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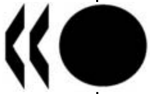

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COMPETITION AND FINANCIAL MARKETS

-- Compilation of some Relevant Articles --

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EC competition law enforcement at grips with the financial crisis: Flexibility on the means, consistency in the principles

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Doctrines

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Abstract

The financial crisis is today's most challenging issue faced by political and economic leaders across Europe and the world. It has been commented at length in recent months, including with respect to the European Union's contribution to a solution thereto. Away from the polemics, this article takes a comprehensive look at the European Commission's enforcement of EC competition law, in particular State aid rules, in the framework of the financial crisis. It is divided into two parts corresponding to what the author views as the two main policy options pursued by the Commission, namely: (i) "flexibility on the means"; but (ii) "consistency in the principles". Those options appear to condition the possibility and legitimacy of the Commission's involvement in managing the crisis and have actually enabled the Commission to play a critical role so far, which, given the circumstances, has evolved into one of coordination between the 27 EU Member States' respective economic policies.

La crise financière constitue actuellement la préoccupation majeure des dirigeants politiques et économiques en Europe et dans le monde. Elle a fait l'objet de nombreux commentaires ces derniers mois, en ce compris à propos de la contribution de l'Union européenne à la définition d'une possible solution. A l'écart des polémiques, cet article offre une analyse systématique de l'application du droit communautaire de la concurrence - principalement en matière d'aides d'Etat - par la Commission européenne dans le cadre de la crise financière. Il comporte deux parties qui correspondent à ce que l'auteur identifie comme les deux options politiques majeures poursuivies par la Commission, à savoir: (i) de la flexibilité dans la mise en œuvre des règles de concurrence; mais (ii) de la cohérence dans les principes guidant l'interprétation de ces règles. Ces options ont conditionné tant la légitimité que la simple possibilité d'une implication de la Commission dans la gestion de la crise et ont en fait permis à la Commission de jouer un rôle clé jusqu'à présent et de s'affirmer, compte tenu des circonstances, en tant que coordinateur des politiques économiques poursuivies par les 27 Etats membres.

* Kindly note that the present contribution reflects the decisional practice of the EU Commission up until December 31, 2008. References are made to Commission's press-releases when formal decisions are not yet publicly available.

1. Mid-September 2007, images of British people queuing to withdraw their savings from local branches of UK mortgage bank Northern Rock hit the screens of millions of bemused Europeans who were told that the "subprime crisis" had crossed the Atlantic. However, barely anyone outside the UK had ever heard about Northern Rock and the UK government seemed to take care of the problem. In the following months, the crisis spread to credit institutions with a particular risk profile, namely those that had relied on assets securitization to fuel their growth and/or had invested heavily in mortgage-backed securities. As a result, various EU Member States were prompted to address solvability issues on a case by case basis. As from March 2008, the situation further deteriorated. While the US authorities engineered the emergency sale of Bear Stearns to JPMorgan, the share price of various large European banks came under serious pressure and headlines started referring to a possible "credit crunch" as European central banks were compelled to inject massive liquidity into money markets.

2. Mid-September 2008, exactly one year after the "bank run" on Northern Rock, Lehman Brothers' filing for Chapter 11 bankruptcy protection in the US triggered a general crisis of confidence and an unprecedented freeze in inter-bank lending that immediately squeezed credit institutions in need of refinancing. At that point, even though the crisis virtually affected Europe as a whole, the absence of an institutionalized forum at EU level competent to deal with such issues meant that Member States remained in the frontline to devise urgent *ad hoc* rescue measures.[1] Quickly, though, the size and cross-border operation of credit institutions forced certain Member States to pull resources together in structuring recapitalization schemes.[2] A coordinated response finally emerged under the leadership of the "Eurogroup" (those EU countries sharing the Euro as their currency) in the form of common principles aimed to respond effectively to the crisis while ensuring the compatibility of national implementing measures with EU single market principles.[3] On October 15, 2008, the European Council endorsed the initiative of the Eurogroup, turned it into a "concerted action plan" and expressly confirmed its support – "*in the current exceptional circumstances*" – for "*the Commission's implementation [...] of the rules on competition policy, particularly State aids*".[4] In the same statement, the European Council called for European rules "*to be implemented in a way that meets the need for speedy and flexible action*".

1 In the past, Member States have attempted to palliate the lack of institutionalized framework at EU level by devising a *Memorandum of Understanding* (MoU) aimed to facilitate cooperation between Financial Supervisory Authorities, Central Banks and Finance Ministries of the Member States in time of financial crises. In particular, the MoU lays down so-called "*common principles for cross-border financial crisis management*" and establishes procedures for the sharing of information and assessments in order to facilitate the pursuance of each institution's respective policy functions (see Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European union on Cross-Border Financial Stability, June 1, 2008, ECFIN/CEFCPE(2008)REP/53106 REV REV).

2 See, in particular, the joint efforts of Belgium, the Netherlands, Luxembourg surrounding the rescue of Fortis and those of Belgium, Luxembourg and France with respect to Dexia.

3 See the "*Declaration on a concerted European action plan of the euro area countries*", October 10, 2008, available at www.ue2008.fr (last visited November 18, 2008). See also the Conclusions of the ECOFIN Council held in Luxembourg on October 7, 2008 (Doc. 13784/08). Generally, a coordinated response was necessary to ensure the credibility of the remedial measures adopted at national level, which is a key factor to restore confidence in the markets.

4 European Council of October 15 and 16, 2008, Presidency Conclusions (doc. 14368/08), §5.

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3. Even though it is difficult to draw any conclusive lessons at this stage, a survey of the European Commission's (the "Commission") decisional practice since September 2007 suggests that two policy options stand at the core of the enforcement of EC competition law in the framework of the financial crisis: (i) ensure *consistency in the principles* relied on to assess the competition issues arising in connection with the financial crisis, with the view to prevent distortions in the EU single market; and (ii) introduce sufficient *flexibility in the implementation* of those principles, in order to provide adequate legal certainty to market operators while preserving the possibility and legitimacy of the Commission's involvement into the management of the crisis. This is apparent primarily from the application of State aid rules to *ad hoc* rescue measures and general remedial plans devised by Member States, but the same options appear to guide the Commission's – to date still limited – merger control practice. This article illustrates how the above policy options have been implemented in those two enforcement areas. It also shares some thoughts as to the institutional constraints that (may) have shaped the Commission's policy and points to some of its (un-)intended consequences.

I. Policy option 1: "Consistency in the principles"

4. As noted, in spite of the exceptional nature of the current situation, the Commission has so far endeavored to rely on established principles in dealing with those competition issues that have arisen in the framework of the financial crisis. In the enforcement of competition policy, consistency is therefore largely prevailing, so far, over calls for greater flexibility.[5] In turn, the Commission aims to demonstrate that – contrary to what some Member States like to pretend – the current legal framework is flexible enough to accommodate exceptional and country-specific circumstances.

1. State aids: From *ad hoc* rescue measures to general remedial plans

5. The enforcement of EC competition law since September 2007 has mirrored the development of the financial crisis. Up until September 2008, the Commission examined case-by-case rescue measures aimed to address liquidity difficulties of credit institutions exposed to the subprime crisis according to established rules on subsidies for firms in difficulty,[6] adopted pursuant to Article 87(3)(c) of the EC Treaty ("EC"). In doing so, the Commission expressly refused to consider those individual measures as remedies to "*a serious disturbance in the economy of the relevant Member State*" pursuant to Article 87(3)(b) EC, a rarely-used and more lenient provision.[7] Since October 2008, however, with the subprime crisis leading to a general freeze in inter-bank lending, the Commission acknowledged the systemic effects of such liquidity shortage and started applying Article 87(3)(b) EC to general remedial schemes put in place by Member States, as well as to certain *ad hoc* measures. Given the circumstances, and in order to promote legal certainty, it even issued detailed guidelines on the application of that criterion to the current global financial crisis.[8] This evolution in the enforcement of State aids rules was dictated by a change in market conditions and in the nature and scope of Member States' remedial measures. Still, it was based on and consistent with existing principles, even if designed for exceptional circumstances.

1.1. Phase I: September 2007 to September 2008

6. *The facts.* Over the September 2007-September 2008 period ("Phase I"), the Commission adopted six State aid decisions on the basis of Article 87(3)(c) EC, a provision allowing Member States to grant subsidies to firms in difficulty, under strict conditions. Those decisions have involved: (i) *Northern Rock*, an important UK mortgage bank relying heavily on mortgage securitization to meet its refinancing needs, which benefited successively from an emergency liquidity assistance from the Bank of England, a State guarantee for existing and new accounts, and then various liquidity facilities from the UK Treasury;[9] (ii) *WestLB AG*, a German commercial bank significantly exposed to the subprime crisis and threatened of a downgrading of its credit rating, which benefited from a €5 billion guarantee against losses in its structured securities portfolio from the state of North Rhine-Westphalia to prevent such downgrading;[10] (iii) *Landesbank Sachsen Girozentrale (Sachsen LB)*, a German commercial bank facing a significant liquidity shortage following the decline of the mark-to-market value of its investments in US mortgage backed securities, which benefited from a credit facility of €17.1 billion provided by a pool of state-owned banks and a €2.75 billion guarantee from the state of Saxony in the framework of its sale to Landesbank Baden-Württemberg;[11] (iv) *Roskilde Bank A/S*, a

5 This is quite remarkable considering the history of antitrust enforcement at times of crises, notably in the US (see D. Crane, "Antitrust Enforcement During National Crises: an Unhappy History", *Global Competition Review*, December 2008, www.globalcompetitionpolicy.org). Commissioner Kroes recently picked on that point to justify the need for a consistent enforcement of State aid rules and argued that, based on researches by UCLA scholars, the suspension of the antitrust laws in the framework of the New Deal had the effect of prolonging the Great Depression by an extra seven years (see N. Kroes, "*EU State aid rules – part of the solution*", speech delivered at the EStALI Conference, Luxembourg, December 5, 2008).

6 Communication from the Commission – Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, *O.J.*, 2004, C 244/2.

7 See, *e.g.*, Commission Decision of December 5, 5007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue aid to Northern Rock*, §37.

8 Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, *O.J.*, 2008, C 270/2.

9 Commission Decision of December 5, 5007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue aid to Northern Rock*, C(2007) 6127 final.

10 Commission Decision of April 30, 2008 in Case NN 25/2008 (ex. CP 15/08) – *WestLB riskshield, Germany*, C(2008)1628 final. WestLB proceeded to the restructuring of its structured securities portfolio by isolating the risks thereto related in a stand-alone SPV to be removed from its accounts.

11 Commission Decision of June 4, 2008 in Case C 9/2008 (ex. NN 8/2008, CP 244/2007) – *Sachsen LB, Germany*, C(2008)2269 final. The sale of Sachsen LB to Landesbank Baden-Württemberg involved a complex restructuring of Sachsen LB's structured investments portfolio. The guarantee provided by the state of Saxony covered losses on a structured investment portfolio with low mark-to-market value transferred in a stand-alone SPV to insulate Sachsen LB from any further losses upon maturity.

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Danish bank, which experienced a severe lowering of its financial strength rating due to its large exposure to the US subprime crisis and that of the Danish real estate market, benefited from unlimited emergency liquidity assistance from the Danish central bank backed by guarantees provided by the Danish banking association and the government;[12] (v) *Bradford & Bingley*, a UK-based financial institution providing specialist mortgages and savings products that was downgraded by the major credit rating agencies in September 2008, lost its banking license, was nationalized and then winded down by the UK authorities, including by means of a sale of its retail deposits and branches to Abbey National, part of the Santander group;[13] and (vi) *Hypo Real Estate Holding AG*, a large German bank holding facing a liquidity crisis due to its involvement in the national and international mortgage business and its short-term refinancing strategy, which benefited from a €35 billion guarantee from the German federal government and a pool of German financial institutions, against collateral in the form of securities and the shares of its subsidiaries.[14]

7. *Consistency in the assessment of the notion of State aid.* In all the above cases, the logical starting point of the Commission's assessment was Article 87(1) EC according to which "*all subsidies granted by Member States which distort or threaten to distort competition in the common market are* prohibited *unless they meet justification grounds as provided for under Article 87(2) and (3) EC*". As a corollary, the notion of State aid requires: (i) an intervention by the State or through State resources; (ii) that is liable to affect trade between Member States; (iii) confers a selective advantage on the recipient(s); and (iv) distorts or threatens to distort competition.[15] The Commission has historically adopted a broad interpretation of the notion of "State resources", which it maintained in the above cases.[16] In the assessment of the other criteria, the Commission relied systematically on the well-established principle of the *market economy investor*, according to which any public intervention to the benefit of economic operators constitutes State aid unless a private investor acting under normal market conditions could have granted the same or similar facilities under the same or similar circumstances.[17] The exceptional nature of the market situations faced already at that time by the relevant credit institutions and the scope of – let alone the motives for – the rescue measures adopted by the Member States *de facto* implies that virtually all those measures amounted to State aid, notably given the risks involved.[18] Interestingly, though, the Commission held that no State aid is at stake in case of emergency liquidity assistance provided: (i) by an independent central bank against high quality collateral and at its own initiative; or (ii) by a State-owed central bank against a guarantee provided by the private sector.[19] Likewise, in line with its past practice and despite the degraded market conditions, the Commission confirmed that a purchase price is considered to be the market price – and therefore that no State aid is involved – if the sale is organized via an open and unconditional tender and the assets go to the highest or only offeror.[20] The Commission also confirmed the controversial approach adopted in the *France Telecom* case, according to which a mere announcement on the part of public authorities aimed to preempt the downgrading of a company by rating agencies, is capable of constituting State aid.[21]

8. *Consistency with the Commission guidelines on State aid for rescuing and restructuring firms in difficulty.* As noted, in all decisions adopted over the Phase I period, the Commission has systematically refused to consider the compatibility of the relevant State measures with the common market pursuant to Article 87(3)(b) EC. Consistent with its *Crédit Lyonnais* practice,[22] the Commission takes the view, indeed, that such justification ground "*needs to be applied restrictively so that aid cannot be benefiting only one company or one sector but must tackle a disturbance in the entire economy of a Member State*".[23] Thus, at the time, the Commission did not consider that the risk of bank failures in the UK or Germany, but also in Denmark, was such as to trigger a systemic crisis. Rather, it viewed those cases as "*based on individual problems,* [requiring] *tailor made remedies, which can be addressed under the rules for companies in difficulties*".[24] Those rules, issued pursuant to Article 87(3)(c) EC, are embodied in the Commission guidelines on State aid for rescuing and

12 Commission Decision of July 31, 2008 in Case NN 36/20085 – *Denmark/Roskilde Bank A/S*, C(2008)4138. However, the rescue plan envisaged in that decision did not succeed and Roskilde Bank was finally taken over and then winded down by the Danish central bank and the Danish banking association. In that framework, the Danish authorities gave a new guarantee to the Danish central bank covering any losses incurred in relation to that transaction. The liquidation plan was approved by the Commission on November 5, 2008, pursuant to Article 87(3)(b) EC as it was found that a default of Roskilde Bank could have caused a systemic crisis and, as a result, a serious disturbance in the Danish economy as a whole (see Commission press-release IP/08/1633, "*State aid: Commission approves Danish liquidation aid for Roskilde Bank*").

13 See Commission Decision of October 1, 2008 in Case NN 41/2008 – *UK/Rescue Aid to Bradford & Bingley*, C(2008)5673 final..

14 See Commission press-release IP/08/1453 of October 2, 2008, "*State aid: Commission approves German rescue aid package for Hypo Real Estate Holding AG*" (Case NN 44/2008, decision only publicly available in German so far).

15 For a restatement of those basic conditions, see, *e.g.*, Case C-345/02, *Pearle et al.* [2004] ECR I-7139, §33.

16 See, *e.g.*, *WestLB riskshield/Germany*, §29; *Sachsen LB*, §71.

17 See, *e.g.*, *WestLB riskshield/Germany*, §32, where the Commission recalls that "*the attitude of the hypothetical private investor is that of a prudent investor, from a position ex ante, whose goal of profit maximization is tempered with caution about the level of risk acceptable for a given rate of return*".

18 See, *e.g.*, *WestLB riskshield/Germany*, §33-35; *Roskilde Bank*, §§34-38; *Sachsen LB*, §§81-85.

19 See, respectively, *Northern Rock*, §§32-34 and *Roskilde Bank*, §§32-33.

20 See, *e.g.*, *Sachsen LB*, §76 and *Bradford & Bingley*, §38.

21 *WestLB riskshield/Germany*, §37, referring to Commission Decision of August 2, 2004 in Case C 13a/2003, *France Telecom* [2006] *O.J.* L 257/55, §194.

22 Commission Decision of May 20, 1998 in Case C(1998) 1454 – *Crédit Lyonnais group/France* [1998] *O.J.* L 221/28, as restated in, e.g., *Northern Rock*, §38.

23 See, *e.g.*, *WestLB riskshield/Germany*, §41; *Sachsen LB*, §94. See also Joined Cases T-132 and 143/96, *Freistaat Sachsen and Volkswagen AG/Commission* [1999] ECR II-3663, §167.

24 *Idem*, respectively §42 and §95 (where the Commission referred to "*company-specific events*").

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restructuring firms in difficulty (the "Guidelines"),[25] which condition the grant of an exemption to the general prohibition of State aid on a number of criteria. The Commission has endeavored to apply its guidelines consistently in the above cases, as follows:

9. *Company in difficulty*. Under the Guidelines, a firm is regarded as being in difficulty when it is unable to stem losses which, without outside intervention by the public authorities, will "*almost certainly condemn it to going out of business in the short or medium term*".[26] This is the case, *e.g.*, when the relevant company fulfils the criteria under its domestic law for being the subject of collective insolvency proceedings, as *Northern Rock* did in September 2007, for example.[27] In line with the Commission's past practice, this is also the case when the total capital ratio of a bank threatens to fall below the minimum quota required by the banking regulator, resulting in a moratorium on the bank's activities,[28] or in case of severe refinancing problems caused by the downgrading of a bank's financial strength rating.[29]

10. *Rescue aid*. Rescue aid consists in temporary and reversible liquidity assistance aimed to keep an ailing firm afloat for the time needed to work out a restructuring or liquidation plan.[30] Technically, it must be: (i) granted in the form of loans or guarantees for a maximum six months term bearing a market-based interest rate; (ii) warranted on the grounds of serious social difficulties and have no unduly adverse spillover effects on other Member States; (iii) accompanied by an undertaking to communicate a restructuring or liquidation plan within six months (or evidence that loans have been reimbursed and/or guarantees terminated); (iv) restricted to the amount needed to keep the firm in business during the relevant period, *i.e.*, proportionate; and (v) limited to a one-off operation.[31] The Guidelines introduce some flexibility with respect to rescue aid in the banking sector in the sense that aid can be granted in a form other than loans or loan guarantee to the extent that it does not consist in structural measures related to the bank's own funds (*i.e.*, recapitalization).[32] All other principles and procedural obligations remain applicable.

11. In the Phase I cases listed above, the Commission has followed the methodology and conditions set forth in the Guidelines, including those rules specific to the banking sector. As far as the form of the rescue aid is concerned, the Commission has assimilated a number of peculiar measures to loans or loan guarantees, such as: (i) a guarantee on deposits;[33] (ii) the acquisition of "toxic" commercial paper leaving the default risk with the original owner (assimilated to a credit line);[34] (iii) a guarantee covering the notes issued by a special investment vehicle ("SIV") and acquired by a bank so as to back the *mark-to-market* losses related to the SIV's structured investment portfolio on the bank's balance sheet (assimilated to a loan);[35] and (iv) an urgent working capital facility.[36] In contrast, it refused to consider as rescue aid facilities having the effect and character of a capital injection.[37] With respect to the duration requirement, the Commission has shown some flexibility for facilities that are indispensable to enable banks to comply with prudential requirements and thus serve the purpose of rescue aids for banks.[38] Above all, the Commission has ensured that any aid remains proportionate, *i.e.*, is limited to the actual needs of the relevant bank, does not enable it to behave aggressively on the market and is subject to effective oversight.[39]

12. *Restructuring aid*. Aid that is not temporary and reversible in nature such as capital injections and the likes (*e.g.*, recapitalization) – including any amount disbursed as rescue aid and not paid back within the initial six months period – is scrutinized under the conditions set forth in the Guidelines for restructuring aid. In a nutshell, the grant of restructuring aid is conditional on the implementation of a restructuring plan capable of restoring the long-term viability of the relevant operator within a reasonable timescale and on the basis of realistic assumptions.[40] It must entail compensatory measures, such as the divestment of assets or reductions in capacity, and the aid recipient is expected to make a significant contribution to the financing of the restructuring plan, of at least 50% in the case of large companies.[41] Finally, specific conditions are

25 Cited above, note 6.

26 *Idem*, §9.

27 *Northern Rock*, §41. See also *Sachsen LB*, §96.

28 In September 2008, for example, the license of *Bradford & Bingley* to accept deposits was withdrawn by the UK Financial Services Authority.

29 *WestLB*, §45; *Roskilde Bank*, §§43-50.

30 Guidelines, cited above, note 6, §15.

31 Idem, §§25(e) and 72-76 (the Commission will oppose rescue aid if the beneficiary has already received rescue or restructuring aid over the preceding 10 years period).

