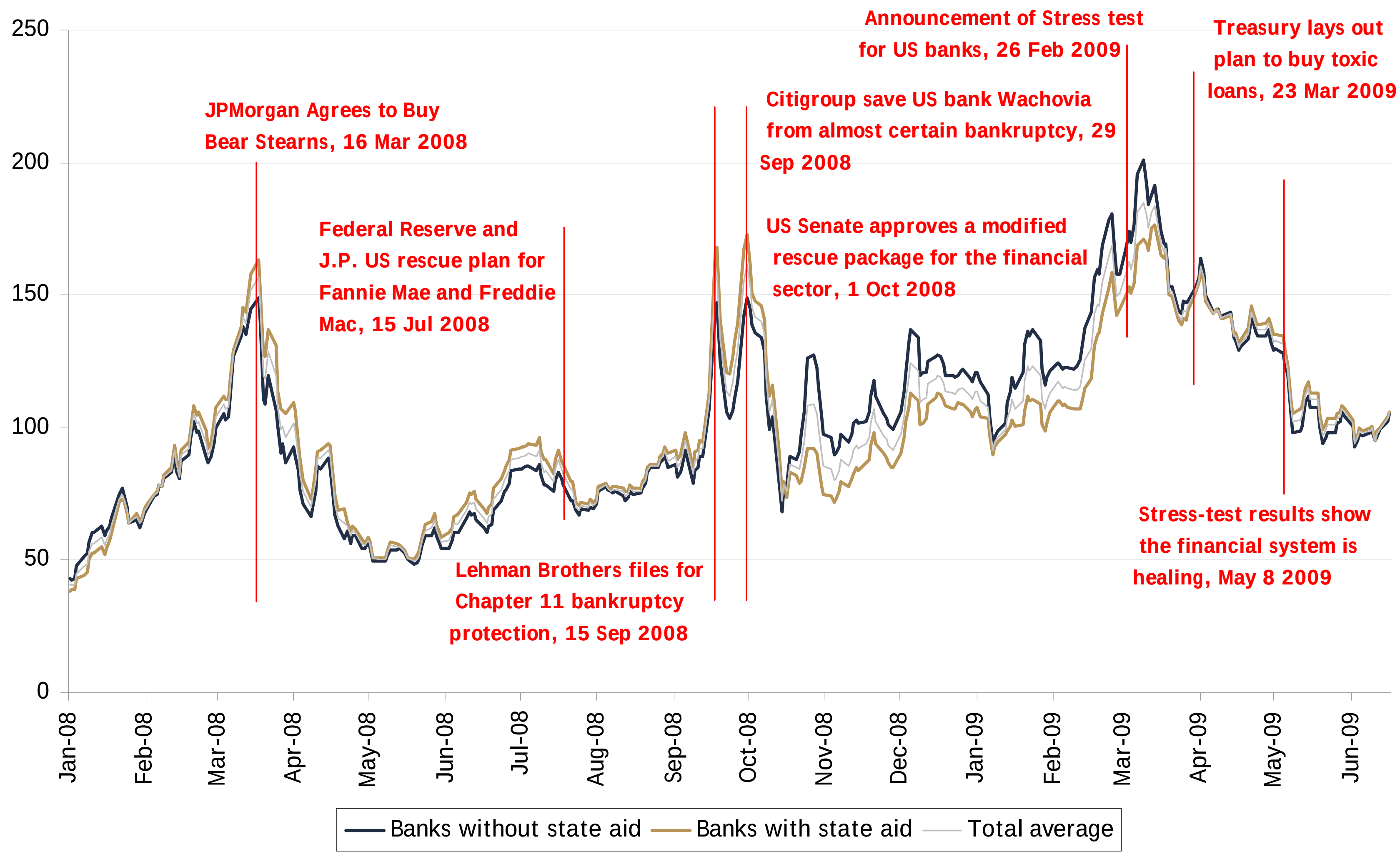
Phone: +49 (0) 30 192 31-0
Fax: +49 (0) 30 192 31-7099

competitionanalysis@esmt.org
www.esmt.org

Literature

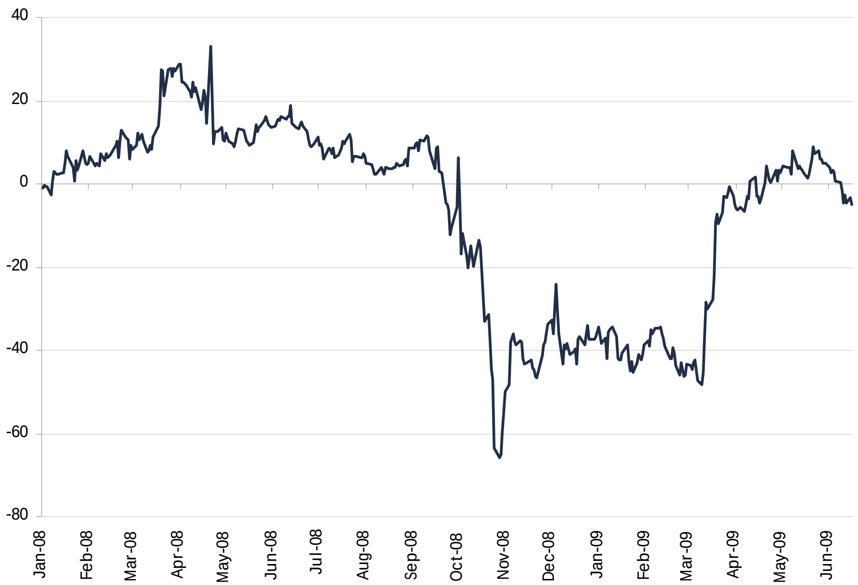
- Commission Guidelines
  - Bank Guidelines: The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, Communication from the Commission, 13. 10. 2008 (OJ 25.10.2008)
  - Recap Guidelines: The recapitalization of financial institutions in the current financial crisis, Communication from the Commission, 5. 12. 2008
  - Toxic Assets Guidelines: The Treatment of Impaired Assets in the Community Banking Sector, Communication from the Commission, 25. 02. 2009
- Databases
  - Bloomberg
  - Factiva
- Scientific Literature
  - Clemens J.M. Kool (2006): Financial Stability in European Banking: The Role of Common Factors. Open Economies Review 17: 525-540

Major Events



Country analysis: UK and Germany

CDS spread of Banks with aid minus spread of Banks without aid Germany



Companies without aid: Deutsche Bank and Bayerische Hypo. Banks with aid: Commerzbank and Dresdner

CDS spread of Banks with aid minus spread of Banks without aid UK

Companies without aid: Abbey National and Barclays. Bank with aid: Lloyds