



EUROPEAN COMMISSION

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# **Banks in distress and Europe's competition regime: On the road to the Banking Union**

Prepared Remarks

## **Banks in Distress and Europe's Competition Regime: On the Road to the Banking Union**

Joaquín Almunia, Vice President of the European Commission responsible for Competition Policy

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Ladies and Gentlemen,

First of all, let me thank my good friend Adam Posen for inviting me to speak at the Peterson Institute.

This is the perfect venue to discuss what the European Commission and the member states have been doing over the past five years to support Europe's banks.

But my presentation today will not look only at the past. I will also talk about the need to integrate Europe's financial markets—including the measures that are being discussed as we speak—and how the financial landscape will evolve until the banking union project is fully achieved.

Since it was launched in June last year, this project sits right on top of Europe's agenda. In his annual State of the Union speech to the European Parliament on September 11, President Barroso described it as "the first and most urgent phase on the way to deepen our economic and monetary union."

The Banking Union is still work in progress—and what a complex and delicate work it is—but things are moving quite fast:

- As from January next year, European banks will apply the new rules set out in the so-called CRD IV package, which implements Basel III. As you know, an insufficient level of capital—both in quantity and in quality—was one of the vulnerabilities shown by banking institutions during the crisis.
- The EU law on deposit guarantee schemes is being revised with the aim to harmonize national deposit guarantee schemes and to provide them with more funds.
- A Single Supervisory Mechanism for euro area banks will be operational next year, and—with it—the European Central Bank will become the single supervisor for euro countries and for all those that decide to join the banking union.

- A new European law on banking recovery and resolution will give us a common toolbox for resolution and better protect taxpayers from having to bailout banks in distress. It is hoped that this law—for the whole European Union—is passed before the end of the year.
- Finally, we are debating the proposal tabled by the European Commission last July for the creation of a Single Resolution Mechanism applicable to the euro area and to other countries willing to join.

As you can see, we really are at a turning point. To prepare for these changes, last month, the European Commission reviewed its state aid guidelines on rescued banks to make sure that future bailouts are consistent with the principles of the banking union and break the link between banks and sovereigns.

### **The Experience So Far and Lessons Learnt**

To understand why the Commissioner for Competition is involved in these matters, we need to go back to the early days of the financial crisis.

As you may know, competition enforcement is one of the few areas in which the commission has federal-like powers in Europe. In particular—thanks to state aid policy—we have the power to control certain government expenses when they risk undermining the single market.

Back in 2008, EU governments responded to the onslaught of the crisis with massive public support to their respective banking institutions.

It was clear that these responses needed to be harmonized at European level, otherwise the tensions between the different national banking systems would quickly compromise the integrity of the single market. And because this is one of the pillars of the European Union, the very survival of the European project was at stake.

Unlike in the United States, the European Union could not rely on an independent resolution authority like the Federal Deposit Insurance Corporation (FDIC). The only instrument available at EU level was state aid control.

Because of the threat of a systemic failure, the commission—after discussions with the member states—introduced a new state aid framework tailor-made to deal with rescued banks. And the commission became de facto a central crisis management and resolution authority.

The new framework identified three main objectives for our action:

- maintaining financial stability;
- safeguarding the internal market; and
- protecting the interests of taxpayers.

Thus, for the past five years the European Commission has been using state aid policy to coordinate the response of member states; preserve the level playing field in the banking sector; and make sure that bailouts were carried out according to similar conditions across the union.

Through our decisions, since 2008 we have evaluated every rescue and restructuring plan for every bank in distress in Europe.

Overall, we have worked on the restructuring of 67 banks—23 of which had to be resolved—and we still have 27 restructuring cases open, in particular in the euro area countries under programmes. This is equivalent to around one-quarter of Europe's banking sector in terms of assets.

In some countries, nearly the entire banking sector was restructured—for example in Greece and Ireland—but this was also the case in countries such as Belgium and the Netherlands.

Returning the banks to long-term viability has been a key element of our assessment. Burden-sharing and the elimination of distortions of competition are also part of our analysis.