32 Idem, §25(a) footnote 3.

33 Northern Rock, §44.

34 Sachsen LB, §99.

35 WestLB, §47 and references to precedents provided at §52. The Commission found, in particular, that such measure was "*the least structural* […] *possible in order to settle the regulatory problem of WestLB in line with the banking legislation*" and noted that it fell short of an equity provision (§§48-49).

36 *Bradford & Bingley*, §§43-46.

37 Commission Art. 88(2) EC letter to Germany of February 27, 2008 in Case C 10/2008 (ex. CP233/07 and NN7/08) – *IKB, Germany* (§50). IKB is a German bank specialized in long-term financing to medium-sized companies, which accumulated a total subprime exposure of approximately €7.7 billion arising from direct investments in CDOs and liquidity facilities provided to a structured investment vehicle.

38 See, *e.g.*, in the Northern Rock case, the PIK Interest Agreement providing for interest payments on the other facilities to be deferred for five years (§46).

39 In the *Northern Rock* case, the liquidity facilities were structured so that the bank would receive only the cash needed for one week ahead and the use thereof was controlled by the Bank of England (§§49-51). The acquisition of "toxic" commercial papers in the *Sachsen LB* case was capped at an amount corresponding to the bank's needs and limited to securities that could not be placed on the market (§§100-103). The guarantee provided to *WestLB* on the notes issued by one of its special investment vehicle was also capped to the bank needs, did not lower *WestLB*'s level of refinancing costs compared to other banks and the capital freed could not be used for any expansionary activities (§54-56). In the *Roskilde Bank* case, the Commission emphasized that the loan provided by the Danish central bank entailed a higher level of interest than other credit facilities and was structured so that Roskilde Bank would receive only the cash needed for two weeks ahead, as approved by an independent auditor (§§59-63).

40 Guidelines, §§34-35.

41 Guidelines, §§38-45.

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typically attached to the aid, notably to prevent its use for aggressive, market-distorting activities not linked to the restructuring process. The notification of a restructuring plan has the immediate benefit of extending the duration of any preexisting rescue aid measure pending the Commission's examination of the restructuring plan, which can take months.[42]

13. So far, the Commission has adopted only one final decision involving restructuring aid, in relation to *Sachsen LB*.[43] In addition, it has opened in-depth investigations into restructuring aid packages for *Northern Rock*,[44] *WestLB*[45] and *IKB Deutsche Industriebank AG*.[46] In those cases, the Commission considered measures such as: (i) the outright sale of *Sachsen LB* combined with the prolongation of the guarantee provided by the state of Saxony; (ii) the nationalization of *Northern Rock* combined with an outstanding debt towards the Bank of England and a commitment of the UK Treasury to operate the bank above the minimum capital requirements; and (iii) the riskshield provided to *IKB*, which indirectly amounted to a capital injection. In the *Sachsen LB* decision, the Commission reached the conclusion that, after discounting for the prolongation of the guarantee provided by the state of Saxony, the contribution of the purchaser to the costs of restructuring *Sachsen*'s operations would amount to 51%.[47] The restructuring plan included the sale of certain assets, the closure of Sachsen's Irish subsidiary involved in structured financial investments, undisclosed divestitures and the abandonment of Sachsen's proprietary trading and international real estate businesses. Those measures related to activities accounting for more than 25% of the Sachsen's group 2008 profits and were thus found sufficient to compensate for the aid provided and limit its distorting effect.[48] In addition, the transaction involved the dismissal of Sachsen's management team, which was considered a "*valuable signal against moral hazard*".[49] Finally, it is worth underlining that, in relation to *IKB*, the Commission has admitted the parallel grant of restructuring aid to remedy the exposure to the subprime crisis - still under review - and of a temporary guarantee aiming to palliate refinancing difficulties due to the financial crisis.[50]

14. As acknowledged by EU Competition Commissioner Kroes, the cases dealt with over the Phase I "subprime" period, *i.e.*, prior to October 2008, have allowed her services to "*test and improve our ability to meet the urgent demands that face banks in these* [liquidity shortage] *situations*".[51] In a crisis where many public authorities appear constrained to proceed by trial and error under the pressure of time, the Commission has indeed been able to gain experience progressively and to acquire an intimate knowledge of the various rescue initiatives taken across the EU. This has most probably improved its reactivity when the crisis spread to the whole interbank system and Member States started adopting all sorts of urgent remedial measures. Beyond the precedents, the Commission has demonstrated over that period the resilience of its State aid policy, *i.e.*, its ability to combine the authorization of rescue measures with the protection of competition in the common market. The same approach has guided the Commission's action over the Phase II of the financial crisis.

1.2. Phase II: Since October 2008

15. In the aftermath of Lehman Brothers' Chapter 11 bankruptcy filing on September 15, 2008, the financial crisis intensified both in scale and in scope, leading to a global freeze of the market for interbank lending. Hence, financial institutions across Europe, including fundamentally sound ones, faced refinancing difficulties. The change in the nature of the crisis and the magnitude of the potential consequences thereof led the Commission to adapt its State aid enforcement policy. On October 6, 2008, in an address before the Economic and Monetary Affairs Committee of the European Parliament, Commissioner Kroes *made* known her intention "*not* [to] *shy away if need be from applying the special provisions of Article 87(3)(b) of the Treaty regarding aid granted to address a serious disturbance of the economy of a Member State*".[52] In effect, since that time, the Commission has exclusively relied on that exceptional provision, thus acknowledging the systemic nature of the crisis.

16. *The facts.* Ireland, Denmark and the UK were the first Member States to notify to the Commission general guarantee schemes and financial support measures for the banking sector as a whole. In three decisions adopted on October 10 and 13, 2008, published immediately, the Commission outlined the policy principles underlying the application of Article 87(3)(b) EC in the context of the financial crisis.[53]

42 Guidelines, §26.

43 See above, note 11. The liquidation of *Roskilde Bank* was approved on November 5, 2008 pursuant to Article 87(3)(b) EC, the provision aimed to allow aids aimed to remedy a serious disturbance in the economy of a Member State (see Commission press-release IP/08/1633).

44 Commission Art. 88(2) EC letter to the UK of April 2, 2008 in Case C 14/2008 (ex NN 1/2008) – *United Kingdom/Restructuring aid to Northern Rock*, C(2008) 1210 final.

45 See Commission press-release IP/08/1435 of October 1, 2008: "*State aid: Commission opens in-depth investigation into restructuring of WestLB*".

46 Commission Art. 88(2) EC letter to Germany of February 27, 2008 in Case C 10/2008 (ex. CP233/07 and NN7/08) – *IKB, Germany*.

47 *Sachsen LB*, §§110-119.

48 *Sachsen LB*, §§120-125. In the *IKB* Art. 88(2) EC letter, the Commission viewed positively the abandonment of IKB's main loss making activities, which were also its most important sources of revenues (§53). The *Northern Rock* restructuring plan envisaged a drastic reduction of the bank's lending operations, notably by means of an ambitious retail mortgage redemption program, in order to halve the bank's balance sheet over five years. The plan also included the increase of retail deposits as a proportion of total funding and the closure of some overseas operations.

49 *Sachsen LB*, §126.

50 See Commission press-release IP/08/2055 of December 23, 2008: "*State aid: Commission approves state support for IKB*". In that case, the Commission assessed the compatibility of the guarantee both with the Guidelines and the Banking Communication (see below note 54) and eventually authorized it pursuant to Article 87(3)(b) EC.

51 N. Kroes, "*Dealing with the current financial crisis*", Address before the Economic and Monetary Affairs Committee, European Parliament, Brussels, October 6, 2008 (SPEECH/08/498). See also N. Kroes, "*EU State aid rules – part of the solutions*", speech delivered at the EStALI Conference, Luxembourg, December 5, 2008 (SPEECH/08/679).

52 *Idem.*

53 See, respectively: Commission Decision of October 13, 2008 in Case NN 48/2008 – *Ireland/Guarantee scheme for banks in Ireland*, C(2008)6059; Commission Decision of October 10, 2008 in Case NN 51/2008 – *Denmark/Guarantee scheme for banks in Denmark*, C(2008)6034; and Commission Decision of October 13, 2008 in Case N 507/2008 – *UK/Financial support measures to the banking industry in the UK*, C(2008)6058, as modified (see Commission press-release IP/08/2057 of December 23, 2008: "State aid: Commission approves modifications to UK financial support measures to the banking industry").

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Those principles were consolidated in an official Communication issued on October 13, 2008 (the "Banking Communication"),[54] thus at the same time as the announcement of the coordinated EU response to the crisis. Subsequently, the Commission formally authorized twelve other general remedial schemes adopted respectively by Germany, Sweden, Portugal, France, the Netherlands, Spain, Italy, Finland, Greece, Austria, Slovenia and Latvia,[55] as well as eleven sets of measures aimed for individual financial institutions (Roskilde Bank, ING, Fortis, Dexia, JSC Parex Banka, Aegon, KBC, Carnegie Bank, BayernLB, NordLB and IKB).[56] The content of the remedial schemes varies remarkably from one country to the other, as apparent from the table enclosed as Annex I. Yet, they have all been designed – sometimes after (in)tense discussions with the Commission[57] – to fit the principles governing the application of Article 87(3)(b) EC, as laid down in the Banking Communication.

17. *Consistency in the assessment of the notion of State aid.* As for rescue measures considered over the Phase I period, described in Section I.1.1 above, the Commission has applied established principles to the assessment of the State aid nature of (part of) the general remedial schemes and individual measures adopted by Member States since October 2008. Those measures are most of the time clearly imputable to the Member States and involve financial burdens on the State, whether in form of an immediate transfer of State resources (*e.g.*, recapitalization) or a potential call on State funds in the future (*e.g.*, guarantees). Public interventions to the advantage of certain economic operators, such as banking institutions incorporated in a specific Member States and/or with "*significant and broad footprint in the domestic economy*", *i.e.*, of a systemic importance, also satisfy the selectivity criterion.[58] In contrast, general measures open to all comparable market players, such as guarantees for retail deposits or open market operations and standing facilities entered into with or provided by central banks (to the extent they are not backed by collateral benefiting from State guarantee),[59] are not selective and therefore do not constitute State aid (and, hence, do not need to be notified to and reviewed by the Commission).[60] Above all, given the circumstances and the magnitude of the sums involved, the Commission has consistently found that no market economy investor would have been willing (if able) to intervene on terms similar to those offered by Member States.[61] This is so even though State interventions must entail a proper remuneration to qualify for an exemption under Article 87(3)(b) EC (see below).

18. *Consistency in the assessment of the compatibility of the aids with the common market under Article 87(3)(b) EC.* The Commission's policy decision to resort to Article 87(3)(b) EC appears fully consistent with the reasoning developed in Phase I to precisely refuse the benefit thereof at that time, and thus with the *Crédit Lyonnais* precedent. Indeed, most of the schemes reviewed in Phase II are of a general nature and/or aim to tackle the risk of a systemic disturbance for Member States' financial stability and thus their entire economy.[62] The key element that appears to have triggered the application

54 Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] *O.J.* C270/08.

55 See, respectively: Commission Decision of October 27, 2008 in Case N 512/2008 – Germany/*Rescue package for credit institutions in Germany*, C(2008) 6422, as modified on December 12, 2008 (see Commission press-release IP/08/1966: "*State aid: Commission approves modifications to German financial rescue scheme*"); Commission Decision of October 29, 2008 in Case N 533/2008 – *Sweden/Support measures for the banking industry in Sweden*, C(2008) 6538; Commission Decision of October 30, 2008 in Case N 524/2008 – *Nederland/Garantieregeling ten behoeve van banken in Nederland*, C(2008) 6616; Commission press-release IP/08/1609 of October 31, 2008: "*State aid: Commission authorizes French scheme for refinancing credit institutions*"; Commission press-release IP/08/1630 of November 4, 2008: "*State aid: Commission approves Spanish fund for acquisition of financial assets from financial institutions*"; Commission press-releaseIP/08/2049 of December 23, 2008: "*State aid: Commission approves Spanish guarantee scheme for credit institutions*"; Commission Decision of November 13, 2008 in Case N 567/2008 – *Finland/Guarantee scheme for banks' funding in Finland*, C(2008) 6986; Commission press-release IP/08/1706 of November 14, 2008: "*State aid: Commission authorizes Italian scheme for refinancing credit institutions*"; Commission press-release IP/08/2059 of December 23, 2008: "*State aid: Commission approves Italian recapitalization scheme for financial institutions*"; Commission Decision of November 19, 2008 in Case N 560/2008 – *Greece/Support Measures for the Credit Institutions in Greece*, C(2008) 7382; Commission press-release IP/08/1933 of December 10, 2008: "*State aid: Commission approves Austrian support scheme for financial institutions*"; Commission press-release IP/08/1964 of December 12, 2008: "*State aid: Commission approves Slovenian support scheme for credit institutions*"; Commission Decision of December 17, 2008 in Case NN 60/2008 – *Guarantee scheme for credit institutions in Portugal*, C(2008) 8686; Commission press-release IP/08/2054 of December 23, 2008: "*State aid: Commission approves Latvian support scheme for banks*".

56 See, respectively: Commission press-release IP/08/1633 of November 5, 2008: "*State aid: Commission approves Danish liquidation aid for Roskilde Bank*"; Commission Decision of November 12, 2008 in Case N 528/2008 – *The Netherlands/Aid to ING Groep NV*, C(2008) 6936 final cor.; Commission press-release IP/08/1745 of November 20, 2008: "*State aid: Commission approves joint aid from Belgium, France and Luxembourg to rescue Dexia*"; Commission press-release IP/08/1746 of November 20, 2008: "*State aid: Commission approves Belgian state guarantee for Fortis Bank*"; Commission press-release IP/08/1766 of November 25, 2008: "*State aid: Commission approves Latvian state support for JSC Parex Banka*"; Commission decision of November 27, 2008 in Case N 569/2008 – *The Netherlands/Aid to Aegon N.V.*, C(2008) 7734 final; Commission press-release IP/08/2033 of December 18, 2008: "*State aid: Commission approves recapitalization of Belgian KBC Group*"; Commission press-release IP/08/1977 of December 16, 2008: "*State aid: Commission approves Swedish rescue aid for Carnegie Bank*"; Commission press-release IP/08/2034 of December 18, 2008: "*State aid: Commission approves state support for BayernLB*"; Commission press-release IP/08/2056 of December 23, 2008: "*State aid: Commission approves German banking rescue aid for NordLB*"; Commission press-release IP/08/2055 of December 23, 2008: "*State aid: Commission approves state support for IKB*".

57 See, *e.g.*, Commission press-release IP/08/1742 of November 19, 2008: "*State aid: Commission authorizes support package for Greek credit institutions*" ; Commission press-release IP/08/1933 of December 10, 2008: "*State aid: Commission approves Austrian support scheme for financial institutions*" and Commission press-release IP/08/2059 of December 23, 2008: "*State aid: Commission approves Italian recapitalization scheme for financial institutions*".

58 Ireland, §47.

59 See, *e.g.*, UK, §§40-41; Sweden, §§32-33.

60 As a result, the increase in the ceilings of State guarantees for retail deposits announced by various Member States did not raise State aid issues. Regarding central banks operations, see the Banking Communication, §51 and the UK decision, §§40-41.

61 See, *e.g.*, Denmark, §32; Ireland, §48; UK, §39; Germany, §43; Finland, §28; ING, §§36-51 (citing as relevant factors: "*the current distressed market conditions*", the "*public policy considerations*" that determined the investment; and "*the pricing of the securities*" above the share price on the day the transaction was settled) or Aegon, §§40-51.

62 The Commission has applied Article 87(3)(b) EC to individual measures affecting credit institutions based in relatively small Member States such as Denmark (Roskilde Bank), Belgium (Fortis and Dexia) and Latvia (JSC Parex Banka). In the case of Belgium, for example, the Commission found that a collapse of Dexia "*would have had a snowball effect on the Belgian banking sector and, consequently, on the entire Belgian economy*" (Commission press-release IP/08/1745 of November 20, 2008: "*State aid: Commission approves joint aid from Belgium, France and Luxembourg to rescue Dexia*").

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of Article 87(3)(b) EC is the possibility of "*even fundamentally sound financial institutions […] facing the prospect of going out of business*", which the Commission characterized as a "*clear international market-failure*",[63] combined with the recognition of the "[banking] *sector's pivotal role in providing financing to the rest of the economy*".[64] In contrast, financial institutions affected by losses stemming from poor asset-liability management or risky strategies remain, in theory, subject to the normal framework for rescue aid.[65] That being said, Article 87(3)(b) EC, which may entail the justification of State aid granted to "*remedy a serious disturbance in the economy of a Member State*", is a rarely-used provision.[66] As a result, the Commission has acknowledged that there is no established practice as to the conditions for compatibility of aid granted under that provision.[67] It therefore endeavored to resort to general principles guiding the assessment of the compatibility of aid under Article 87(3) EC as a whole. Those principles are elaborated upon in the Banking Communication. The filiation with the reasoning underlying the assessment of rescue aid during the Phase I period, as explained above, is evident,[68] even though Article 87(3)(b) EC offers additional flexibility as to the nature of acceptable aids (*e.g.*, structural interventions), the duration thereof (*i.e.*, going beyond six months) and, particularly, the absence of structural compensatory measures. The policy principles laid down in the Banking Communication revolve around two central EU single market criteria, namely non-discrimination and proportionality.

19. *Non-discrimination.* To be held compatible with the common market, general remedial schemes adopted in the framework of the financial crisis must contain objective and non-discriminatory eligibility criteria.[69] Guarantee and recapitalization plans, in particular, must be open to all credit institutions with systemic relevance to the economy, regardless of their origin, *i.e.*, all banks incorporated in a relevant Member State, including subsidiaries or branches of banks headquartered abroad, with "significant activities" in that Member State.[70] Compliance with that criterion was at the core of discussions between the Commission and Ireland during the review of the general guarantee scheme for banks in Ireland. The first version of the scheme notified on October 3, 2008, which limited eligibility to domestic banks, was amended on October 12 *in* order to comply with "*issues […] raised by the Commission relating to the maintenance of the integrity of the single market in financial services*" (sic).[71]

20. *Proportionality.* The principle of proportionality typically requires the measure(s) under scrutiny to be: (i) suitable for securing the objective pursued; (ii) limited to what is necessary in order to attain it; and (iii) the least disruptive solution possible, taking into account other laws, regulations and "measures" in place. Translated in the current context, it implies that State aids must be: (i) appropriate and adequately targeted to remedy the alleged serious disturbance in the economy of the Member State concerned; (ii) the least distortive possible of competition; and (iii) not redundant with existing arrangements or other means.[72]

21. As far as State guarantees are concerned, the appropriateness criterion is first of all appreciated in relation to the scope of the debt and liabilities covered. For the Commission, the drying-up of interbank lending may justify guaranteeing not only retail deposits but also certain types of wholesale deposits and even short- and medium-term debt instruments.[73] However, shareholders and investors are not permitted to benefit from such guarantees, which ought therefore to exclude, in principle, hybrid or subordinated debt considered as Tier 2 capital.[74] The duration of the guarantee scheme is also relevant and may extent to a period *up* to two years (absent compensation),[75] to the extent that the scheme is

63 See, *e.g.*, UK, §§44 and 47; Denmark, §40. Therefore, Article 87(3)(b) EC in principle covers remedial schemes limited to accommodate the liquidity difficulties of solvent companies (see, *e.g.*, Denmark, §43). See also UK, §§14 and 57; Germany, §7 (eligibility limited to those credit institutions with a Tier 1 ratio above a certain threshold); Sweden, §5 (eligibility limited to institutions with at least 6% Tier 1 capital and at least 9% combined Tier 1 and Tier 2); Finland refers to general solvency criteria set forth in the Finnish Act on Credit Institutions and requires the opinion of the Finnish Financial Supervisory Authority (Finland, §8). Note that the capital injection into ING, in spite of its AA rating, was prompted by stricter requirements imposed by capital markets (and rating agencies) in the form of core Tier 1 ratios in the range of 7-9%, compared to previous levels of 5-7% (ING, §10).

64 See, *e.g.*, Germany, §46; Sweden, §36; Portugal, §29 ("*As a consequence, there is a systemic crisis that affects not only the entire functioning of the financial market but of the economy as a whole*").

65 Banking Communication, §§14 and 33.

66 C. Quigley and A. M. Collins, in their leading treatise on EC State aid law (Hart, Oxford, 2003) refer to aid granted by several Member States in the mid-1970s to protect employment during recession and to the privatization of hundreds of Greek firms and public-sector banks as part of a national economic recovery plan in the early 1990s (p.86).

67 See, *e.g.*, Denmark, §41; UK, §45.

68 See, *e.g.*, the various references to the cases handled over the Phase I period in the *Banking Communication.*

69 *Banking Communication*, §16.

70 *Banking Communication*, §18 and *Recapitalization Communication*, §46. See, *e.g.*, Denmark, §6: an estimated 140 banks are eligible under the Danish scheme. In Spain, the guarantee scheme is open to all solvent registered credit institutions having a share of at least 1/1000 of the credit market (see Commission press-release IP/08/2049 of December 23, 2008: "*State aid: Commission approves Spanish guarantee scheme for credit institutions*") Note also that the issue of discrimination is particularly sensitive in those Member States, like Belgium, which have adopted a series of individual measures instead of devising a general remedial scheme.

71 See Commission press-release MEMO/08/615 of October 12, 2008: "*State aid: Commission welcomes revised Irish guarantee scheme*". The final Irish guarantee schemes covers six domestic credit institutions and "*such specific subsidiaries as may be approved by the Government following consultation with the Central Bank and the Financial Regulator*" (Ireland, §§5 and 16). In the UK, the relevant criterion is the eligibility to sign up for the Bank of England's Standing Facilities (UK, §4). In Germany, eligibility is conditional on the "best judgment" of the Federal Ministry of Finance, based on a series of benchmarks (§6).

72 *Banking Communication*, §§15 and 21.

73 *Banking Communication*, §21.

74 See, *e.g.*, Denmark, §8: the guarantee scheme excludes covered bonds and subordinated debt, which the Commission considered positively (§47). See also UK, §59; Germany, §63. The *Banking Communication* notes that if such debt is covered, specific restrictions may be necessary (§23). See, *e.g.*, Ireland, §§17 and 63-64. For a discussion on the coverage of covered bonds, see Sweden, §§24 and 42 and Finland, §§23 and 38.

75 Even though it is valid up to three years, the UK Guarantee Scheme was found justifiable because it covers only new debt issued over a has a six months period (§60). See also Germany, §65; Sweden, §44 (up to five years for covered (mortgage backed) bonds, exceptionally justified by the Swedish situation, the cap set on the overall amount covered and a six month review commitment – see also Finland, §§39-40). In the decision concerning the Portuguese guarantee scheme, the Commission stated that: "*the coverage of liabilities with a maturity up to two years is in principle sufficient to attain the objectives pursued but accepts that liabilities with a longer time-frame may be accepted if additional safeguards are put in place in order to prevent excessive distortion of competition*" (§37).

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re-notified to the Commission for review every six months.[76] In turn, the necessity criterion mainly requires guarantees to be: (i) granted against adequate remuneration from individual financial institutions and/or the financial sector as a whole,[77] fees being set according to the degree of risks and the beneficiaries' respective credit profiles and needs;[78] and (ii) tied to duly monitored behavioral constraints preventing aggressive commercial conduct, *e.g.*, by introducing GDP-related, market share or balance sheet growth ceilings.[79] Even though the scope and structure of guarantee schemes vary from one Member State to the other, the most commonly adopted one aims to cover, for 24 to 36 months, new short and medium term debts (*i.e.*, with a maturity between three months and three years) issued over a six months period starting on the date of the Commission's approval and remunerated according to European Central Bank's recommendations.[80]

22. With respect to *recapitalization schemes*, the Banking Communication provides that, to remain proportionate, capital injections must be:[81] (i) limited to the minimum necessary; (ii) provided against properly valued and remunerated securities,[82] ideally carrying corresponding rights;[83] and (iii) tied to duly monitored behavioral safeguards, primarily to prevent aggressive commercial practices,[84] with accompanying sanctions. The Commission considers that the irreversible nature of capital injections requires recapitalization schemes to be accompanied by particularly clear ex-ante behavioral safeguards that Member States must monitor and enforce in order to ensure their observance and avoid undue distortions of competition.[85] In addition, Member States are also bound to report every six months on the evolution of the scheme and the individual restructuring plans for the beneficiaries.

23. Generally, the Commission has been reluctant to allow Member States to buy financial assets from banks outright because of the valuation difficulties caused by the credit crisis and the perceived higher risk of providing undue advantages to banks. In the case of Spain, the Commission's reluctance was overcome by limiting such purchase to highly rated covered bonds and asset backed securities by means of an auction process.[86]

24. However, the main difficulty with recapitalization schemes has been the calculation of their proper remuneration rate.[87] At the request of Member States, the Commission has endeavored to give further guidance in that respect, in the form of a dedicated Communication (the "Recapitalization Communication").[88] The difficulty stems from the diversity in the possible objectives pursued by recapitalization schemes as they may aim to: (i) avoid the insolvency of individual credit institutions; (ii) strengthen banks' capital ratios in order to facilitate the recovery of inter-bank lending; and/or (iii) prevent credit supply restrictions to the "real economy". In turn, they may raise different competition and systemic concerns, either because they may result in undue competitive advantages and/or may frustrate the return to normal market functioning. A proper remuneration rate, combined with behavioral safeguards, is a critical tool to arbitrate among those various objectives and concerns. The Recapitalization Communication emphasizes two key elements to factor into

76 *Banking Communication*, §24. See, *e.g.*, Ireland, §§65-66; Denmark, §§17-18; the Netherlands, §§34-36 (the guarantee schemes can be extended, if necessary, upon review and authorization by the Commission).

77 In Denmark, the general remedial scheme is funded partly by the participating banks and partly by the Danish banking association, as well as by the State as far as the winding-up vehicle is concerned (§§10-11).

78 The Commission concedes that the payment of such remuneration may be deferred until beneficiaries are effectively in a position to do so. See, *e.g.*, Ireland, §§20-23 and 68-69, which provides for a claw-back clause to collect the remuneration over time "*in a manner consistent with the* [covered institutions] *long-term viability and sustainability*". Generally, fees are based on market benchmarks comprising various elements including a measure of institution-specific risk and a fixed mark-up designed to compensate the State (see, *e.g.*, UK, §§ 15-17 and 61). See also: Germany, §§22 and 66 (premium corresponding to an interest rate set 0.5% above each institution's credit default swap spread); the Netherlands, §§10 and 39. Sweden made an express reference to the October 20, 2008 "*Recommendations on government guarantees on bank debt*" of the European Central Bank (§§11 and 45-47). See also Finland, §§9-12 and 41-43; Portugal, §13; Slovenia and Spain.

79 *Banking Communication*, §§26-27. See, ***e.g.***, Ireland, §§24-28 and 71-72; Denmark, §§14-15 and 52-53; UK, §§20 and 62; Germany, §23 and 67; Sweden, §§13-14 and 4; Finland, §§14-15 (the Finnish Financial Supervisory Authority is responsible for monitoring the growth of balance sheet volume and reporting back to the government; additional constraints are to be included in the bylaws of banks participating in the guarantee scheme); the Netherlands, §§40-45; Portugal, §§18-19. Note that the benefit of a guarantee scheme can also be made conditional on other requirements, *e.g.*, related to management remuneration or bonus payments (see, *e.g.*, Latvia).

80 See Finland, Germany, Greece, Italy, the Netherlands, Sweden, UK.

81 *Banking Communication*, §§35-40.

82 On the proper remuneration rate of capital injections, see below.

83 See, *contra*, UK, §10. In the *ING* case, the securities acquired by the Dutch State do not carry voting rights but the State is entitled to two representatives at ING's Supervisory Board with veto rights on a list of important Board decisions (ING, §§16-19; idem in the *Aegon* case, see §22). Assets purchases or swaps by or with Member States also require a valuation that reflects their underlying risks (*Banking Communication*, §40 – see, e.g., Germany, §29). For a discussion on assets purchase, see Spain and for assets swaps, see Italy and Greece.

84 The UK Bank Recapitalization Scheme also imposes, *e.g.*, no cash bonuses to be paid to Directors for the current year's performance, the appointment of news independent directors, commitments to maintain the availability and active marketing of competitively priced lending to homeowners and to small business and to support schemes to help people struggling with mortgage payments to stay in their homes (UK, §12). The German scheme includes similar behavioral constraints (*e.g.*, with respect to executives' remuneration and bonuses) and conditions the distribution of dividends to shareholders to the sale of the Recapitalization Fund's shares to a third party or the repurchase thereof (§§14 and 57). The French capital-injection scheme also requires beneficiary banks to adopt measures concerning the remuneration of senior management and market operators (including traders) and limiting severance packages for executives (see Commission press-release IP/08/1900 of December 8, 2008: "*State aid: Commission authorizes French scheme to inject capital into certain banks*").

85 UK, §51. Note that competitors of *Fortis Bank* and *KBC* in Belgium and of *ABN AMRO* in the Netherlands have already complained that those banks introduced more aggressive offers after having benefited from capital injections by the Belgian, French, Dutch and/or Luxemburg authorities.

86 See Commission press-release IP/08/1630 of November 4, 2008 : "*State aid: Commission approves Spanish fund for acquisition of financial assets from financial institutions*".

87 Remuneration is no more an issue, however, when State capital injections are combined, on equal terms, with significant participations (30% or more) by private investors. In those circumstances, the Commission accepts the remuneration set in the deal as reflecting the market price. See the Recapitalization Communication, §21.

88 "*Communication from the Commission – The recapitalization of financial institutions in the current financial crisis : limitation of aid to the minimum necessary and safeguards against undue distortions of competition*", December 5, 2008, C(2008) 8259 final.

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the remuneration rate of capital injections: (i) closeness to market prices; and (ii) exit incentives, *i.e.*, incentives to redeem the State as soon as possible.[89] In turn, it introduces a distinction between fundamentally sound, well-performing banks, on the one hand, and distressed, less-performing banks, on the other hand, the lower risk profile of the former category justifying a lower remuneration rate than for credit institutions belonging to the latter.

25. In a nutshell, the remuneration rate for fundamentally sound banks is assessed according to a methodology devised by the Governing Council of the European Central Bank.[90] That methodology provides for a price corridor of 7 to 9.3% within which an "entry level" rate is set on the basis of different parameters:[91] (i) the type of capital chosen (the lower the subordination, the lower the required remuneration in the price corridor); (ii) appropriate benchmark risk-free interest rate; and (iii) the individual risk profile at national level of all eligible financial institutions (including both financially sound and distressed banks).[92] The "entry level" rate ought then to be adjusted upwards to incentivize exit when the market so allows. In that respect, pricing structures reflecting an increase in the remuneration rate over time or linking the payment of dividends to an obligatory remuneration of the State that increases over time, are viewed positively.[93] For reasons of administrative convenience, Member States may also resort to alternative pricing mechanisms leading to a total expected annualized return for all banks participating in the scheme "*sufficiently high to cater for the variety of banks and the incentive to exit*",[94] *i.e.*, so far, at least 10%.[95] In addition, capital injections in fundamentally sound banks must be tied to "*effective and enforceable national safeguards* [to] *ensure that the injected capital is used to sustain lending to the real economy*".[96] Likewise, they are linked to an obligation to report periodically on the long term viability of the beneficiary and the steps taken to limit distortions of competition.[97] Capital injections in ailing banks, on the other hand, should be set at a higher rate and combined either with a winding-up or a far-reaching restructuring plan, including management and corporate governance changes.[98]

26. In the early cases of the UK and German recapitalization schemes, the Commission accepted flat remuneration levels of 12 and 10%, respectively, while in the ING case, it considered that the return on the State's investment was likely to be in excess of 10%. Following the publication of the Recapitalization Communication, the Commission accepted lower remuneration rates, such as: (i) 8% on average for a capital-injection scheme set up by France and aimed to stabilize financial markets and incentivize French banks to increase lending to the real economy;[99] and (ii) 8.8% for the capital injection into KBC by the Belgian State. In turn, the UK and German schemes were modified to reflect the methodology set forth in the Recapitalization Communication.[100] As far as exit incentives are concerned, the modified German scheme provides for either a dividend ban or a 0.5% remuneration rate increase per year over 5 years. Alternatively, the capital injections into KBC, Aegon and SNS REAAL provide for a remuneration paid only if a dividend is distributed on ordinary shares, in the form of a coupon equal to the higher of: (i) a flat amount per security; or (ii) a premium on the dividend paid on the ordinary shares increasing over time.[101]

27. The benefit of a recapitalization plan, like the activation of a guarantee, must be followed by a restructuring plan within six months, to be separately examined by the Commission.[102] In the alternative, it may be followed by or combined with a *controlled winding-up*, possibly involving another contribution of public funds,[103] *e.g.*, to reimburse certain creditors of the liquidated bank, cover debts or guarantee against the default of certain assets. In the event of a winding-up, the Commission insists on the need to exclude shareholders from the benefit of any aid, to carry out the liquidation under strict time limits and to proceed to the sale of relevant assets by means of an open and non-discriminatory tender procedure with the aim of maximizing the sales price.[104] The best example of such winding-up process so far is that of *Roskilde Bank*,[105] following the failure of the rescue plan analyzed above (see Section I.1.1). Roskilde was taken over by a NewCo owned by the Danish central bank and the Danish banking association, which was to remain active as a

89 *Recapitalization Communication*, §19.

90 Recommendations of the ECB Governing Council on the pricing of recapitalizations, November 20, 2008 (available at http://www.ecb.int/pub/pdf/other/recommendations_on_pricing_for_recapitalisationsen.pdf, last visited December 22, 2008).

91 The ECB methodology uses average values of relevant parameters such as government bond yields, CDS spreads and equity risk premia to determine a corridor with a 7% lower bound representing the average required rate of return on preferred shares with features similar to those of subordinated debt and a 9.3% higher bound representing the average required rate of return on ordinary shares relating to Euro area banks (see *Recapitalization Communication*, §27).

92 *Recapitalization Communication*, §28. Member States may also include step-up or payback clauses in their pricing formula. Alternative pricing methodologies are also accepted provided they lead to higher remunerations rates than achieved by means of the ECB one.

93 *Recapitalization Communication*, §§31-32.

94 *Idem*, §46.

95 *Idem*, footnote 22, as confirmed by the modifications accepted to the German recapitalization scheme (see Commission press-release IP/08/1966 of December 12, 2008: "*State aid : Commission approves modifications to German financial rescue scheme*"). See also the commitment entered into by the Dutch authorities in the *Aegon* case to achieve an overall return on the securities of at least 10% (§31).

96 *Idem*, §39.

97 See, *e.g.*, Aegon, §58.

98 *Idem*, §§43-45.

99 Commission press-release IP/08/1900 of December 8, 2008: "*State aid: Commission authorizes French scheme to inject capital into certain banks*".

100 Commission press-release IP/08/1966 of December 12, 2008: "*State aid: Commission approves modifications to German financial rescue scheme*".; Commission press-release IP/08/2057 of December 23, 2008: "*State aid: Commission approves modifications to UK financial support measures to the banking industry*". See also the Italian scheme approved on December 23, 2008 (Commission press-release IP/08/2059: "*State aid: Commission approves Italian recapitalization scheme for financial institutions*".

101 See, *e.g.*, Aegon, §13.

102 *Banking Communication*, §§30-35. See, *e.g.*, Ireland, §73; UK, §69; Germany, §§18, 24, 58; Sweden, §49, Finland, §45; the Netherlands, §§46-47.

103 However, a private sector solution must first be considered before committing any additional state resources (see, *e.g.*, Denmark, §57).

104 *Banking Communication*, §§46-50.

105 See Commission press-release IP/08/1633 of November 5, 2008: "*State aid: Commission approves Danish liquidation aid for Roskilde Bank*".

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bank for the time necessary to complete the sale of the Roskilde's branches and the redemption of all its senior creditors (with the exception of hybrid and subordinated loans). The Commission was satisfied eventually that the sale of the branches had been achieved at the maximum possible market price and that the corresponding assets and liabilities were transferred to the buyers without any aid attached. The redemption of creditors was deemed necessary to preserve the financial stability of the Danish financial system and was approved pursuant to Article 87(3)(b) EC.

2. Merger control: Consistency at EU level vs. flexibility at national level

28. On the merger control front, the activity of the Commission in direct relation with the financial crisis has been relatively limited, as few cross-border rescue acquisitions have taken place within Europe so far.[106] Since most markets involved in banking and insurance mergers are still considered national in scope and few consolidated European players have emerged to date,[107] those transactions are not likely to raise major competition issues.[108] Commissioner Kroes has indicated her readiness to take into account "*where applicable, the failing firm defense*",[109] but no instance of reliance on that theory in relation to the financial crisis has been reported yet. Interestingly, in the framework of the nationalization of banks, in particular that of Fortis Bank Nederland and ABN AMRO Bank Nederland by the Dutch authorities, the Commission has insisted for the new owner, *i.e.*, the Dutch State, to comply with the merger control commitments entered into by Fortis group at the time of the ABN Amro acquisition. In particular, the Commission has emphasized that pending an agreement as to the implementation of those commitments by the Dutch State, no merger of the two banks could take place.[110] Like for State aid, the Commission therefore intends "*to continue applying existing* [merger control] *rules*" to cases brought in the framework of the crisis.[111]

29. At national level, however, a number of rescue acquisitions have taken place, some of which raising the possibility of anticompetitive effects. This has been particularly the case in the UK in relation to the acquisition of HBOS by Lloyds. The terms of that transaction were finalized on October 13, 2008 and provided for the intervention of the UK Bank Recapitalization Scheme. On October 24, 2008, the Office of Fair Trading ("OFT") reported to the UK Secretary of State for Business that the acquisition was likely to create a so-called "*relevant merger situation*" warranting further inquiry by the UK Competition Commission. In particular, it was likely to result in a substantial lessening of competition in markets such as personal current accounts, banking services to SMEs in Scotland and mortgages. In the meantime, the UK government introduced a bill providing for the "*stability of the UK financial system*" to be introduced as a policy exception, along with national security, to the referral of relevant merger situations to the Competition Commission under Section 58 of the Enterprise Act 2002.[112] The bill was turned into law and came into force on October 24, 2008. A few days later, on October 31, 2008, the Secretary of State relied on that new provision to justify its decision not to refer the merger between Lloyds and HBOS before the Competition Commission for further inquiry. In a nine page decision citing extensively submissions made by the Bank of England, the Financial Services Authority and the UK Treasury before the OFT, Lord Mandelson explained that the benefits of the transaction for the stability of the UK financial system outweighed the potential for the merger to result in anticompetitive outcomes, which was therefore deemed to be in the public interest.[113]

30. The least to say is that the introduction of the stability of the financial market as a new "specified consideration" under Section 58 for not referring a merger to the Competition Commission is a bold move by the UK authorities, reflecting a pragmatic approach to coping with the financial crisis. Merger control is a shared competence within the EU; the UK authorities were therefore entitled, in theory, to proceed as they did. Nonetheless, the decision of the Secretary of State was challenged before the Competition Appeal Tribunal ("CAT") by a group of account holders, bank employees and business people, called the "Merger Action Group",[114] as a disproportionate and therefore unlawful use of the Secretary of State's discretion. At the core of the dispute stood a conflict between the opinions of the OFT and the Financial Services Authority as to the counterfactual to the merger, namely the possibility for HBOS to be "rescued" by the UK government by means of, *e.g.*, a capital injection and/or a guarantee, and to remain an independent source of competitive pressure in the future. In turn, the plaintiffs claimed that the Financial Services Authority's statement before the OFT was filled with

106 Only three cases are so far related to the financial crisis: Commission decision of September 16, 2008 in Case COMP/M.5293 – *Santander/Alliance & Leicester* (not yet published, see press-release IP/08/1325); Commission Decision of December 3, 2008 in Case COMP/M.5384 – *BNP Paribas/Fortis* (not yet published, see press-release IP/08/1882); Commission Decision of December 18, 2008 in Case COMP/M.5363 – *Santander/Bradford & Bingley Assets* (not yet published, see press-release IP/08/2012). See also Commission Decision of December 4, 2008 in Case COMP/M.5361 – *Bank of America/Merill Lynch*, C(2008) 8105.

107 Markets for retail banking (incl. products for corporate customers) and insurance products, in particular, are still considered national in scope (for a recent account, see, *e.g.*, Commission decision of October 3, 2007 in Case COMP/M.4844 – *Fortis/ABN AMRO Assets*, §§80, 86 and 92).

108 In the case of *BNP Paribas/Fortis*, for example, section 1.2 of the Form CO reports that "*BNP Paribas mainly operates in France and Italy, while Fortis Entities mainly operate in Belgium and Luxembourg*" (see http://ec.europa.eu/comm/competition/mergers/cases/additional_data/779467 .pdf).

109 N. Kroes, "*Dealing with the current financial crisis*", Address before the Economic and Monetary Affairs Committee, European Parliament, Brussels, October 6, 2008 (SPEECH/08/498, available at http://ec.europa.eu /comm/competition/speeches/index_2008.html).

110 See Commission press-release MEMO/08/729 of November 21, 2008: "*Mergers: Commission closely monitoring Dutch State plans as regards Fortis Bank Nederland and ABN AMRO Bank Nederland*".

111 N. Kroes, "*Dealing with the current financial crisis*", *op.cit.*, note 109 above.

112 See "The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008", available at http://www.opsi.gov.uk/si/ si2008/uksi_20082645_en_1#f00001 (last checked on December 1, 2008).

113 Decision by Lord Mandelson, the Secretary of State for Business, not to refer to the Competition Commission the merger between Lloyds TSB Group plc and HBOS plc under Section 45 of the Enterprise Act 2002, October 31, 2008 (available at http://www.berr.gov.uk/files/file48745.pdf, last checked on December 1, 2008).

114 See the submission available at http://www.mergeractiongroup.org.uk/ (last visited December 2, 2008).

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factual and legal errors and that the Secretary of State relied excessively on its findings whereas the OFT's report should have been given precedence. The action was dismissed by the CAT on December 10, 2008, after a two days hearing.[115] Generally, though, concerns remain as to the way the Secretary of State is likely to use the powers provided by the amended Section 58 in the future. From an EU single market perspective, the key element is the extent to which the new exception is applied consistently and remains truly exceptional, *e.g.*, by referring to "systemic standards" similar to those used by the Commission in assessing the compatibility of State aids with Article 87(3)(b) EC.