Unlike the FDIC, however, the commission has no recourse to funding facilities, which are in the hands of the national Treasuries, the European Central Bank, and national central banks in the member states.

Let me give you an idea of the public funds still involved in the context of the financial crisis. According to Eurostat, the statistical office of the European Union, in 2012 government interventions increased the government deficit in the EU 27 by €53.4 billion, or 0.4 percent of EU GDP.

If we look at the period 2009–12, the net cost for EU 27 governments amounted to €140.6 billion, or 1.1 percent of EU GDP in 2012.

The amounts involved in state guarantees for banks were very high in particular in 2009 at the peak of the crisis, but they have now been cancelled in some countries such as France, the Netherlands, Germany, and the United Kingdom.

In absolute terms, the three EU countries that most supported their banks by way of permanent support—that is, recapitalization and asset-relief measures, excluding guarantees—for the period 2008–11 are Ireland, the United Kingdom, and Germany.

And, when compared to national GDP, Ireland's support was equivalent to 42 percent of GDP, Belgium's to 8 percent of GDP and the proportion for the United Kingdom was 7 percent of GDP.

As to the banks, those that have received the largest permanent support in absolute terms are Royal Bank of Scotland—up to €128 billion—Bankia with €36 billion, closely followed by Anglo Irish Bank with €32 billion.

As a proportion of banks' risk weighted assets—or RWA—the largest permanent support was received by banks in resolution such as two Spanish institutions—Banco de Valencia with 65 percent RWA and Caja Castilla La Mancha with 52 percent RWA—and two Irish banks; INBS with 59 percent RWA and Anglo Irish bank with 44 percent RWA.

This unique experience has taught us a number of lessons.

One lesson we can draw from our experience is that funding and liquidity are of utmost importance; overreliance on wholesale funding is the surest way to bankruptcy when markets are hit by serious turbulence.

Another thing we have learnt is that risk is inherent to banking. We have seen failures even in the business models that were previously considered safe—such as retail banking and public banking.

Moreover, we have learned that the task of restructuring or resolving a bank—which is never easy—gets a lot more complicated for cross-border banks.

So, we have no magic recipe for success, but an adequate level of capitalization, proper risk management, and good and strict supervision are solid pillars on which we can start to build the banking sector of the future in Europe and elsewhere in the world.

## **Banking Union**

As I said at the start, the Banking Union is Europe's way to build a safe and competitive financial sector.

The EU laws on capital requirements, deposit guarantee schemes, the Bank Recovery and Resolution Directive, together with the Single Supervisory Mechanism and the Single Resolution Mechanism for the euro area, include vital measures.

In particular, the Bank Recovery and Resolution Directive offers a set of instruments that can tackle potential banking crisis at three stages: preventive, early intervention, and resolution.

Not only will banks be required to draw up recovery plans, but resolution authorities will have the power to force implementation if certain conditions are not met.

As to the resolution tools, the national authorities will have powers such as selling a business, establishing a bridge institution, separating bad assets from the viable

structure, and asking a bail-in from a bank's creditors—including junior and senior bondholders and some categories of depositors.

Bail-ins are crucial. They will reduce the need for public backstops. Or, at least, they will help to reduce their size. Under the current proposal, taxpayers' money will not be disbursed until a minimum 'bail-inable' buffer of 8 percent is exhausted.

More importantly still, bail-in will help break the vicious circle between banks and sovereigns in which failing banks can undermine the financial stability of whole countries and ultimately erode their credibility vis-à-vis the markets.

Indeed, the euro area requires some more instruments to achieve a fully-fledged banking union. And some additional mechanisms are needed.

Let me explain the relations between the Bank Recovery and Resolution Directive and the future Single Resolution Mechanism.

While the BRRD applies to all 28 EU countries—with a certain degree of national discretion—the SRM applies to euro area countries and is open to countries that are willing to join the banking union even before they become members of the monetary union.

The Single Resolution Mechanism will use the same tools as the Bank Recovery and Resolution Directive; only it will be more stringent because—as proposed by the commission—a single authority will implement the same rulebook and use the same backstop.

The rulebook covers all the steps, including drawing up resolution plans, assessing the resolvability of banks, deciding to place a bank under resolution, exercising and implementing the resolution tools and powers, and deciding on the use of the resolution funding.