31. The consistency displayed so far by the Commission in the enforcement of the relevant EC competition law principles is part of a general aim to use those principles "*as a stabilizing force throughout this crisis*".[116] In the same way, Commissioner Kroes has repeatedly stated that the competition rules were part of the solution to the crisis, not part of the problem.[117] Indeed, from an institutional point of view, in the absence of a central EU Treasury competent to propose and implement solutions to solvency issues faced by European financial institutions, it is primarily through the review of national rescue measures pursuant to EC State aid rules that the Commission has been formally involved in the design and implementation of remedial measures to the financial crisis. In turn, from a substantive point of view, the application of State aid principles to national rescue measures allows the Commission to ensure that general EU law principles, such as non-discrimination and proportionality, are complied with. In other words, by means of the enforcement of EC competition law the Commission is able to ensure that the "European interest" is taken into account by Member States in dealing with the crisis. With money flowing from banks in trouble to those benefiting from State guarantees, the risk of national measures exporting problems to other Member States appears indeed very tangible.[118] In addition, by keeping track of all national rescue plans and individual remedial measures in the exercise of its State aid competence, the Commission is also able to advise on their compatibility with the concerted action plan agreed upon by the European Council on October 15, 2008, thus ensuring a *de facto* coordination among national measures in spite of a lack of express competence in the area of economic policy.

115 Judgment of December 10, 2008 in *Merger Action Group v. Secretary of State for Business*, [2008] CAT 36 (available at http://www.catribunal.org.uk/237-3402/1107-4-10-08-Merger-Action-Group.html).

116 N. Kroes, "*Dealing with the current financial crisis*", *op.cit.*, note 109 above.

117 See N. Kroes, "*Competition policy and the financial/banking crisis: taking action*", open letter available at http://ec.europa.eu/commission_barroso/kroes/financial_crisis_en.html, as repeated, *e.g.*, in Commission press-release IP/08/1453 of October 2, 2008, "*State aid: Commission approves German rescue aid package for Hypo Real Estate Holding AG*" and again on December 2, 2008 in a briefing with EU Economics and Finance Ministers (see MEMO/08/757).

118 See N. Kroes' briefing to EU Economics and Finance Minister on December 2, 2008 (MEMO/08/757).

II. Policy option 2: "Flexibility on the means"

32. The consistency in the principles underlying the enforcement of EC competition law to issues related to the financial crisis stands in contrast with the flexibility introduced at various levels in the implementation of those principles. Again, this is apparent primarily in the field of State aid but also in the merger control area. Such flexibility has been a key element in the Commission's strategy to use competition law enforcement as a stabilization factor. In particular, the Commission has endeavored to provide legal certainty to market operators by acting swiftly according to exceptional procedures,[119] thereby contributing to restore confidence in the market, on the one hand, while preserving the possibility and legitimacy of its own role in the management of the crisis, on the other hand.

1. State aid: Swift decisions to ensure legal certainty

33. *Notification obligation, duration of proceedings and legal certainty.* Pursuant to Article 88(3) EC, Member States have the duty to notify any plans to grant State aid to the Commission, prior to the implementation thereof. In addition, aid cannot be put into effect before the adoption of an authorization decision by the Commission.[120] A failure to notify an aid or the implementation thereof pending review may, under the current case-law of the EU Courts, have drastic consequences for the recipient(s). In a nutshell, if national authorities act in breach of the notification and/or standstill obligations provided for in Article 88(3) EC, the validity of measures giving rise to the aid is affected and national courts are bound to order the cessation of the aid, the recovery of any sums already paid and damages to compensate the possible harm suffered by third-parties.[121] Needless to say that, in particular in the context of the current crisis, such prospects are rather gloomy. However, they represent a concrete threat to the effectiveness of rescue operations, as apparent from the challenge brought by shareholders against the nationalization of Fortis Bank Belgium, followed by a sale to BNP Paribas, precisely on grounds of lack of notification and improper implementation of what they perceive as unlawful aid. Hence the critical need to ensure legal certainty for market operators.

34. Legal certainty is also conditioned on the rapidity of the Commission's authorization process. Under normal circumstances, though, the Commission is supposed to carry a

119 The Commission appears to have also displayed some flexibility in opening formal proceedings into relative sketchy restructuring plans, thereby allowing rescue measures to remain in effect pursuant to §26 of the Guidelines. See, *e.g.*, Commission press-release IP/08/1435 of October 1, 2008: "*State aid: Commission opens in-depth investigation into restructuring of WestLB*".

120 Article 3 of Regulation 659/99 laying down detailed rules for the application of Article 93 of the EC Treaty [1999] *O.J.* L83/1.

121 See, *e.g.*, Case 120/73, *Gebrüder Lorenz GmbH/Germany and Rhénanie-Palatinat*, [1973] ECR p. 1471, §8; Case C-354/90, *FNCE/France*, [1991] ECR I-5505, §12; Case C-39/94, *SFEI et al./La Poste et al.*, [1996] ECR I-3547, §44 ; Case C-199/06, *CELF et al./SIDE*, [2008] ECR I469, §55.

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"preliminary examination" of any notified aid within a two months period and then decide whether to authorize the aid or to initiate a formal investigation procedure.[122] In the case of rescue aid, the Commission already recognized the need for some flexibility and therefore endeavors to take a decision within one month, but only if the aid does not exceed €10 million.[123] As a result, it is not uncommon for State aid review procedures to last several months. Obviously, those time frames are not suited to deal with emergency rescue operations or the adoption of urgent multi-billion remedial plans. Had the Commission not been able or willing to take drastic measure to speed up the review process, it would have been quickly sidelined by Member States and the future of State aid law enforcement would have been significantly jeopardized. As further discussed below, the exceptional procedural framework set forth by the Commission, notably by means of a delegation of decisional power from the College of Commissioners to Commissioner Kroes, now allows for the approval of State aid linked to the financial crisis in a matter of days, if not hours. For example, the Commission was able to decide on the compatibility with State aid principles of the package of measures designed to ensure the orderly winding down of Bradford & Bingley, within 24 hours.[124] The effectiveness of the Commission's action in providing legal certainty is naturally conditional upon close cooperation on the part of Member States, *i.e.*, through the involvement of the Commission in the design of the State aid plans and the timely notification thereof.

35. *Delegation of powers to Commissioner Kroes.* Commission decisions, such as those taken in the area of EC competition law enforcement, must be adopted by the College of Commissioners acting collectively.[125] That authority can be delegated to one or more Commissioners, subject to strict restrictions and conditions.[126] In a move that is truly exceptional as far as the adoption of final decisions in the area of competition law enforcement is concerned, the Commission has, on October 1, 2008,[127] decided to empower Commissioner Kroes, in agreement with President Barroso and Commissioners Almunia (Economic and Monetary Affairs) and McCreevy (Internal Market), with responsibility to authorize so-called "emergency rescue measures". The empowerment is limited to positive decisions concerning measures in favor of financial institutions facing serious difficulties due to the "*current exceptional market situation*" and "*with a view to prevent harmful spill-overs on the financial system or the economy as a whole*".[128] It is valid for three months, *i.e.*, until December 31, 2008, and is conditioned upon: (i) the certification of the urgency of the measures to be adopted by a reasoned letter of the governor of the central bank of the Member State concerned;[129] and (ii) prior approval by the Commission's Legal Service, DG ECFIN and DG Markt.[130]

36. The empowerment is expressly designed to allow the Commission to take decisions "*if necessary within hours*" and "*at any moment in time in particular over the weekend, during the evening or at night and also on bank holidays*" in order to "*positively contribute to the resolution of the current crisis*".[131] It proceeds from the Commission's acknowledgment of the need to reconcile "*the legitimate interests of Member States to prevent […] potentially harmful spill-over effects in the financial sector*", "*the need for effective State aid control*" and "*the need* [*for private undertaking participating in rescue operations, e.g., the acquirer of a financial institution in difficulty*] *to obtain as quickly as possible a degree of legal certainty […] as to the State aid law implications of envisaged or adopted rescue measures*".[132] In the eight weeks following the empowerment, the Commission adopted more than 20 decisions, which is by all means remarkable. Meanwhile, the Commission has established an Economic Crisis Team to assist Member States in the design of their economic recovery plans.[133]

2. Merger control: Allowing risk management pending merger control review

37. In the field of merger control, the Commission has also announced its readiness to grant derogations to the standstill obligation enshrined in Article 7 of the European merger control regulation (ECMR) "*where there is urgency and where there are no 'a priori' competition concerns*".[134] In effect,

122 Article 4 of Regulation 659/99 laying down detailed rules for the application of Article 93 of the EC Treaty [1999] *O.J.* L83/1.

123 Guidelines, §30. Note that, during the Phase I period, the Commission was able to adopt decisions within days or weeks of the notification, but often still weeks or months after having been communicated for the first time with background information concerning the envisaged rescue measures (see, *e.g.*, Case NN 70/2007 *Northern Rock*, decided on December 5, 2007 following a notification filed on November 26, 2007 but with background information already provided to the Commission on September 28 and October 14, 2007).

124 See "*State aid: Commission approves UK rescue aid package for Bradford & Bingley*", European Commission press-release IP/08/1437 (October 1, 2008).

125 See Articles 1 and 4 of the Commission's Rules of Procedure as modified on November 15, 2005 [2005] *O.J.* L 347/83.

126 *Idem*, Article 13.

127 Minutes of the 1845th meeting of the Commission, October 1, 2008, PV(2008) 1845 final, §10.4.

128 Communication from the President in agreement with Ms Kroes – Temporary empowerment, SEC(2008) 2575/2. Positive decisions include: (i) decisions finding that rescue measure does not constitute aid pursuant to Article 4(2) of Regulation 659/1999; (ii) decisions not to raise objections against a notified aid pursuant to Article 4(3) of Regulation 659/1999; and (iii) decisions not to raise objections against a non notified (so-called "unlawful") aid pursuant to Articles 13(1) and 4(3) of Regulation 659/1999.

129 See, *e.g.*, Sweden, §23; Germany, §35; Finland, §20, the Netherlands, §26; Portugal, §30.

130 Note that the empowerment decision originally provided for the sole prior approval of the Legal Service; it was then amended to include prior approval by DG ECFIN and DG MARKT.

131 Communication from the President in agreement with Ms Kroes – Temporary empowerment, SEC(2008) 2575/2. See, *e.g.*, the German aid scheme to the "real economy" approved on December 30, 2008, *i.e.*, "*within a matter of days and during the Christmas break*" (press-release IP/08/2063).

132 *Idem*.

133 See http://ec.europa.eu/competition/contacts/stateaid_mail.html. The primary contact point for State aids designed for the financial sector is DG COMP's Financial Services Directorate.

134 N. Kroes, "*Dealing with the current financial crisis*", *op.cit.*, note 109 above.

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such derogation enables the immediate implementation of (part of) transactions that are part of rescue operations, *i.e.*, pending their merger control clearance. Under the current circumstances, it is easy to imagine that acquirers would typically request at least the ability to monitor the nature and structure of their target's risks portfolio and to take appropriate measures to protect the value of certain assets. For example, BNP Paribas is reported to have been overseeing Fortis Bank Belgium' trading floor activities, pending approval of the transaction by the Commission, and to have already injected substantial amounts into Fortis Bank Belgium in order to keep the bank afloat. Generally, although the Commission has little possibility to reduce the duration of the examination of merger control notifications, it may display some flexibility with respect to the scope of the information to be provided by merging parties, thus in effect lightening the notification burden on the parties. The scope of any waiver is of course dependent on the existence of significant overlaps in the parties' activities.

38. The flexibility introduced in relation to the implementation of EC competition rules reflects the Commission's willingness to "*react with the adequate responsiveness to the current situation*" and to "*ensur*[e] *that measures designed for financial stability can be implemented with legal certainty*".[135] Member States have both praised the Commission's reactivity and encouraged continuous flexibility in its action.[136] Obviously, this has put some strains on the Commission's resources, constraining Commissioner Kroes' cabinet members and competent services to work virtually 24/7. The situation is unlikely to improve in the coming months given the need to ensure the follow up of the various national rescue plans and restructuring measures adopted by Member States. However, it is the price to pay for the Commission to remain involved in the management of the financial crisis and, as noted, to ensure that the "European interest" is taken into account by Member States in dealing with the crisis.

Conclusion

39. The financial crisis, which is unprecedented in many respects, raises a myriad of issues, including in relation to the implementation of EC competition law. Few are truly novel but most carry a particular sensitivity given the circumstances. And this may be just a start. Spreading to the economy as a whole, the crisis is entering a Phase III that will involve economic stimulus packages likely to raise further issues under State aid law (and, possibly, under trade/WTO law),[137] while consolidations between/among banks and/or with other financial institutions may become a source of concerns under merger control rules. As is well known, times of crises are also fertile in collusive practices. So far, as noted, the crisis has not forced the Commission to bend the substance of the law: the enforcement of EC competition law has been largely consistent with established principles, which tends to demonstrate that those principles are sufficiently flexible in themselves to accommodate exceptional and country-specific circumstances or, in the words of Commissioner Kroes: "*sophisticated enough to cope with the differences and strong enough to cope with the difficulties*".[138] It is in relation to the implementation of those principles that the Commission has been the most flexible, and rightly so since such flexibility conditioned both the possibility and legitimacy of its involvement into the management of the crisis. ■

135 See, respectively, N. Kroes, "*Dealing with the current financial crisis*" (*op.cit.*, note 109 above) and Commission press-release IP/08/1453 of October 2, 2008 in "*State aid: Commission approves German rescue aid package for Hypo Real Estate Holding AG*".

136 See, *e.g.*, Conclusions of the Ecofin Council of October 7, 2008 (doc. 13930/08, Presse 284) and European Council of October 15 and 16, 2008, Presidency Conclusions (doc. 14368/08), §5.

137 See, in that respect, the Communication from the Commission – Temporary framework for State aid measures to support access to finance in the current financial and economic crisis, December 17, 2008. In that Communication, the Commission acknowledges the need for new temporary State aid as "*the full impact of the financial crisis on the real economy is now being felt*". The first aid scheme complying with that Communication was approved on December 30, 2008 (see Commission press-release IP/08/2063: "*State aid: Commission approves first real economy crisis measures*"). The Communication complements the European Economic Recovery Plan unveiled by the Commission on November 26, 2008.

138 N. Kroes, "*The role of State aid in tackling the financial & economic crisisState aid: Commission approves Latvian support scheme for banks*".

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Financial Crisis – Remedial Measures authorized pursuant to Article 87(3)(b) EC*

Member State	Guarantees	Recapitalization	Winding-up	Others
Austria	*N 557/2008*: the "Interbankmarktstärkungsgesetz" provides for the setting up of a Clearingbank aimed to collect funds with the view of guaranteeing up to €75 in new and existing wholesale debt.	*N 557/2008*: the "Finanzmarktstabilitätsgesetz" introduces various recapitalization measures such as State guarantees covering the value of certain assets, loans and recapitalizations for a total budget of €15 billion.		
Belgium	*N 574/2008*: State guarantee of Fortis' short and medium term wholesale debt for a period of six months (renewable upon Commission's approval). *NN 45/2008*: State guarantee of Dexia's newly issued short and medium term debt, valid until October 31, 2009.	*NN 42/2008, NN 46/2008 and NN 53/2008/A*: Capital injection in and liquidity assistance to Fortis between September 29 and October 5, 2008 (*i.e.*, prior to its sale to BNP Paribas), combined with the divestment of its Dutch operations. *N 602/2008*: €3.5 billion capital injection in KBC Group by means of the issuance of special securities qualifying as core Tier 1 capital.		
Denmark	*NN 51/2008*: The Financial Stability Act 2008 provides for guarantee arrangements covering existing deposits to supplement the Danish Deposit Guarantee Scheme. It excludes covered bonds and subordinated debt.	*NN 64/2008*: €225 million emergency liquidity assistance from the Swedish central bank converted into an emergency loan from the National Debt Office, which led subsequently to the nationalization of Carnegie Bank.	*NN 51/2008*: The Financial Stability Act sets up a winding up company vehicle owned and capitalized by the State. *NN 39/2008*: Liquidation of Roskilde Bank pursued by means of a takeover by the Danish central bank and the Danish banking association, which proceeded to the sale of branches and the redemption of all senior creditors of the bank (except for hybrid and subordinated loan capital).	

* For an up-dated version as of 21 January 2009, see Chronique Aides d'Etat, J. Derenne, *Concurrences* N° 1-2009.

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Financial Crisis – Remedial Measures authorized pursuant to Article 87(3)(b) EC

Member State	Guarantees	Recapitalization	Winding-up	Others
Finland	*N 567/2008*: State guarantee of new short and medium term debt (issued over a six months period, to be prolonged if necessary until December 31, 2009), valid for up to 36 months (five years for covered bonds) and capped at €50 billion.			
France	*N 548/2008*: Setting up of a public company (the "SRAEC" for "refinancing company for the activities of credit institutions") which will issue securities guaranteed by the State with a view to making loans up to €265 billion to credit institutions against collateral. *NN 45/2008*: State guarantee of Dexia's newly issued short and medium term debt, valid until October 31, 2009.	*N 618/2008*. Capital-injection scheme for "fundamentally sound" banks, capped at €21 billion, aimed to incentivize beneficiaries to continue financing the economy. The scheme provides for the purchase of newly issued subordinated debt securities classified as non-core Tier 1 capital, to be remunerated at an average 8% rate, by a State-owned investment vehicle. *NN 42/2008, NN 46/2008 and NN 53/2008/A*: Capital injection in and liquidity assistance to Fortis between September 29 and October 5, 2008 (*i.e.*, prior to its sale to BNP Paribas), combined with the divestment of its Dutch operations.		
Germany	*N 512/2008*: Financial Market Stabilization Act providing for a €400 billion state guarantee of new debt instruments (issued over a six months period, possibly prolonged until December 31, 2009) with a term of up to 36 months. *N 655/2008*: Guarantees provided by the Länders of Lower Saxony and Saxony-Anhalt for short and medium term debt issued by a special purpose vehicle to cover the medium-term refinancing needs of NordLB. *N 639/2008*: State guarantee of new short and medium term debt issued by IKB to cover its medium-term refinancing needs up to €5 billion.	*N 512/2008*: Financial Market Stabilization Act setting up an €80 billion stabilization fund for recapitalization and assets swap purposes (capped at €10 billion per individual institution), as modified (*N 625/2008*). *N 615/2008*: €10 billion capital injection into BayernLB by the state of Bavaria combined with a risk shield of €4.8 billion to cover part of the bank's assets-backed securities portfolio.		*N 661/2008 and N 668/2008*: reduced-interest rate loans up to €50 million for mid-size enterprises and direct aids up to €500,000 for firms in need.

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FINANCIAL CRISIS – REMEDIAL MEASURES AUTHORIZED PURSUANT TO ARTICLE 87(3)(B) EC

Member State	Guarantees	Recapitalization	Winding-up	Others
GREECE	*N 560/2008*: State guarantee of new short and medium term debt issued over a six months period starting November 19, 2008.	*N 560/2008*: Recapitalization scheme consisting in capital injections in exchange for preferential shares remunerated with a 10% interest.		*N 560/2008*: Securities scheme enabling credit institutions to borrow government bonds against collateral (and a fee) to enhance their access to liquidity, in particular with the European Central Bank.
IRELAND	*NN 48/2008*: The Credit Institutions Financial Support Act 2008 provides for guarantee arrangements covering retail and corporate deposits, interbank deposits, senior unsecured debt, asset covered securities and dated subordinated debt (lower tier 2), for a two-year period.	*NN 48/2008*: "Financial support", including the exchange of assets, is foreseen under the Credit Institutions Financial Support Act 2008		*NN 48/2008*: Loans are foreseen under the Credit Institutions Financial Support Act 2008.
ITALY	*N 520a/2008*: State guarantee: (i) of banks' newly issued short and medium term debt; and (ii) in favor of third-parties lending high-grade assets to banks to get refinancing from the European Central Bank.	*N 520a/2008*: Six-month renewable swap between banks' debt certificates and Treasury bills whose interest rate and maturity match perfectly (to ensure identical cash flow and straightforward pricing). *N 648/2008*: €15 to 20 billion committed to subscribe subordinated debt instruments qualifying as core Tier 1 capital		*N 520a/2008*: One-month €40 billion swap facility set up by the Italian central bank to allow a temporary exchange of governments bonds held by the central bank with financial instruments held by banks and rated at least BBB.
LATVIA	*NN 68/2008*: State guarantee of JSC Parex Banka's existing and newly issued debt. *N 638/2008*: State guarantee of a broad range of liabilities with a maximum maturity of three years, valid until June 23, 2009 and capped at 10% of Latvia's GDP			*NN 68/2008*: State loans to JSC Parex Banka with a maturity of three to five years.

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FINANCIAL CRISIS – REMEDIAL MEASURES AUTHORIZED PURSUANT TO ARTICLE 87(3)(B) EC

Member State	Guarantees	Recapitalization	Winding -up	Others
LUXEMBOURG	*NN 45/2008*: State guarantee of Dexia's newly issued short and medium term debt, valid until October 31, 2009.	*NN 42/2008, NN 46/2008 and NN 53/2008/A*: Capital injection in and liquidity assistance to Fortis between September 29 and October 5, 2008 (*i.e.*, prior to its sale to BNP Paribas), combined with the divestment of its Dutch operations.		
THE NETHERLANDS	*N 524/2008*: State guarantee covering newly issued senior unsecured debt instruments (commercial paper, commercial deposits and medium term notes) with a term of up to three years, valid until June 30, 2009 and capped at €200 billion	*N 528/2008*: €10 billion capital injection into ING against special securities qualifying as core Tier 1 capital. *N 569/2008*: €3 billion capital injection into Aegon (insurance group) by means of a loan to one of its main shareholders combined with a first right of pledge for the authorities. *N 611/2008*: €750 million capital injection into SNS REAAL by means of the issuance of special securities qualifying as core Tier 1 capital.		
PORTUGAL	*NN 60/2008*: State guarantee of newly issued short and medium term debt, valid until December 31, 2009 and capped at €20 billion.			
SLOVENIA	*N 531/2008*: State guarantee of newly issued short and medium term non-subordinated debt (*i.e.*, with maturity between 90 days and five years), valid until June 11, 2009 and capped at €12 billion.			
SPAIN	*NN 54/B/2008*: State guarantee of newly issued short and medium term debt (*i.e.*, with maturity between 3 months and 3 years), valid until June 23, 2009 and capped at €100 billion (initially).	*NN 54/2008*: Reverse auctions with a government-sponsored fund entitled to purchase only AA(A) rated covered bonds or asset backed securities (i) outright or (ii) on a temporary basis via Repo agreements.		
SWEDEN	*N 533/2008*: State guarantee of new short and medium term debt (issued over a six months period, to be prolonged if necessary until December 31, 2009), valid for up to 36 months and capped at €150 billion.			*N 533/2008*: Widening of the scope of accepted collateral by the Swedish Riskbank.
UK	*N 507/2008*: Wholesale Funding Guarantee Scheme – state guarantee of new short and medium term debt issuance (to be issued over a six month period), valid for up to 36 months.	*N 507/2008*: Bank Recapitalization Scheme – GBP 50 billion committed for the purchase of preference shares and the likes over a six month period, as modified (N 650/2008).		*N 507/2008*: Short-term Liquidity Measures – setting up of a GBP 200 billion Special Liquidity Scheme and extension of collateral range accepted for sterling and US dollar money market operations.

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Managing the Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of the Problem

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Managing the Financial Crisis in Europe: Why Competition Law is Part of the Solution, Not of the Problem

Damien Gerard*

EU Competition Commissioner Kroes likes using catchphrases to encapsulate policy statements. Since early October, one of her favorite lines is that competition law, and State aid law in particular, is part of the solution to the financial crisis, not part of the problem. Understand: competition rules do not stand in the way of a solution to the crisis, they are part of that solution.[1] She used it for the first time on October 2 when announcing the approval of a Euro 35 billion aid package laid down by Germany to rescue Hypo Real Estate Holding AG, a German bank holding that became troubled as a result of its involvement in the national and international mortgage business and its short-term refinancing strategy.[2] She repeated it on October 6 in an address to the Economic and Monetary Affairs Committee of the European Parliament outlining her enforcement priorities in the framework of the financial crisis.[3] She resorted to it again on December 2

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[1]N. Kroes, "*Competition policy and the financial/banking crisis: taking action*", open letter available at http://ec.europa.eu/commission_barroso/kroes/financial_crisis_en.html.

[2]Commission press-release IP/08/1453 of October 2, 2008: "*State aid: Commission approves German rescue aid package for Hypo Real Estate Holding AG*".

[3]N. Kroes, "*Dealing with the current financial crisis*", address to the Economic and Monetary Affairs Committee, European Parliament, Brussels, October 6, 2008.

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to defend her record in front of the 27 EU Economics and Finance Ministers,[4] some of them clearly upset at the Commission's active involvement in the design of general financial recovery plans and individual rescue measures.

Indeed, within the European Union, economic and financial policy remains first and foremost a competence belonging to each of the 27 Member States; there is nothing like an EU Treasury, a centralized EU economic policy institution, or a common EU financial services regulator. Some economic coordination takes place at the EU level, though, notably in the framework of the so-called "Stability and Growth Pact," but it is driven by Member States' representatives seating in the Economic and Financial Affairs Council (ECOFIN). As a result, in mid-September, when the crisis spread to the whole financial system following the bankruptcy filing of Lehman Brothers, thus affecting credit institutions across Europe, Member States remained in front to devise urgent recovery measures. It was at the ECOFIN meeting of October 7 that Member States came together to devise common principles to guide their respective reactions to the crisis.[5] Those principles were turned into a concerted action plan on October 10 by the Eurogroup, (a meeting of those EU countries that share the Euro as currency), which was then endorsed by the European Council of October 15, 2008.[6]

Originally, in the design of a coordinated effort to contain the financial crisis, the Commission appeared to be largely only a witness to the Member States' initiatives,

[4]Commission press-release MEMO/08/757 of December 2, 2008: "*State aid: Commissioner Kroes briefs Economic and Finance Ministers on financial crisis measures*".

[5]Conclusions of the ECOFIN Council held in Luxembourg on October 7, 2008 (Doc. 13784/08).

[6]"*Declaration on a concerted European action plan of the euro area countries*", October 10, 2008, available at www.ue2008.fr; European Council of Oc*to*ber 15 and 16, 2008, Presidency Conclusions (doc. 14368/08).

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under the leadership of the French Presidency. However, in parallel, it was also taking steps to preserve the possibility of playing its own role in managing the crisis, notably to ensure compliance of Member States' measures with EU single-market principles. The European Council's support for the continued implementation of EC competition rules in spite of the exceptional circumstances, including "the principles of the single market and the system of State aids,"[7] combined with a lack of resources at ECOFIN's level to monitor Member States' adherence to the concerted action plan, in effect enabled the Commission to play a critical role in the design of the general recovery plans and individual rescue measures envisaged by various Member States. Eventually, the circumstances led to the emergence of State aid rules as a conduit for "positive" economic policy coordination rather than solely for "negative" control of compliance with the EC Treaty. Some Member States consider such *de facto* evolution as undue encroachment on their competences while the Commission finds its action legitimized by the magnitude of the amounts at stake and the associated potential for competition distortive effects due, notably, to the massive flow of money to banks benefiting from State backing and the disparity in Member States' resources to address the challenges posed by the crisis.[8]

This paper describes three factors that contributed to shaping the role played so far by the Commission, in its capacity as antitrust enforcement authority, in the

[7]European Council of October 15 and 16, 2008, Presidency Conclusions (doc. 14368/08), ¶5.

[8]See, *e.g.*, the inflow in customers and deposits that followed the nationalization of UK bank Northern Rock, just weeks after it suffered from an impressive bank run in September 2007, which signaled the contamination of Europe by the subprime crisis.

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management of the financial crisis in Europe and, hence, the contribution of EC competition law to a solution of the crisis, as advocated by Commissioner Kroes.

I. PROVIDING LEGAL CERTAINTY TO ECONOMIC OPERATORS

Since the subprime crisis hit Europe around mid-September 2007 and even more so a year later when it spread to the whole financial system, the primary concern of the Commission has been to ensure the compatible implementation of EC competition law with the need for legal certainty on the part of economic operators. In other words, the Commission endeavored to react with adequate responsiveness to the crisis situation by taking actions necessary to reassure markets that rescue measures envisaged by Member States were "not going to be jeopardized by EU rules."[9] To appreciate the Commission's efforts in that respect, it is useful to introduce some chronological points of reference. Indeed, two phases can be distinguished in the financial crisis so far:[10]

- a Phase I period corresponding to the "subprime crisis," which lasted from mid-September 2007 and the bank run on Northern Rock to mid-September 2008 and the Chapter 11 bankruptcy filing of Lehman Brothers. Over that period, the Commission authorized six individual rescue packages, pursuant to established rules on subsidies for firms in difficulty,[11] in favor of banks largely exposed to the

[9]N. Kroes, "*Dealing with the current financial crisis*", cited above, note 3.

[10]Note that a third phase is now emerging following the contamination of the crisis to the real economy. An important concern is now the need to keep a stable flow of credit to the economy, which may require providing capital incentives to fundamentally sound banks while avoiding abuses in the use of public funding. The Commission has addressed that issue in a new communication of December 5, 2008: *Communication from the Commission - The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*, C(2008) 8259 final.

[11]Communication from the Commission—Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, *O.J.*, 2004, C 244/2.

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U.S. subprime crisis and/or heavily dependent on mortgage securitization to meet their refinancing needs. At the time, the Commission viewed those issues essentially as “individual problems” requiring “tailor-made remedies."[12]

- a Phase II period that started in mid-September 2008 with the general crisis of confidence and unprecedented freeze in interbank lending that followed the bankruptcy filing of Lehman Brothers. At that point, the crisis took a systemic turn and started affecting “even fundamentally sound financial institutions,"[13] a situation that prompted the Commission to recognize the likelihood of bank failures leading to “a serious disturbance in the economy of [Member States]." As a result, the Commission resorted to a rarely-used and more lenient provision to authorize national recovery plans and individual rescue measures,[14] namely Article 87(3)(b) of the EC Treaty (“EC”).[15]

[12]Commission Decision of December 5, 5007 in Case NN 70/2007 (ex. CP 269/07) – *United Kingdom Rescue aid to Northern Rock*, C(2007) 6127 final; Commission Decision of April 30, 2008 in Case NN 25/2008 (ex. CP 15/08)—*WestLB riskshield, Germany*, C(2008)1628 final; Commission Decision of June 4, 2008 in Case C 9/2008 (ex. NN 8/2008, CP 244/2007)—*Sachsen LB, Germany*, C(2008)2269 final; Commission Decision of July 31, 2008 in Case NN 36/20085—*Denmark/Roskilde Bank A/S*, C(2008)4138; Commission Decision of October 1, 2008 in Case NN 41/2008—UK/Bradford & Bingley (no decision available, see press-release IP/08/1437: “*State aid: Commission approves UK rescue aid package for Bradford & Bingley*”); Commission decision of October 2, 2008 in Case NN 44/2008—*Germany/Hypo Real Estate Holding AG* (decision available only in German, see press-release IP/08/1453: “*State aid: Commission approves German rescue aid package for Hypo Real Estate Holding AG*”).

[13]See, *e.g.*, Commission Decision of October 10, 2008 in Case NN 51/2008 – *Denmark/Guarantee scheme for banks in Denmark*, C(2008)6034, ¶40 and Commission Decision of October 13, 2008 in Case N 507/2008—*UK/Financial support measures to the banking industry in the UK*, C(2008)6058, ¶44.

[14]For a comprehensive list of the decisions adopted since October 2008 pursuant to Article 87(3)(b) EC, see http://ec.europa.eu/competition/sectors/financial_services/financial_crisis_news_en.html.

[15]In a nutshell, Article 87(3)(b) EC, compared to State Aid rules for rescuing and restructuring firms in difficulty adopted pursuant to Article 87(3)(c) EC, offers additional flexibility as to the nature of acceptable aids (*e.g.*, structural interventions), the duration thereof (*i.e.*, going beyond 6 months) and, particularly, the absence of structural compensatory measures.

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Legal certainty is conditional upon: (i) clarity in the applicable legal framework and (ii) rapidity of action. The Commission has been particularly keen on acting swiftly in the framework of the financial crisis, undoubtedly well aware that, absent drastic measures to speed up the State aid review process, in particular, it would have been quickly sidelined by Member States. Already during the Phase I period, the Commission significantly shortened the decision-making process leading to the authorization of rescue packages involving State aids.[16] Since a prohibition of such rescue measures was not an option given the circumstances, the Commission also became involved early on in the design of those measures to make them State aid law compatible. Likewise, during that somewhat less pressing period, the Commission was able to gain experience and to "test and improve [its] ability to meet the urgent demands that face banks in […] crisis situations."[17]

In turn, when the crisis entered the Phase II period, while remaining involved in the design of financial recovery plans, the Commission was able to take further actions to accommodate the increased need for speedy and definitive action. Thus, on October 1, in a move that is rather uncommon as far as the adoption of final decisions in the area of competition law enforcement is concerned, the College of Commissioners decided to empower Commissioner Kroes, in agreement with President Barroso and Commissioners Almunia (Economic and Monetary Affairs) and McCreevy (Internal Market), with the

[16]See, *e.g.*, Case NN 70/2007—*UK/Northern Rock*, decided on December 5, 2007 following a notification filed on November 26, 2007 but with background information already provided to the Commission on September 28 and October 14, 2007.

[17]N. Kroes, "*Dealing with the current financial crisis*", cited above, note 3.

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responsibility to authorize so-called "emergency rescue measures."[18] The empowerment, valid for three months, is expressly designed to allow the Commission to take decisions "if necessary within hours" and "at any moment in time in particular over the weekend, during the evening or at night and also on bank holidays" in order to "positively contribute to the resolution of the current crisis."[19] As a result, the Commission was able, for example, within 24 hours to decide on the compatibility with State aid principles of the measures designed to ensure the orderly winding down of U.K,-based Bradford & Bingley.[20] Over the 8 week period following the empowerment, more than 20 positive State aid decisions were adopted.

In the area of merger control, the Commission also announced its readiness to grant acquirers of ailing banks derogations to the standstill obligation enshrined in Article 7 of the European merger control regulation ("ECMR") "where there is urgency and where there are no 'a priori' competition concerns."[21] In effect, such derogation enables the immediate implementation of transactions (or elements of any transactions) that are part of rescue operations, pending merger control clearance; *e.g.*, to enable acquirers to

[18]Minutes of the 1845th meeting of the Commission, October 1, 2008, PV(2008) 1845 final, ¶10.4; Communication from the President in agreement with Ms Kroes—Temporary empowerment, SEC(2008) 2575/2. The authorization of "e*mergency rescue measures*" includes: (i) decisions finding that rescue measure does not constitute aid pursuant to Article 4(2) of Regulation 659/1999; (ii) decisions not to raise objections against a notified aid pursuant to Article 4(3) of Regulation 659/1999; and (iii) decisions not to raise objections against a non notified (so-called "unlawful") aid pursuant to Articles 13(1) and 4(3) of Regulation 659/1999.

[19]Communication from the President in agreement with Ms Kroes—Temporary empowerment, SEC(2008) 2575/2.

[20]Commission press-release IP/08/1437 of October 1, 2008: "*State aid: Commission approves UK rescue aid package for Bradford & Bingley*".

[21]N. Kroes, "*Dealing with the current financial crisis*", cited above, note 3.

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monitor the nature and structure of the target's risks portfolio and take appropriate measures to protect the value of certain assets.

II. ACTING AS A STABILIZING FORCE THROUGHOUT THE CRISIS

As noted, legal certainty is also conditional upon clarity and stability in the applicable legal framework. So far, the Commission has resisted calls to show greater flexibility in the interpretation of EC competition law principles in view of the conditions created by the financial crisis. Rather, it has endeavored to demonstrate that, contrary to what some Member States like to pretend, the current legal framework is flexible enough to accommodate exceptional and country-specific circumstances.

With respect to State aid law enforcement, the Commission consistently refused to authorize rescue measures pursuant to Article 87(3)(b) EC during the Phase I period, standing by the principle that such justification

> "needs to be applied restrictively so that aid cannot be benefiting only one company or one sector but must tackle a disturbance in the entire economy of a Member State".[22]

Instead, taking the view that the solvability issues faced by banks embroiled in the subprime crisis were not systemic in nature, the Commission followed the established methodology and conditions set forth in its guidelines for rescuing and restructuring firms in difficulty, including those rules specifically designed for the banking sector.[23] Later on, however, when the crisis spread to the whole financial system as a result of the freeze in interbank lending, *i.e.*, since the start of the Phase II period, the Commission

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[22] See, *e.g.*, *WestLB riskshield/Germany* case, ¶41; *Sachsen LB*, ¶94. See also Joined Cases T-132 and 143/96, *Freistaat Sachsen and Volkswagen AG/Commission* [1999] ECR II-3663, ¶167.

[23] Communication from the Commission – Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty, cited above, note 11, in particular ¶24(a), footnote 3.

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acknowledged that the change in the nature of the crisis and the magnitude of the potential consequences thereof permitted action on the basis of Article 87(3)(b) EC. Since that provision is rarely used,[24] there was no established practice as to the conditions regulating the compatibility of aid granted under that provision. Given the urgent need for clarity, though, the Commission issued on October 13 (at the same time as the announcement of the concerted action plan) detailed guidelines on the application of that provision to recapitalization and guarantee schemes aimed to contain the financial crisis.[25]

In the merger control area, Commissioner Kroes also indicated her willingness "to continue applying existing rules," including "where applicable, the failing firm defense."[26] The merger control activity of the Commission in direct relation with the financial crisis is still limited, though, and no instance of reliance on the failing firm theory has been reported yet. However, that commitment to abide by existing merger control principles, even if designed for exceptional circumstances, stands in sharp contrast with the rather pragmatic approach adopted by some Member States, most notably the United Kingdom. Facing the prospect of the government-engineered acquisition of HBOS by Lloyds creating a so-called "relevant merger situation" warranting further inquiry by the U.K. Competition Commission, the U.K. government

[24]C. Quigley and A. M. Collins, in their leading treatise on EC State aid law (Hart, Oxford, 2003) refer to aid granted by several Member States in the mid-1970s to protect employment during recession and to the privatization of hundreds of Greek firms and public-sector banks as part of a national economic recovery plan in the early 1990s (p.86).

[25]Communication from the Commission—The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, *O.J.*, 2008, C 270/2.

[26]N. Kroes, "*Dealing with the current financial crisis*", cited above, note 3.

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introduced a bill providing for the "stability of the UK financial system" to justify, along with national security, an exception to the referral of relevant merger situations to the Competition Commission. The bill was turned into law,[27] becoming effective on October 24. On October 31 the Secretary of State for Business took the decision not to refer the Lloyds/HBOS transaction to the Competition Commission.[28]

III. PREVENTING NEGATIVE SPILL-OVER EFFECTS FROM MEMBER STATES' FINANCIAL RECOVERY PLANS AND INDIVIDUAL RESCUE MEASURES

Beyond legal certainty and stability, enforcing EC competition law and, in particular, State aid rules, has also enabled the Commission to make a more substantive contribution to the management of the crisis; to "maintain a level playing field and to make sure that national measures would not simply export problems to other Member States."[29] In a nutshell, the concern is to prevent unfair competition among banks and avoid a subsidy race among Member States by promoting compliance with general EU single market principles, notably those of non-discrimination and proportionality. Achieving those objectives necessarily requires coordination among the various and tremendously diverse national approaches to solving the crisis, a role that the

[27] See "The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008", available at http://www.opsi.gov.uk/si/si2008/uksi_20082645_en_1#f00001 (last visited on December 1, 2008).

[28] Decision by Lord Mandelson, the Secretary of State for Business, not to refer to the Competition Commission the merger between Lloyds TSB Group plc and HBOS plc under Section 45 of the Enterprise Act 2002, October 31, 2008 (available at http://www.berr.gov.uk/files/file48745.pdf, last checked on December 1, 2008). The decision has been appealed by a group of account holders, bank employees, and business people calling themselves the "Merger Action Group" (see the submission available at http://www.mergeractiongroup.org.uk/, last visited December 2, 2008).

[29] Commission press-release MEMO/08/757 of December 2, 2008: *State aid: Commissioner Kroes briefs Economic and Finance Ministers on financial crisis measures*.

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Commission was the only entity entitled to endorse and that was bound to be unpopular. Practically, the Commission has done so by attaching conditions to the authorization of financial recovery plans and individual rescue measures pursuant to Article 87(3)(b) EC.

First of all, to be held compatible with that provision, general recovery plans adopted in the framework of the financial crisis must contain objective and therefore non-discriminatory eligibility criteria.[30] Guarantee and recapitalization plans, in particular, must be open to all credit institutions with systemic relevance to the economy of the relevant Member States, regardless of their origin, *i.e.*, including subsidiaries and branches of banks headquartered abroad. Second, the Commission has insisted that State guarantees be granted with adequate remuneration from individual financial institutions and/or the financial sector as a whole; fees being set according to the degree of risk and the beneficiaries' respective credit profiles and needs.[31] Likewise, capital injections must be provided against properly valued and remunerated securities,[32] ideally carrying corresponding rights. Third and most important, guarantee and recapitalization schemes must be tied to duly monitored behavioral constraints preventing aggressive commercial conduct on the part of beneficiaries, *e.g.*, by introducing GDP-related, market share, or

[30]Communication from the Commission—The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, cited above, note 25, ¶16. Compliance with that criterion was at the core of discussions between the Commission and Ireland during the review of the general guarantee scheme for banks in Ireland (Commission Decision of October 13, 2008 in Case NN 48/2008—*Ireland/Guarantee scheme for banks in Ireland*, C(2008)6059).

[31]Generally, fees are based on market benchmarks comprising various elements including a measure of institution-specific risk and a fixed mark-up designed to compensate the State. In that respect, the European Central Bank issued on October 20, 2008 *Recommendations on government guarantees on bank debt*, which have, since then, often been referred to by Member States.

[32]The level of remuneration payable to the State was at the core of discussions between the Commission and the French government in relation to a capital-injection scheme for banks designed to stabilize financial markets and incentivize French banks to increase lending to the real economy (see Commission press-release IP/08/1900 of December 8, 2008: *State aid: Commission authorizes French scheme to inject capital into certain banks*).