The commission also proposes to set up a single European fund for bank resolution financed by the banking sector to replace national funds. It will cover euro area and other participating countries.

But it will take at least 10 years to build up the Fund so that it reaches an adequate size to fulfill its tasks. In the meantime, it is realistic to assume that other public backstops—be they national or at the euro area level such as the ESM—will be used in case of need.

The Banking Recovery and Resolution and the Single Resolution Mechanism are scheduled to become operative in 2015, but the bail-in tool will not come into force until 2018.

Timing issues aside, the Banking Union needs to start on a credible basis. To this end, the ECB will run a comprehensive assessment of the banks it will directly supervise before taking on the task.

This assessment—which will involve an asset quality review, a risk assessment and a stress test—will be completed in the course of next year.

### **New Banking Guidelines**

Ladies and Gentlemen:

To manage this complex transition, the commission will be equipped with the revised state aid rules for banks—which entered into force in August—updating the framework put in place five years ago.

The new rules introduce three main changes.

**First**, they make clear the principle that before resorting to taxpayers' money, banks should foot the bill by going to the market, using internal resources, and asking for the contribution of shareholders, hybrids holders, and junior debt creditors. This change actually reprises a practice that has already been applied in a number of European countries.

And we have good reasons for that. To start with, it is not fair that taxpayers continue to pay for bank failures as they have done in the past; this is a moral and political point to which I attach great importance.

Moreover, junior creditors will be treated in the same way across the European Union. Apart from strengthening the level playing field, this sends a clear message that senior debt and depositors are protected, which—after the rescue of Cyprus's banks—eliminates a major factor of risk in bond markets.

Lastly, the new rules make sure that banks from stronger EU countries don't benefit from an implicit guarantee and thus enjoy cheaper funding costs.

The **second** major change of our new state aid rules follows from the positive experience of the Spanish MoU approved last year.

No state aid in the form of recapitalization or impaired-asset relief will be approved before the burden sharing takes place and the restructuring plan is approved by the commission.

We have often seen in the past that the restructuring and stabilization process would take longer after the funds were disbursed. Under the new system, we will be able to adopt final recapitalization and restructuring decisions in a shorter period.

For instance, in the Spanish case the commission approved final restructuring decisions for eight banks less than three months after the capital shortfalls were identified. And we have a long record of rapid decisions when banks need to be urgently rescued.

The **third** main change that the new rules introduce is a cap on executive pay for all aided banks. The point here is to give management the right incentives to implement the agreed restructuring plans and have their organizations refund the money received from the public coffers as soon as possible.

As you can imagine, the new state aid framework for banks will be tested in the context of the upcoming balance-sheet assessment and stress test of the ECB.

With the new rules we are better equipped to react quickly and to ensure that banks contribute to a maximum extent before tapping public aid.

In particular, the burden-sharing principle will help to limit the size of the potential public backstops that might be needed. Banks should also have now the time and the incentive to build up a sufficient capital buffer.

## **Looking Ahead**

Ladies and Gentlemen:

Let me just repeat in closing the strategic importance we give to the banking union project.

It will help maintain financial stability, put the EU banking system in good order, strengthen the economic and monetary union (EMU), break the link between the banking system and the sovereigns, and—most importantly—it will help restore normal lending conditions to the economy.

We are addressing the root causes of the crisis together with member states, the ECB, and the other economic and financial authorities. Much has been done over the past five years; but we are not there yet.

On our side, the commission will use the new state aid rules to keep a level playing field in the single market, protect the interests of taxpayers, and ensure stable and predictable conditions for market participants at all times.

When the banking union and the new financial regulatory framework are fully in place, Europe's banks will be stronger and safer. Above all, they will return to their primary function, which is lending to the real economy throughout the European Union. And our financial activities will be better integrated in the single market, especially within the EMU.

For this to happen, we must not lose the sense of urgency that prevailed during the G-20 summits of end-2008 and beginning 2009 and—more recently—during the European Council of June 2012 which inspired the reforms I have illustrated today.

We must not lose momentum. Thank you.