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balance sheet growth ceilings,[33] potentially combined with other safeguards aimed to address more diffuse moral hazard issues.[34]

IV. CONCLUSION

The financial crisis poses a myriad of challenges to public authorities around the world, including to those in charge of competition law enforcement. In the EU, the rules on State aids have enabled the Commission to become involved in the design of the various financial recovery plans and individual rescue measures adopted at national levels and, as a result, to play an important role so far in the management of the crisis. Given the circumstances, that role has virtually become one of economic policy coordination even though economic and financial policy is primarily a competence belonging to Member States. Eventually, it may be only one among various institutional implications for the EU that could arise from the crisis. To fulfill its task, the Commission has taken decisive actions to ensure legal certainty for economic operators confronted by the crisis by improving its responsiveness and ability to adopt decisions swiftly, on the one hand, and by ensuring clarity and stability in the applicable legal

[33] Communication from the Commission—The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, cited above, note 25, ¶¶26-27.

[34] The U.K. Bank Recapitalization Scheme imposes, among other items, that no cash bonuses be paid to Directors for the current year's performance, appointing new independent directors, making commitments to maintain the availability and active marketing of competitively priced lending to homeowners and to small business, and supporting schemes to help people struggling with mortgage payments to stay in their homes (UK, ¶12). The German scheme includes similar behavioral constraints (*e.g.*, with respect to executives' remuneration and bonuses) and conditions the distribution of dividends to shareholders with the sale of the Recapitalization Fund's shares to a third party or the repurchase thereof (Commission Decision of October 27, 2008 in Case N 512/2008—Germany*/Rescue package for credit institutions in Germany*, C(2008) 6422, ¶¶14 and 57). The French capital-injection scheme also requires beneficiary banks to adopt measures concerning the remuneration of senior management and market operators (including traders) and limiting severance packages for executives (see Commission press-release IP/08/1900 of December 8, 2008: *State aid: Commission authorizes French scheme to inject capital into certain banks*).

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framework, on the other hand. More fundamentally, it has attempted to demonstrate the resilience of EC competition law principles and in particular of the State aid policy, *i.e.*, its ability to combine the protection of competition with the pursuit of other important economic policy objectives. So far, so good, but a long road lies ahead.

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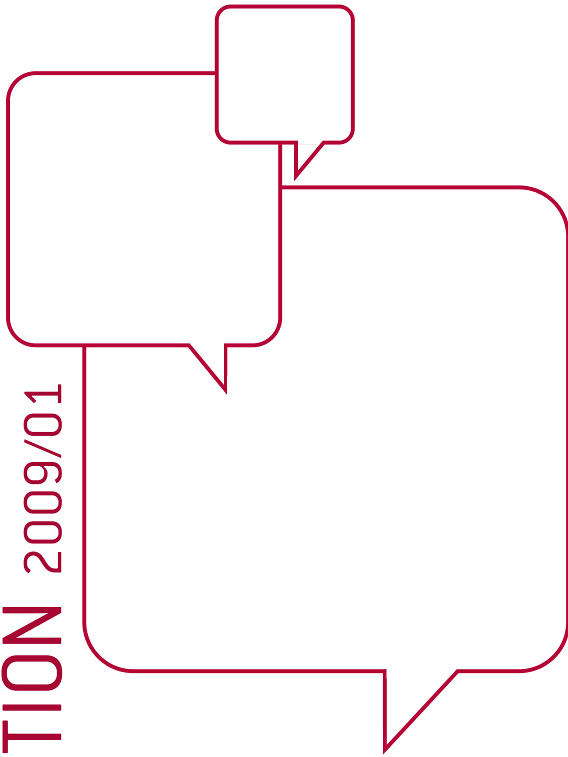

FEBRUARY 2009

RATING AGENCIES: AN INFORMATION PRIVILEGE WHOSE TIME HAS PASSED

Briefing paper for the European Parliament's ECON Committee

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bruegel

Rating agencies: an information privilege whose time has passed

Nicolas Véron[1]

January 2009

EXECUTIVE SUMMARY

The European Union's response to the financial crisis as regards credit ratings and rating agencies should be grounded in a proper identification of the underlying problem. These agencies make an easy target for scapegoating, even if their responsibility is smaller than that of some other market participants. That said, **rating agencies have failed the marketplace** in the run-up to the crisis, as their risk assessment processes have been found wanting on a number of counts. However, it is **not clear that conflicts of interests have been the root cause** of this serious failure, even if such conflicts may have existed. Thus, legislation eliminating conflicts of interests (supposing such a thing were possible) would probably not address what really went wrong, and may in addition have harmful unintended consequences. This is a complex policy issue for which there exists **no simple, quick fix**.

Fair competition in financial risk assessment services

The real problem, running deeper than the possibility of conflicts of interests, is that **our system of financial risk assessment is broken**. Investors, regulators and other market participants now realise that the information basis on which they have been used to considering financial risk, consisting in large part of credit ratings, has been insufficient and, to a certain extent, distorting. What we need are whole **new forms of intermediation of the information about financial risk**. However, while the need for new types of financial risk assessment services is increasingly obvious, it is not yet clear what exactly they will be. Public policy should maximise the chances of such new services emerging quickly through **fair competition among risk assessment firms**, rating agencies or otherwise, an environment where rating agencies will not necessarily prevail and in which they should not be given any unfair advantage in view of their recent failings. One crucial aspect is that **rating agencies should no longer be granted the information privilege** they currently enjoy compared with other market participants whose business is partly or mainly to assess financial risk.

Avoid unintended consequences

Beyond this crucial point and in view of existing proposals, the European Union should be mindful of the *'primum non nocere'* principle and make sure that its legislative initiatives do not make the situation worse than it currently is. This principally applies to three dimensions:

- The new legislation should not result in **decreased competition** on the market for credit ratings, entrenching of the current oligopoly and raising barriers to new entrants.
- The new legislation should not result in **reduced independence** of the rating agencies, through mechanisms that would allow political authorities to exert direct or indirect discretionary pressure on agencies to modify their ratings.
- The new legislation should not result in **fragmentation of the global and European financial space**, at the risk of making all economic actors poorer. The openness of the financial system is a global public good whose integrity is not guaranteed in the current environment, and which policymakers must strive to preserve.

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1 A BROKEN SYSTEM OF FINANCIAL RISK REPORTING

Rating agencies have played a central role in the way financial risk has been assessed by market participants in the recent past. However, a combination of flawed use of ratings and shortcomings in the ratings themselves has led to a situation in which our system of financial risk assessment is unsuited to the needs of the marketplace.

The central role of rating agencies

For corporate and state issuers, much information about financial risk is in the public domain, including for listed corporate issuers in the disclosure notes to audited financial statements. Public information helps market participants form opinions about financial risk. However, a number of factors have conspired to give credit ratings a central role in the formation of judgments about risk, including that:

- Rating agencies play a useful role in mutualising the effort to analyse information, a costly process that most participants, even those who have their own credit research teams, cannot afford individually;
- Rating agencies have a unique historical perspective, experience, and proprietary databases of past credit behaviour of a large number of issuers;
- Rating agencies have access to some non-public information, typically on business prospects and financial planning in the case of corporate ratings, and on underlying assets in the case of asset-backed securities;
- Rating agencies are granted reference status both by widespread market practice and by public regulation, including (but not only) by the Basel 2 framework for banking supervision.

'The rating business has developed into a natural oligopoly'

The centrality of rating agencies to market participants' financial risk assessment helps explain both the high degree of concentration of the market for rating services, and the observed high level of profitability of the three leading agencies. Moody's, the only large rating agency to be a stand-alone listed company, achieved the highest profit margins of all the companies in the S&P500 index for five years running in the early 2000s[2]. In part because market participants display an apparent preference for the simplicity of having to analyse only a limited number of ratings, the rating business has developed into a 'natural oligopoly': new entrants have tended either to be absorbed by one of the three most established firms, or to remain relatively marginal or specialised players. The author is not aware of any evidence of anti-competitive behaviour by the leading rating agencies to prevent new entrants from penetrating their market.

Rating agencies have come under repeated criticism, either for their delay in modifying ratings in view of market developments, or for the abruptness of unexpected downgrades. A stream of academic studies suggests that ratings have little or no informational value added compared to market signals[3], and some observers have suggested that market indicators could advantageously replace the agencies' rating. However, there seems to be a strong consensus among market participants that rating agencies, for all their failings, serve a useful purpose.

Misjudgments by investors and regulators

The current crisis has exposed a number of misjudgments and policy mistakes made by a variety of market participants as regards credit ratings, including flawed investment policies and the creation of perverse incentives.

Until August 2007, many participants in capital markets operated on the implicit understanding that credit ratings could provide the basis for their assessment of financial risk. Many investors, especially in fixed-income securities, made investment decisions mainly, even in certain cases solely, on the basis of the credit rating of the corresponding instruments. Such investment behaviour was plainly misguided. The distribution of risk is not identical for all issuers or securities, and this should have an impact on investment strategies beyond the mere consideration of a probability of default.

Beyond investors, a variety of market participants, both public and private, have assigned ratings a key role. Especially prudential regulators have automatically linked certain capital calculations under the Basel 2 framework for banking supervision to the credit rating of the corresponding instruments. Prudential rules have restricted the investment options of regulated players, including financial firms or investment funds, on the basis of credit ratings. In the private sector, some investment vehicles have similarly been restricted by contract to invest only in certain instruments on the basis of ratings, and rating 'triggers' have been inserted into loan agreements, thus ensuring that rating changes would automatically bear economic consequences.

2. Sam Jones, 'How Moody's faltered', *Financial Times / FT Weekend*, 17 October 2008.
3. See Richard Levich, Giovanni Majnoni and Carmen Reinhart (eds.), *Ratings, Rating Agencies and the Global Financial System*, Kluwer, 2002.

With hindsight, it seems odd that such an important role has been assigned to what the rating agencies themselves generally present as mere opinions, provided by firms which do not bear any significant liability for their misjudgments (although the jurisprudence is still underdeveloped, and situations may vary from one jurisdiction to another on this count). An obvious comparison is the media, which also expresses opinions on the assessment of a wide range of risks, including financial ones, and is subject to the same freedom and liability regime as rating agencies. While the media plays an important role in financial markets, no one would consider advocating that regulations or contractual clauses, such as those mentioned above, be based on the content of newspapers' editorials.

'Public policy should aim to close the risk information gap'

Rating agencies have failed the marketplace

However, some failings revealed by the current crisis are attributable to the rating agencies themselves. Specifically, they have failed to assess correctly the risk associated with a wide range of structured products backed by real-estate assets, most notoriously subprime mortgages in the US. The downgrading of a number of such products, which started too late in July 2007[4], was a key trigger of the beginning of the crisis when, as a consequence, 'investors lost confidence in the ratings of a wider range of structured assets'[5].

Unlike with equity analysts at the time of the internet bubble, no clear evidence has surfaced at this stage of conduct by the rating agencies that could unambiguously be characterised as a material breach of existing laws or regulations. However, there is increasing evidence of the agencies having been overstretched during the securitisation boom of the mid-2000s. Probably the clearest evidence so far is the report published on 8 July 2008 by the US Securities and Exchange Commission (SEC). A typical statement quoted in this report from an email sent in February 2007 by a senior analytical manager at one of the leading rating agencies states: 'We do not have the resources to support what we are doing now'[6]. This is particularly damning as the subprime segment, in contrast to other segments of the US real-estate market, did not rely on long historical data series, with the consequence that the in-depth analysis of each transaction and of the broader economic context should have been given especially high priority. Indeed, when the subprime downturn materialised in 2007, it was more abrupt, and revealed a different pattern of correlations from earlier housing downturns.

The picture that emerges is one in which the rating agencies were ready to compromise the quality of their processes in order to grab or defend market share in a booming environment, with the volumes and complexity of securitisation sharply on the rise in the years to 2007. Diligence has been deficient both at a 'micro' level, with not enough in-depth analysis of the assets underlying specific securities and/or the related risks, and at the 'macro' level. On the latter point specifically, insufficient market research (or insufficient attention given to it) could be one of the reasons for the agencies' failure to anticipate the major downturn in the US housing market in time and to revise their risk assessments accordingly.

The agencies' desire to maintain their high profitability levels may have played a role in these failings, which could otherwise have been at least partly addressed by adequate recruitment.

Conflicts of interest in the rating agencies' relationships with their clients may have aggravated the situation. Structured products inherently present more scope for such conflicts than traditional corporate ratings, in part because of the relatively small number of securitisation arrangers, mainly leading investment banks, compared to the relatively large number of rated corporates, which means that rating agencies are not crucially dependent on any individual corporate client. However, available evidence suggests that agencies may have failed even in cases where such conflicts were absent or immaterial.

This underallocation of resources and lack of sufficient market analysis is most obvious in the rating of subprime securities and a range of other structured products, mainly in the US. In contrast, rating processes appear to have remained of high quality in many mature segments, including prime residential mortgage-backed securities and other asset-backed securities. However, with hindsight the failings in relation to subprime and other products have had at least an indirect effect on the reliability of other ratings as well, most obviously those of financial firms which were negatively impacted by subprime-related downgrades. AIG, Fannie Mae and Freddie Mac were given a high 'triple A' rating by the leading agencies until a fairly short period before their downfall.

It is difficult to assess how existing regulatory regimes

4. Gretchen Morgenson, 'Debt Watchdogs: Tamed or Caught Napping?', *The New York Times*, 7 December 2008.
5. Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience', 7 April 2008.
6. US Securities and Exchange Commission, 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies', July 2008.

have influenced the extent of the shortcomings in rating processes. Structured products are significantly more developed in the US than in Europe, in terms of both volume and complexity. It is therefore unsurprising that most problematic evidence comes from the US, which does not necessarily mean that rating practice in Europe has generally met higher standards.

One can also observe that the fact that ratings in the US have been subject to a formal regulatory regime since 1975, strengthened by the Credit Rating Agency Reform Act of 2006, while no comparable regulation yet exists in Europe, does not appear to have made a material difference. Admittedly, implementation of the Credit Rating Agency Reform Act was too recent at the time the crisis erupted for a full impact assessment of that legislation.

The current financial risk assessment system is insufficient

The failings of the leading rating agencies leave the marketplace in a quandary. While it is easy to see that ratings have gained too much importance and trust in the last few years, it is not easy at all to see what might now take their place. Market measures of some risks, such as those provided by the price of credit-default swaps, have developed significantly over the past decade. But they are inherently very volatile, subject to market manipulation, and not necessarily available for all rated instruments. Thus, in spite of their usefulness, they do not fulfil the marketplace's need for financial risk information and analysis.

Financial risk information is inherently multidimensional, difficult to standardise and hard to analyse. Financial statements and accounting have historically been developed chiefly to serve the information needs of shareholders, who are also accorded privileged status in the conceptual framework that currently underlies the setting of International Financial Reporting Standards (IFRS)[7]. While an ongoing discussion to amend this framework would place creditors alongside shareholders as primary constituents of IFRS standards-setting, it is likely that financial statements and their disclosure notes will remain an inadequate source of information for some aspects of financial risk assessment in the foreseeable future.

'A diversity of opinions will always serve the marketplace better'

In any case, current levels of risk disclosure can hardly be considered satisfactory. A study by the Securities Industry and Financial Markets Association (SIFMA) indicates that 'enhanced disclosure and standardisation of information' comes first among the concerns of polled market participants[8].

Moreover, disclosure is not the only, or perhaps even the main, aspect of a discussion about the requirements of financial risk assessment. Analysing the available information can take considerable time and resources, which, as mentioned, is one of the reasons for credit rating agencies' historic success. The current realisation that credit ratings do not carry sufficient informational content to guide investment decisions, and that they are not as reliable as had been widely assumed before, creates a demand for new forms of financial risk assessment, a 'risk information gap' which is not currently being plugged. This gap is made larger by financial innovation and is especially acute for new, comparatively untested market segments for which no long historical data series exist, as was the case with the subprime housing market.

2 HOW TO FIX IT: FAVOUR THE EMERGENCE OF NEW FINANCIAL RISK ASSESSMENT SERVICES

In order to ensure the proper functioning of credit markets, and especially of markets for fixed-income securities, public policy should aim to close the 'risk information gap' identified in the previous section.

A comparable information gap was bridged exactly a century ago, in 1909, when the first credit ratings were published in New York. This was a period of tremendous regulatory upheaval (the US Federal Reserve system was created by legislation passed in 1913, following a major banking crisis in 1907), but the response came at the time through the entrepreneurial initiative of John Moody, a financial journalist by background, whose name one of the leading rating agencies still carries.

Today's challenge is similar. Decentralised innovation is more likely than regulatory initiatives to invent the new forms of information intermediation that are needed to overcome the shortcomings of credit ratings. In other words, we need a John Moody for the twenty-first century, and she is more likely to be a private entrepreneur than a

7. International Accounting Standards Board, Framework for the Preparation and Presentation of Financial Statements, 1989. Freely downloadable in European Commission, 'Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting', November 2003.
8. SIFMA/ESF/ASF/AusSF report, 'Restoring Confidence in the Securitisation Markets', December 2008.

public official. As economists David Smick and Adam Posen put it, 'no one suggests that a central institution would definitely tell one the worth of a stock, especially under changing circumstances. So why should that be true for a fixed-income security? [...] Our financial system is a highly adaptable organism forever evolving. Disenfranchise the ratings dinosaurs and the broader system will produce a myriad of small, more agile, more inventive private risk assessment investor services'[9].

The same argument goes against the idea suggested by some of transforming the rating agencies into a public monopoly. While there should be no objection to state-controlled rating agencies competing for financial risk assessment services (in compliance with the EU competition policy, which does not discriminate against state-controlled entities), introducing a monopoly, public or otherwise, would be counterproductive. Ratings are opinions about risks, and a diversity of opinions will always serve the marketplace better than one single source. Some commentators have used an analogy with public agencies that vet the safety of foods or drugs[10]; but if such an analogy is to be pursued, it is about the regulation of financial products, which is a different matter from their credit rating.

Among new risk assessment business propositions that may emerge or expand in the next few years, some may focus on the risk of default, as do credit rating agencies, and others on other dimensions of risk; some may make their assessments public, others may reserve them for their clients or, in the case of buy-side credit research, for proprietary investment purposes; some may be paid by investors, others by issuers, or by other market participants.

Rather than trying to impose a single model for the assessment of intrinsically multidimensional financial risk, public policy should mandate and enforce an adequate level and quality of disclosure, which is something only public authorities can do. Moreover, public policy should be designed to ensure that the rating agencies' current dominant position in the market for financial risk assessment does not prevent new and better risk assessment service providers from emerging through fair competition.

In practical terms, this means at least two things: fair competition among risk assessment methods; and equal access to information. The first requirement would lead to the elimination of specific references to credit ratings in public regulations. The second requirement would lead to the removal of rating agencies' current information privilege, which has ceased to be justified by the quality of their service to the marketplace.

Fair competition among risk assessment methods

The specific reference by prudential rules and other regulations to credit ratings, mentioned in the previous section, started as far back as the 1930s in the US[11]. But it has been much reinforced by more recent developments, including the extensive role assigned to ratings in the Basel 2 framework for banking supervision. The rating agencies themselves cannot be faulted for such developments, which they even tried to forestall in some instances[12]. But, as expressed in vivid terms by recognised legal scholar Frank Partnoy, the result has largely been to shift them 'from providing information to selling "regulatory licences", keys that unlock financial markets'[13]. Other public rules that make specific reference to credit ratings apply to some investment funds, or to the types of collateral that central banks may accept in their liquidity operations.

The crisis has made obvious the perverse effects of such regulatory arrangements. To correct them, regulations should no longer refer specifically to credit ratings, but more broadly to appropriate risk assessments. In certain cases, these could be based on available ratings published by rating agencies, but the automaticity should be removed. The gradual elimination of the explicit reference to credit ratings has already started as a consequence of the crisis, especially in the US by the SEC, whose chairman has publicly recognised that '[the SEC's] own rules may be contributing to an uncritical reliance on rating agencies as a substitute for independent evaluation'[14], an expression which is itself directly borrowed from the Financial Stability Forum (FSF)'s report of 7 April 2008. Other regulators should do likewise, especially (but not only) in the context of future revisions of the Basel 2 framework, as has been advocated by, among others, an eminent group of financial economists[15].

Because credit ratings are useful to issuers independently of their regulatory impact, they would continue to be available throughout and beyond the transition to a regulatory

9. David Smick and Adam Posen, 'Disenfranchise The Ratings Agencies', *The International Economy*, Fall 2008.
10. Heiner Flassbeck, 'They should be taken over by a public regulatory agency', *The International Economy*, Fall 2008.
11. Richard Sylla, 'A Historical Primer on the Business of Credit Ratings', in Levich, Majnoni & Reinhart, *Op. Cit.* (see footnote 2).
12. See Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008, p. 98
13. Frank Partnoy, 'Do away with rating-based rules', *Financial Times*, 8 July 2008.
14. Kate Plourd, 'SEC: Credit Ratings Are a Crutch', *CFO.com*, 26 June 2008.
15. Financial Economists Roundtable, 'Statement on Reforming the Role of the Statistical Rating Organizations in the Securitization Process', 1 December 2008; downloadable from: http://fic.wharton.upenn.edu/fic/Policy%20page/FER12%201%2008rev.pdf.

regime that would not itself make explicit reference to them. Thus, the suggested regulatory changes would not adversely impact market developments.

As also called for by the FSF, a parallel effort should be undertaken by private-sector market participants. For example, the European asset management industry recently announced steps to diminish their reliance on credit ratings[16].

'Regulations should no longer refer specifically to credit ratings'

Ending the information privilege: equal access to information

For alternative forms of financial risk assessment services to emerge, a level playing field must imperatively be ensured in terms of access to information. Otherwise market participants will continue to assign priority status to credit ratings, if these are assumed to rely on more complete information than other sources. For ratings of corporate and financial issuers, this equal access is not guaranteed under present regulatory arrangements, which confer a *de facto* information privilege on rating agencies. Rating agencies are specifically exempt from some of the provisions of Regulation Fair Disclosure (Reg FD) in the US and of the Market Abuse Directive (MAD) and its implementing regulations in the EU, enabling them to access privileged information to an extent other market participants cannot (with the exception of the financial press). When Reg FD was adopted by the SEC in 2000, and the MAD by the EU in 2003, the concern was mainly insider trading by analysts or the financial firms which employ them. In the case of the risk assessment industry, the problem is not insider trading *per se*, but the undue competitive advantage that rating agencies enjoy through their access to non-public information[17].

It has sometimes been argued that the extent of non-public information on which the rating agencies are reliant for corporate ratings is limited and does not significantly distort competition for risk assessment services. If so, the removal of the agencies' information privilege would not have any adverse impact on ratings quality. However, the agencies themselves have occasionally recognised that such information is important to them. For example, in a recent document that discusses the current business model of rating agencies, Standard & Poor's has noted that 'rating agencies using the subscription model [in which users of ratings, rather than issuers, pay for the rating service] may have more limited access to issuers, who have no obligation to inform those agencies of material changes in their businesses. This type of information can be extremely helpful when providing forward looking ratings'[18].

The rating agencies' information privilege may have been justified in the past by the perceived collective value of the services they delivered to the entire marketplace. In view of their recent failings, however, this privilege has become indefensible and should be taken away. Specifically, new regulations should ensure that any material information provided by issuers to the rating agencies should be made available to the entire marketplace through public disclosure. This could be done by removing the exemptions granted to the rating agencies in Reg FD and the MAD.

As issuers would be unwilling to suffer less favourable ratings based on limited information, they would have a strong incentive publicly to disclose key information which they earlier reserved to the rating agencies, to the benefit of the entire marketplace. Moreover, the spread of information technology makes broad disclosure much easier technically than was the case in the past. Thus, the removal of the agencies' information privilege is unlikely to lead to a decrease in the quality of ratings due to missing information, either on a temporary or a permanent basis.

Such a change is most obvious in the case of listed corporate issuers, which already disclose significant financial information. It could also be envisaged for unlisted corporate issuers, perhaps at a later stage. From this standpoint, the rules currently proposed by the SEC, which would force rating agencies to share such information with other rating agencies requesting it, may not go far enough[19]. In structured products as well, public disclosure should be vastly improved and harmonised at international level; some progress on this latter aspect may result from ongoing industry initiatives.

'A single EU regulator would have been a more appropriate response'

New forms of competition in credit ratings and financial risk assessment are already emerging. A number of specialised risk consultancies have prospered in the last few years, even though the current difficulties of hedge funds and of the asset management industry may make their economic environment more challenging in the near future. Coface, a

16. European Federation of Asset Management Associations (EFAMA), European Securitisation Forum (ESF), UK Investment Management Association (IMA), 'Asset Management Industry Guidelines to Address Over-Reliance Upon Ratings', 11 December 2008.
17. See François Meunier, 'Faut-il que les agences de notation soient « initiées » ?', *Risques/Les cahiers de l'assurance* No.61, March 2005.
18. Standard & Poor's, 'Guide to Credit Rating Essentials', 2008 (available on www.AboutCreditRatings.com).
19. 'Fact Sheet – Open Meeting of the U.S. Securities and Exchange Commission', 3 December 2008, on www.sec.gov.

France-based credit insurer, has announced the launch of a new rating practice, based on quantitative statistical analysi[20]. At the other end of the methodological spectrum, Kroll, the business intelligence services group, is eyeing the creation of a rating service focusing on complicated financial products[21]. But not all such risk assessment providers need be rating agencies in the regulatory sense – with Nationally Recognised Statistical Rating Organisation (NRSRO) status in the US, or the equivalent future EU regime – as some of them may focus on other dimensions of risk, such as stress-testing in extreme scenarios, or assessment of the quality of issuers' risk management. New entrants are unlikely to realise their full potential as long as they are hampered by regulatory barriers or distortions. Conversely, a multiplicity of new models and methods for risk assessment could significantly contribute to financial stability.

3 THE CURRENT DRAFT REGULATION: AVOID UNINTENDED CONSEQUENCES

The thrust of the proposals presented above – removing references to ratings in public regulations, and ensuring that all providers of financial risk assessment services have equal access to information – does not put emphasis on regulating the rating agencies. Nor is such regulation even necessary from that perspective. The regulatory framework that has existed since 1975 in the US, reinforced by the Credit Rating Agency Reform Act of 2006, has not prevented the agencies' most visible failings so far from occurring there rather than in 'unregulated' Europe. As Annette Nazareth, then a (Democratic) Commissioner of the SEC noted of some observers in 2007, 'They wish government edict would make the credit rating agencies smarter and faster. The Credit Rating Agency Reform Act does not address that nor should it'[22].

A new European framework to regulate rating agencies can bring welcome improvements. This may include higher requirements for internal documentation of ratings and for disclosure of past ratings' performance over time, as well as stronger limitations on consulting or quasi-consulting activities which may create conflicts of interest with the core ratings business. In fact, many such benefits are already provided by the regulation of rating agencies by the SEC, which has a de facto extraterritorial effect and is likely to be significantly reinforced in the near future.

However, regulating rating agencies in the EU also responds to a perceived political necessity. The trick here will be to avoid unintended consequences while responding to this political pressure. Three main areas of concern are identified here and dealt with in summary fashion, as these topics have already been the matter of many contributions to the European policy debate, especially with regard to the European Commission's proposal for a regulation on credit rating agencies published on 12 November 2008.

Competition concerns

Regulation tends to impose one single model of organisation and activity modeled on existing examples, and thus may restrict the scope for new entrants on the risk assessment market by limiting the possibility of building a competitive edge through innovative and differentiating features. Moreover, regulation may introduce significant compliance costs, which favours large established players over new and smaller ones. Finally, a vast empirical literature tends to suggest that, in regulated industries, incumbent players tend partly to capture the regulator to their own advantage and to the detriment of potential new entrants, and there is no reason to believe that rating agencies would be any different.

Independence concerns

Regulation would empower national authorities to impose sanctions or otherwise exert coercive powers on the rating agencies, in some scenarios with a significant degree of discretionary power. Simultaneously, the same national authorities issue debt which is rated, and so do national agencies, local authorities, and state-controlled enterprises. It is not impossible to imagine situations in which the newly created regulatory power would be leveraged by national governments in order to exert pressure on ratings agencies to obtain more favorable ratings for such entities or for otherwise favoured 'national champions' in the private sector. Thus, regulation could play against, not in favour of, the quality of credit ratings.

This potentially harmful effect is larger if governments are granted more discretion when applying sanctions, and smaller if sanctions are triggered by objective factors (such as failure to disclose a defined set of data) on which governments have little margin for arbitrary application. Also, it would be much reduced if the power to apply sanctions were given to an EU-level regulatory body rather than to national ones, as the potential for conflicts of interest would be significantly reduced.

20.'Jérôme Cazes (Coface): « Le projet de règlement proposé par Bruxelles ne résout pas les problèmes liés à la crise »', *Les Echos*, 8 December 2008.
21.Brooke Masters, 'Kroll on the trail of a new conquest', Financial Times, 15 December 2008.
22.Sarah Johnson, 'How Will the SEC Rate the Rating Agencies ?', CFO.com, 13 September 2007.

International fragmentation concerns

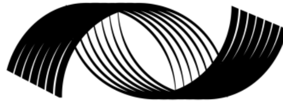
Given the global nature of the rating agencies' activities, and the obvious need for international consistency of ratings, there is a significant risk to fragmenting the regulation of rating agencies. From this perspective, a single regulator at European level would have been a more appropriate response than the rather clumsy, and potentially unstable, current proposal of 'colleges' led by a 'facilitator'. In practice, and given the concentration of the leading agencies' European activities in London, it is likely that the 'facilitator' will be the UK Financial Services Authority in most cases, which will raise issues of political legitimacy in continental Europe. This echoes the problematic nature of the 'colleges' concept more generally[23].

The risk of transatlantic fragmentation as a result of the new regulation has been widely commented upon. The language of the European Council in December, mentioning 'the obligation for financial institutions to only use, for regulatory purposes, credit ratings which are issued by credit rating agencies registered in the [European] Community, since it appears the most appropriate solution to ensure a proper surveillance of these credit rating agencies'[24], raises significant concerns.

After having rightly lambasted the US Sarbanes-Oxley Act of 2002 for its extraterritorial effects, Europeans, who like to pride themselves on their multilateralist ethos, may now adopt legislation which is even more unilateralist. This is happening at a moment when international financial integration appears more at risk than for at least a generation, with potentially serious consequences for all economies. At a time of unprecedented need and arguably unprecedented opportunity for transatlantic and global financial regulatory initiatives, this would be an ironic development indeed.

23. See Nicolas Véron, 'Les collèges de superviseurs financiers, vraie ou fausse solution ?', *La Tribune*, 26 November 2008; English translation available on www.bruegel.org.

24. Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council on credit rating agencies – Progress report', Interinstitutional File 2008/0217 (COD), 16 December 2008.



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Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul

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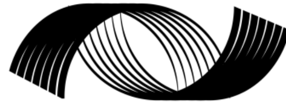

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Executive Summary

The financial debacle of 2007-2008 has clearly propelled financial regulation and its overhaul to a must-do topic for the incoming Obama Administration and the 111th Congress. Unfortunately, financial regulation is still arcane. And it is unbelievably complicated. It encompasses a myriad of safety-and-soundness (prudential) regulatory provisions for banks, thrifts, credit unions, insurance companies, pension funds, and money market mutual funds; consumer protection provisions across the same spectrum; information revelation requirements for these institutions; financial statement revelation and corporate governance requirements for publicly traded companies; rules that apply to exchanges and to the financial instruments that are traded on those exchanges; and the list could go on. To paraphrase Rahm Emanuel, never allow a debacle to go to waste.

Lessons from the Debacle of '07-'08
for Financial Regulation and Its Overhaul

Lawrence J. White

If someone had shouted "financial regulation" in a crowded auditorium a year ago, nary a soul would have stirred. "Why bother? That's boring, arcane stuff," would have been the general sentiment.

No more. Shout those same words in that same auditorium today, and heated discussions would ensue and maybe even a few fistfights might break out. Well, perhaps I exaggerate a bit. But the financial debacle of 2007-2008 has clearly propelled financial regulation and its overhaul to a must-do topic for the incoming Obama Administration and the 111th Congress.

Unfortunately, financial regulation is still arcane. And it is unbelievably complicated. It encompasses a myriad of safety-and-soundness (prudential) regulatory provisions for banks, thrifts, credit unions, insurance companies, pension funds, and money market mutual funds; consumer protection provisions across the same spectrum; information revelation requirements for these institutions; financial statement revelation and corporate governance requirements for publicly traded companies; rules that apply to exchanges and to the financial instruments that are traded on those exchanges; and the list could go on...

I will not suggest reforming everything. My proposals include:

- A new prudential regulatory regime for large systemic-risk financial institutions;
- A true privatization of Fannie Mae and Freddie Mac;
- A different approach to dealing with credit rating agencies;
- An extension of deposit insurance to 100% coverage;
- Modifications in mortgage lending arrangements;
- Avoiding a re-enactment of Glass-Steagall;
- Clearing-house arrangements for financial derivatives;
- Great caution in any restructuring of financial regulatory agencies; and
- A few regulatory reforms that are unconnected to the current debacle but that are badly needed anyway.

To paraphrase Rahm Emanuel, never allow a debacle to go to waste.

The Backdrop

Since the Debacle of '07-'08 is what got us here, let's start with what went wrong: A 10-year national housing bubble expanded dramatically, and then popped just as dramatically. That bubble was inflated by progressively looser lending standards, allowing increasingly inappropriate households to borrow increasingly excessive amounts of money on residential mortgages that couldn't be repaid. These mortgages were often bundled/packaged into securities that were blessed with high ratings by rating agencies and sold to insufficiently cautious investors; in some instances the securities became the collateral for yet further rounds of securities that again were blessed and sold.

Much of this happened because the participants -- from the borrower to the mortgage broker (who made the match between the borrower and the initial lender/originator) to the initial lender/originator to the securities packager to the rating agency that rated the securities to the investor who bought the securities -- were collectively "drinking the Kool-Aid" of "housing prices can only increase". If housing prices would always increase, then even otherwise inappropriate mortgages would not be a problem, because the borrower could always refinance the mortgage or repay by selling the house at a profit. Further, the parties in between the borrower and the investor could all earn handsome fees from the transactions and could comfort themselves with, "These mortgages won't be a problem because housing prices will always increase -- but even if some mortgages do become a problem, they will be somebody else's problem," and then pocket the money and move on to the next transaction.

This is not the whole story. On the borrowing end, there were clearly some instances of fraud -- sometimes committed by the borrower with the connivance of mortgage broker and/or the lender; and sometimes committed by the mortgage broker in inducing unwitting households to sign and commit to obligations that were patently beyond their capabilities. But fraud (which ought to be prosecuted vigorously when discovered) was only a modest part of the story.

On the lending and investing end, mortgage finance was occurring in the context of an even wider under-recognition of risk. Normally cautious banks were making loans to highly leveraged private equity firms and not insisting on the tight controls that would have been commonplace a few years earlier. Similarly, cautious bond investors, who earlier had been requiring that high-risk "junk bonds" pay interest rates that were 5-6 percentage points above Treasury bonds of the same maturity were apparently satisfied with interest rates that were only 2½ percentage points above Treasuries.

In sum, the combination of a housing boom and a surprising disregard for risk by lenders and investors conspired to create an environment where slipshod practices by "middlemen" remained profitable for too long. When housing prices ceased to rise -- as had to happen sooner or later -- the house of cards collapsed. When subprime borrowers couldn't refinance, they defaulted, the mortgage securities fell in value, and the mortgage finance system imploded, dragging much of the rest of the financial sector down with it because of the relatively low capital levels and concomitant high leverage of most of the institutions in the financial sector, some of which owned significant slugs of these toxic mortgages and mortgage-related securities.

[Because the terms "capital" and "leverage" are essential parts of understanding the financial sector and what went wrong, as well as understanding important parts of what corrections are needed, I have written an appendix primer on capital and leverage. Uninitiated readers are urged to read this primer sooner rather than later.]

By now the major pieces of this story are understood, although why so many participants continued to believe for so long that housing prices could only go up and why so many lenders and bond investors disregarded the standard precautionary actions of those who should be worrying whether they will be repaid are puzzles that are better tackled by psychologists than by economists.

From the spring of 2008 onward, the actions of the federal government have been focused on efforts to mitigate the destruction. With luck those efforts -- at substantial cost -- will eventually succeed. This essay is not about those efforts. Instead, I will focus on the longer-run reforms that should be put in place to strengthen the financial sector and reduce the likelihood that a debacle of this magnitude can occur again.

I will first lay out the rationales for regulation in an otherwise markets-oriented economy; then describe some broad categories of regulation; and then tackle some major (and a few not-so-major) changes in financial regulation that should be part of the new financial landscape -- as well as cautioning against some changes that are likely to be advocated by others.

Throughout I will assume that the participants within the financial markets can be expected to have learned the lessons of the Debacle of '07-'08 -- i.e., that these relatively sophisticated participants are not the "widows and orphans" who need to be protected from repeatedly making mistakes that are self-harming. Indeed, in the immediate aftermath of the Debacle, lenders and investors appeared to have learned so much and were so risk averse (as a reaction to their previous risk obtuseness) that financial markets were close to frozen.

Nevertheless, there are structural changes that are necessary even in this "sophisticated participants" context. And it is clear that more needs to be done for the less sophisticated retail customers -- some of whom may genuinely be widows and orphans, and some of whom may simply be overwhelmed by the complexity of financial transactions.

Why Financial Regulation?

The arguments that favor financial regulation may seem obvious to some; the arguments against regulation may seem obvious to others. Let's try to steer a middle course.

We start with the neoclassical microeconomics world of well-functioning markets, with lots of competing and knowledgeable sellers and lots of well-informed buyers. This is the world about which economists wax rhapsodic when they describe the efficiencies and social benefits that flow from competitive markets.

Market failure

What could go wrong that could create a case for government intervention? What are the potential market imperfections or market failures?

First, competition could be absent, replaced by monopoly. Prices will be higher, output lower, and efficiency reduced in the presence of monopoly. That's why cities and/or the 50 states have traditionally limited by regulation the prices that the local electricity company, the local natural gas company, the local water distribution network, and the local telephone company could charge. Alternatively, states or localities have sometimes tried to provide these services themselves to their citizens.

Though this kind of monopoly power is only occasionally present in modern financial markets, it was a traditional argument for taming the perceived power of the local bank in a small community. (Think of mean Mr. Potter, the owner of the local bank, in the film "It's a Wonderful Life".) Perhaps the most prominent place where market power can still be found in financial services is in credit card networks, where there are the two major networks (Visa and MasterCard) and two more modest networks (American Express and Discover). The rating agency market is similarly dominated by two large firms (Moody's and Standard & Poor's), a modest size firm (Fitch), and a few smaller competitors.

Second, there could be spillover or externality effects -- positive or negative -- from production or consumption activities. If an act of production or consumption affects third parties, outside of a market context, then those efficiencies about which economists wax rhapsodic may dissipate. Too much of a negative externality (think of pollution or greenhouse gases) interferes with others' enjoyment of their consumption. Too little of a positive externality (think of education) similarly reduces the benefits for society more widely.

Until recently, no one would have associated the financial sector with "pollution". And it's still a stretch to liken a bank to a coal-fired electricity generator. But the failure of one bank could cause ill-informed (see below) depositors at other banks to become nervous and to "run" on their bank to withdraw their deposits, which could cause the failure -- or at least, the temporary closure -- of other banks, with yet further "contagion" or cascading effects. On the other hand, there does seem to be a positive social benefit to households' becoming homeowners (although, as we have recently learned to our collective sorrow, home ownership is not for everyone), which argues for encouraging home ownership -- and encouragement inevitably involves finance.

Third, the problems of asymmetric information -- one side of a transaction knowing things about itself or its actions that the other side doesn't know -- are pervasive in finance. The essential acts of finance -- lending or investing or insuring -- involve initial commitments and subsequent repayments. If the borrower knows more about its repayment proclivities than does the lender, the latter is at a disadvantage; if the insured party knows more about its riskiness than does the insurer, the latter is at a disadvantage.

Again, the presence of these asymmetries will lead to partial or complete breakdowns of markets that, in the presence of better information, could thrive.

Fourth, an extended version of the asymmetric information problem might be termed the "widows and orphans" problem: Some market participants may be incapable of looking after their own best interests and will not learn from their own mistakes. Many retail customers in financial transactions -- whether as depositors or borrowers -- may well qualify here.

These four rationales would probably qualify with many economists -- perhaps most -- as "legitimate" qualifications to that rhapsodic waxing over the efficiencies of the competitive markets.

There is, of course, a fifth motive for regulation that would not be in this pantheon: income redistribution. As George Stigler and Richard Posner pointed out over three decades ago, regulation can be used to redistribute income from one category of market participants to another group of

participants. Though usually a far less efficient form of income redistribution than a direct subsidy, it is also less blatant and therefore easier to "fuzz up" and justify under some other rubric. In the financial sector, limits on anything from fees and interest rates to specific bans on financial products may well have substantial income distribution consequences but be justified -- with greater or lesser legitimacy -- under one or more of the earlier four rationales.

Government failure

Lest one think that only markets fail, it's worth remembering that governments too can be imperfect.

First, asymmetric problems apply also to government efforts to regulate, with the consequence that government's inadequate information leads to inferior regulatory outcomes.

Second, when government does make regulatory mistakes, undoing those mistakes may well be difficult. Often there are few or no alternatives, and the costs persist -- or there are workarounds (take the activity abroad; or try an alternative unregulated activity that isn't as good), but at higher costs.

Third, the pursuit of income distribution gains through regulation can lead to the "capture" of the regulatory process, with consequent distortions in otherwise efficient allocations of resources. The large gainers from capture find it worthwhile to devote the effort to doing so; the more numerous small losers from capture find the costs of organizing to resist capture to be too great.

Fourth, even if regulatory capture doesn't occur, the pursuit of such gains -- what has come to be called "rent seeking" -- can cause large amounts of society's scarce resources to be squandered in wasteful (and often mutually nullifying) efforts to influence those regulatory outcomes.

In sum, because both markets and governments are prone to imperfections, any proposal for governmental intervention to correct a market imperfection should pass a benefit-cost test and a threshold of non-triviality.

Types of Financial Regulation

At first glance, government regulation may appear to be a hodge-podge of intervention, with no discernible pattern. There are, however, major categories of regulation that can help organize our thinking about regulation.

First, there is "economic" regulation: the direct control over prices, profits, entry, and/or exit. This form of regulation is often used to address monopoly problems (think the public utility regulation mentioned above), but it may be used to address other problems and is often employed in income redistribution efforts. In financial services, "usury" limits on interest rates are (arguably) an effort to deal with the market power of lenders. Merchants' periodic campaigns to try to limit the "interchange" fees levied by the credit card networks can also be interpreted through this market-power lens. Consumers' efforts to limit credit card fees, on the other hand, are not so much about the abuses of monopoly (after all, there are hundreds of credit card issuers, who are the entities that determine these fees) as the problems of asymmetric information.

Second, there is health-safety-environment regulation, which is usually aimed at altering production processes or product characteristics to bring about desired improvements in health, safety, or environmental outcomes. The underlying problems that are being addressed may be those of externalities or of asymmetric information.

In the financial sector, safety is the paramount concern. In turn, the focus on safety comes in two "flavors": safety as applied to financial institutions; and safety as applied to the customer.

Safety as applied to financial institutions usually is formalized as a safety-and-soundness (or "prudential") regulatory regime. There are three major categories to which such regimes apply: depositories, such as banks, savings institutions (thrifts), and credit unions; insurance companies; and defined-benefit pension funds (i.e., the "traditional" company-funded pension arrangements). Money market mutual funds might, arguably, constitute a fourth category

The goal of these prudential regimes is to keep the regulated financial institution solvent, so that it can meet its obligations to its creditors: the depositors, insureds, and pension claimants. The reasons for singling out these categories of financial institution for this special treatment are twofold. First, their creditors are probably in a poor position to be able to protect themselves against the failures of these institutions, which could then mean substantial hardships in the event of failures. It is no accident that these types of institutions all have government-operated insurance funds (federal deposit insurance, state guarantee funds for insureds, and federal pension guarantees) as a backup in the event that prudential regulation fails to prevent insolvencies. Second, especially for banks and other depository institutions, depositors' fears of failures could lead to runs on institutions and a consequent contagion or cascade of failures.

Safety as applied to retail customers encompasses the prudential regulatory regimes just discussed but also encompasses requirements that financial institutions provide specified types of information (e.g., about interest rates and extra fees on loans), often in a standardized format so as to enhance comparisons; limits on prices and fees (e.g., "usury" limits on interest rates on loans; limits on credit card fees); and outright bans on sufficiently "dangerous" products and services, such as "payday" loans or other "predatory" loan products with obviously onerous terms.

The third broad category of regulation is information regulation, whereby firms are required to provide standardized information on their products (think of the "nutrition facts" labels on canned and packaged foods), so as to help deal with asymmetric information problems. As was discussed above, financial firms are required to provide standardized interest rates and fee information for credit cards and other kinds of loans; and all publicly traded companies are required to provide certified (by an auditing firm) financial statements to shareholders in a standardized format ("generally acceptable accounting principles", or GAAP).

This broad categorization is not airtight nor are individual instances of regulation always capable of being pigeonholed exclusively into one category of regulation or another. Nevertheless, this categorization does provide some coherence to what otherwise might look like an undifferentiated mass ("financial regulation") of intervention.

Reforming Regulation

With the structural foundations established, let's go down the list.

Large financial institutions that pose systemic risks

Perhaps the largest surprise for policy makers in the Debacle of '07-'08 was the likely systemic damage that the demise of the large investment banks (like Bear Stearns and its brethren) and a few other large financial firms could cause. Unlike commercial banks, to which a prudential regulatory framework applied, these large financial firms were largely exempt from prudential regulation. Though the SEC did establish nominal capital requirements for broker-dealers (which are at the center of most investment banks), those requirements were noticeably loosened in 2004 and apparently didn't restrain these large firms in significant ways.

These firms were so large (Merrill Lynch's assets exceeded $1 trillion) and intertwined with the rest of the financial sector that their failure could have widespread cascading consequences; and

the fears of their failure could lead to "runs" on them by their short-term creditors and counterparties that had all of the characteristics of a "classic" bank run by a commercial bank's depositors. Compounding these problems were the thin capital levels -- high leverage -- maintained by these firms, so that even modest (in percentage terms) losses could threaten their solvency and lead to the runs that, at a minimum, would create liquidity problems for them.

In some respects much of this specific problem has been resolved, but at some cost to the federal government: Bear Stearns was absorbed (with help from the Federal Reserve) by JPMorgan Chase, a commercial bank; Merrill Lynch voluntarily merged with Bank of America, another commercial bank; Goldman Sachs and Morgan Stanley voluntarily converted themselves into bank holding companies and will consequently be subject to the prudential regulatory regime that is imposed on BHCs by the Fed; and Lehman Bros. entered bankruptcy and is being liquidated. One additional financial conglomerate, AIG, has received over $130 billion in federal loans and investments in efforts to stabilize it.

Nevertheless, there are large financial firms that remain outside prudential regulatory regimes -- GE Capital, GMAC, Ford Motor Credit, Vanguard, Fidelity, other large mutual fund complexes, some large hedge funds, and a rehabilitated AIG come readily to mind -- and others may arise in the future (the privatized Fannie Mae and Freddie Mac, discussed below, would be candidates). "Never again" is a reasonable slogan going forward.

The necessary regulatory actions are to impose a new prudential regulatory regime, basically similar to the one that is in place for commercial banks and savings institutions, on these large financial firms that are outside any existing prudential regimes. At the heart of such a prudential regime must be the following:

1) Minimum risk-based capital requirements (or, equivalently, maximum allowable leverage), as determined by sensible accounting conventions -- with market-value accounting at the center. Capital is the buffer that protects a financial institution's creditors -- or protects the government that explicitly (e.g., through deposit insurance) or implicitly promises to keep creditors whole in the event that the institution becomes insolvent. As the capital buffer becomes thinner, governmental restrictions on the institution's actions must become tighter, so as to prevent greater risk-taking.

Since capital is measured by the simple subtraction of fixed obligations from the value of the institution's assets, up-to-date valuations of the institution's assets -- i.e., market-value accounting -- is essential.

2) Limitations on activities. If regulators cannot understand an activity of a financial institution well enough to set sensible capital requirements and to be able to assess the institution's competence in managing the activity, that activity should not be permitted.

This stance may seem harsh. But it makes perfectly good sense for institutions where the goal is to avoid insolvency (and to avoid the government's again having to inject funds and guarantees so as to keep creditors whole).

3) Special scrutiny of financial dealings between the financial institution and its owners. It is too easy for money to be drained out of a financial institution, to benefit its owners at the expense of its creditors. Regulators must scrutinize dividends paid to owners, loans made to the owners or to their subsidiaries or to their friends, and purchases made from the owners, etc.

4) Managerial competence requirements. Again, if avoiding insolvency is the goal, the regulator must be able to assess the competence of the senior managers of a financial institution and must have the power to remove those that are deemed incompetent.

5) An adequate staff of examiners and supervisors. These are the men and women who make the periodic examinations of the financial institutions and who decide on appropriate enforcement actions. They must be well trained and well paid.

6) Clear receivership powers by the regulator. If a financial institution becomes insolvent, the regulator must have clear powers to take over the institution, wash away the owners, remove senior management, and then liquidate the institution in an orderly way. The receivership process should be one that provides a good deal more speed and certainty to creditors than the vagaries of a bankruptcy court.

At what size should a financial institution (that is not effectively part of another prudential regime) be required to be part of this new prudential regime? There are tradeoffs: Because regulation will inevitably stifle innovation and creativity ("Hooray!" critics might shout in the wake of the current debacle; but that would be a long-run mistake), the extension of such prudential regulation to every small hedge fund or investment partnership seems unwarranted. On the other hand, one would want to worry about the collective consequences of herd behavior by smaller financial institutions. A bright line at $25 billion in assets (or assets under management for

institutions such as mutual fund complexes) -- so that smaller firms can innovate but size will bring scrutiny and responsibilities -- feels about right.

Who should be the regulator? A wholly new agency is a possibility. The Fed is another possibility, since the prudential regulatory regime envisioned here is similar to the Fed's regulation of bank holding companies. The one agency that should not be a candidate is the Securities and Exchange Commission, since the SEC's culture is that of information revelation and not prudential regulation.

Finally, should the regulator explicitly guarantee the liabilities of these large financial institutions? Probably not. The federal government has already stepped in to protect the creditors of Bear Stearns, AIG, and Fannie Mae and Freddie Mac. Even without an explicit guarantee, the financial markets may believe that in a future financial crisis the federal government would again intervene to avoid systemic disruptions. If the prudential regime advocated here is successful, that future crisis ought not to arrive. If it does arrive anyway, the federal government can then decide what actions to take. To the extent that creditors "today" are worried that the federal government would not keep them whole "tomorrow", they will engage in more monitoring that would supplement the prudential regulator's efforts. That is all to the good.

Fannie Mae and Freddie Mac

Until their government takeover in September 2008, Fannie Mae and Freddie Mac were two large, hybrid (private-public) companies that dominated the secondary residential mortgage markets. They engaged in two lines of business: securitizing mortgages that generally conformed to high lending standards, with the mortgage-backed securities (MBS) carrying their guarantees if the mortgage borrower failed to repay; and investing in mortgages, funded overwhelmingly (around 96%) with debt.

Though they were publicly traded companies with shares listed on the New York Stock Exchange, the two companies were also creatures of Congress that had special governmental ties and advantages, as well as limitations (they were restricted to secondary mortgage markets, there was a ceiling on the size of mortgage that they could buy or securitize, and they were subject to prudential regulation) and obligations (they were expected to make a special effort to support lending to lower-income households -- an obligation that became more burdensome in 2003). Within the past few years the term "government-sponsored enterprise" came into common use to

describe the two companies (as well as the Federal Home Loan Bank System, a wholesale bank for banks and thrifts that similarly enjoys special privileges and limitations).

As a consequence the financial markets believed (correctly, as it turned out) that if Fannie or Freddie were ever in financial difficulties, the federal government would keep their creditors whole.

This belief in the federal government's "implicit guarantee" meant that Fannie and Freddie were able to borrow in the bond markets (in normal times) at about 0.35-0.40 percentage points less (i.e., at lower interest rates) than their financial condition would otherwise have justified. In turn, they caused interest rates for the mortgages that they could securitize or hold to be about 0.20-0.25 percentage points lower than otherwise would have been the case.

Both Fannie and Freddie had grown rapidly in the 1990s and in the early years of this decade. Accounting scandals at Freddie in 2003 and at Fannie in 2004 caused their growth to slacken, especially for the mortgages that they held in their portfolios. Nevertheless, at year-end 2007 their combined holdings of mortgages and outstanding mortgage-backed securities totaled about $5 trillion, or over 40% of the total residential mortgage market.

It is easy to understand the political popularity of their hybrid structure, since it looked like they were providing a free lunch: lower interest rates on mortgages, special efforts to expand lending to lower-income households, and no explicit cost to the federal government. The way that these outcomes were reconciled with adequate returns to shareholders was through low capital requirements (only 2.5% for holding a mortgage in portfolio; only 0.45% to support the guarantees on their MBS) and thus high leverage.

Although Fannie and Freddie were not at the center of the subprime debacle, their portfolios and MBS did become more risky in the middle of this decade, as they expanded into "Alt-A" (between prime and subprime) mortgages. Further, as housing prices fell steeply in some areas like Las Vegas, parts of California, and south Florida, even some "prime" mortgages (i.e., those where the borrower made a 20% down payment, had an adequate income, and had a good credit score) yielded borrower defaults and losses. Other apparently good mortgages, where private mortgage insurance was covering shortfalls in borrowers' down payments, came into doubt because of rising questions about the solvency of the mortgage insurers and thus their ability to make good on their obligations. And Fannie and Freddie were also burned on investments (intended to help satisfy those distributional requirements) in supposedly safe tranches of mortgage-based securities that had lower-quality mortgages as their underlying collateral.

At the end of the day, however, it was inadequate capital for the overall risks in their portfolios and their MBS that did them in. The free lunch turned out to be an illusion. At the time of their government takeover, the Treasury set aside $200 billion in aggregate to cover the two companies' accumulated losses. With luck, that will be adequate.

In the current shaky environment, Fannie and Freddie should remain as wards of the government. But the hybrid model is clearly too fraught with problems. After the financial markets have stabilized, the two companies should be fully and truly privatized, with no remaining special ties to the federal government -- but also no special burdens or restrictions on their activities, except for those that would be part of their inclusion in the special prudential regulatory regime discussed above. The privatization of the Federal Home Loan Bank System should similarly occur, for similar reasons.

Encouraging home ownership is a worthwhile social goal. But instead of trying to do it implicitly and on the cheap (but ultimately paying heavily), the federal government should be explicit, through on-budget programs. However, the usual broad-brush encouragements for housing (of which Fannie and Freddie were a part) mostly subsidize higher-income households -- who would buy anyway -- to acquire larger and better-appointed houses on larger lots and to acquire second homes; where's the social value in that? Instead, housing policy should focus on encouraging low- and moderate-income families (after appropriate screening and counseling for suitability) to become first-time homeowners.

Rating agencies

Rating agencies offer judgments -- "opinions" is the word that they prefer -- about the creditworthiness of bonds that have been issued by various kinds of entities: corporations, governments, and (most recently) the packagers of mortgages and other forms of debt. Those judgments come in the form of "ratings", which are usually a letter grade. The best-known scale is that used by Standard & Poor's and some other rating agencies: AAA; AA; A; BBB; BB; and so on (with pluses and minuses, as well). These ratings can be used by bond investors to help them determine the riskiness of the bonds that they might buy and the risk premiums that they should require.

The three major rating agencies in the U.S. -- Moody's, S&P, and Fitch -- clearly played a significant enabling role in the Debacle. Absent their excessively optimistic ratings on the

increasingly poor quality mortgage-related securities in 2005 and 2006, the housing boom would have ended sooner, and the collapse would have been less severe. Further, it is clear that their basic business model, in which they charge the securities issuers fees for the rating, didn't help matters.

It is tempting to want to regulate the rating agencies, so as somehow to force them to do a better job in the future. (The SEC has recently proposed just such regulations.) Forcing them to deal better with the conflicts of interest that are inherent in the issuer-pays model -- perhaps even banning the issuer-pays model as inherently too dangerous -- has its attractions.

But a larger perspective is necessary. For decades financial regulators -- bank regulators, insurance regulators, etc. -- have been requiring that their regulated entities heed the ratings of a select few rating agencies. For example, since the 1930s banks have not been allowed to invest in bonds that are below "investment grade" (which, for example, is BBB- or better on the S&P scale) -- as determined by the select few rating agencies. Although the goal of having safe bonds in the portfolios of banks (as part of prudential regulation) is a worthy one, the bank regulators have essentially delegated their safety judgments to the rating agencies.

When the SEC in 1975 decided to delegate its safety judgments with respect to broker-dealers, it wanted to ensure that the delegations weren't made to bogus agencies. It therefore created the category "nationally recognized statistical rating organization" (NRSRO) and immediately "grandfathered" into the category the three large rating agencies. Other financial regulators soon adopted the NRSRO category for their delegations.

Over the next 25 years, the SEC allowed only four more rating firms to achieve the NRSRO designation; but mergers among the entrants and with Fitch reduced the number of NRSROs back to three by year-end 2000. The SEC never developed criteria for the designation and handled the entire designation process in a remarkably opaque fashion. And, once designated, a NRSRO was never again scrutinized by the SEC for competence or accuracy.

As a practical matter, the SEC had created a substantial barrier to entry into the rating business (since only the NRSROs' ratings mattered for the bond investment decisions of regulated financial institutions). It shouldn't be a surprise that the protected rating industry incumbents -- whose importance for bond markets was greatly magnified by all of those safety delegations by financial regulators -- might grow sluggish and careless.

Although the SEC has designated six additional NRSROs since 2000, and legislation passed in 2006 required that the SEC cease being a barrier to entry and gave it limited regulatory powers

over the NRSROs, the pattern that had been established in the earlier decades has had lasting consequences.

This brief history of regulation gone awry (remember the possibilities of government failure?) points to a different and potentially superior course of action, rather than trying to regulate them into better behavior and more accurate ratings. Suppose that financial regulators were to withdraw their safety delegations to the NRSROs and instead were to place the responsibility for choosing -- and defending their bond investment choices -- directly on their regulated institutions. Banks, for example, could defend their choice of bonds by doing original research or by relying on an outside source of information, which could (but need not) be a rating firm -- and, in either case, defending their choices to their regulator. Banks would then have the incentive to choose the information-gathering method that they found most reliable (and defensible to their regulator) rather than being forced to heed the ratings of only a select few.

If other financial regulators were to follow suit and replace their delegations with the direct responsibility model, the SEC could eliminate the NRSRO category. More importantly, new ideas about creditworthiness, rating methodologies, and even business models could flourish, in a way that hasn't been true since the 1930s.

Oh, about that word "opinions": The rating agencies like it so much because, when sued by unhappy investors or issuers, the agencies have claimed that they are "publishers" and are thus protected by the First Amendment. This is yet another instance of too much protection for the incumbents. Although perfection is an unrealistic goal for the accuracy of their ratings, some liability for their wider errors might well help provide the right incentives for improving their accuracy.

Deposit insurance

Federal deposit insurance first came into existence in 1933. The maximum insured sum in that year was $2,500. The Congress subsequently raised the maximum insured amount at various intervals, the next-to-last time being 1980, when $100,000 was designated. In the wake of depositor nervousness about banks in the late summer of 2008, the Congress in early October temporarily raised the maximum insured amount to $250,000 on interest-bearing deposits and authorized unlimited coverage for business checking accounts (with the termination date for both changes set for December 31, 2009).

Deposit insurance has never been designed to cover 100% of all deposits in banks and thrifts. A coherent rationale for this incomplete coverage has never been articulated by policy makers; but the argument seems to be centered on a belief that large depositors will somehow monitor their bank's activities and that this monitoring, and the consequent potential for deposit outflows will restrain banks from risky activities.

Although this idea that creditors can and should monitor the entity to which they have lent their funds is a sensible one when applied to the bond markets and to commercial lending generally, the idea is misplaced when it comes to deposits in banks and thrifts. For the most part, household depositors are not sophisticated participants in the financial system and are unlikely to become experts on a bank's financial condition. And a modest-sized enterprise (with no special expertise in bank monitoring) can have transaction accounts -- covering payroll expenses and payments to suppliers -- that can periodically exceed $100,000 or even $250,000.

To ask such depositors to be monitoring banks is simply to be asking for nervousness and periodic bank runs -- which is not a recipe for financial stability.

Although the recent increase in deposit insurance coverage is a vast improvement, the argument underlying the increase should be extended to its logical conclusion: 100% insurance coverage of all deposits in banks, thrifts, and credit unions. Bank monitoring should be the responsibility of the prudential regulators. The Federal Deposit Insurance Corporation and the National Credit Union Administration should charge appropriate fees for this coverage.

Mortgages

Though there are probably dozens of modifications to mortgages and mortgage documents that can be made, there are four that would be especially valuable going forward. First, the home buyer needs to have a simple one-page document, available prior to the closing, that states clearly and simply the aggregate and monthly costs that the home buyer will experience, including all relevant fees.

As anyone who has bought a house can attest, the closing process is a horror. There are stacks of documents to sign, there's no hope of being able to read them, and there's no clear statement of costs. Small wonder that unsophisticated buyers could be confused and perhaps defrauded. A simple, one-page statement is vital.

Where the future costs are contingent -- as, say, for an adjustable-rate mortgage -- the statement of costs may be a bit more difficult. But ways of bringing greater clarity to a statement of costs can surely be found.

Second, and consistent with the first, it should be possible for a single party in the closing process to be a "consolidator" who can offer the buyer "one-stop shopping" and a single price for all of the closing services (appraisal, title insurance, document filing, etc.). Current rules (under the Real Estate Settlements Practices Act of 1974) discourage that from happening. Instead, the buyer -- who usually buys homes infrequently and therefore doesn't have an opportunity to become familiar with the providers of the various services -- is nevertheless expected to shop around for these services.

Allowing a single party (with fiduciary obligations, of course) to offer the buyer an all-in consolidated price -- whether it's the mortgage broker, the lender/originator, the lawyer, or even a separate specialist who does this -- should improve the process and ultimately reduce costs.

Third, and applicable to all forms of retail lending, there should be a "suitability" and "know your customer" fiduciary obligation on the part of the lender and any other intermediary (such as a mortgage broker). These obligations seem to work fairly well (though perfection is elusive and shouldn't be expected) in stock brokerage. For a stock broker to suggest an investment in petroleum futures for a retiree's portfolio is clearly a violation of such obligations. Predatory lending or placing a borrower in an inappropriate mortgage could and should similarly be considered violations.

Fourth, because securitization is likely to persist as a mechanism for financing mortgages, the role of the mortgage servicer (who collects the monthly payments and forwards them to the securities holders) will continue to be important. As the Debacle has revealed, when mortgages need to be renegotiated, this renegotiation is much harder when the mortgage has been securitized, since there is often not a single owner/investor in the mortgage, and the servicer feels that it does not have adequate authority for conducting the renegotiation with the borrower. Future mortgages, as well as securitization documents, should clarify the authority and responsibilities of the servicer in such renegotiations.

Re-enact Glass-Steagall?

The Glass-Steagall Act of 1933 required the separation of commercial banking from investment banking. Beginning in the 1960s, regulatory and judicial interpretations gradually eroded some of the separation and allowed commercial banks to re-enter some aspects of investment banking. This erosion was completed in the Gramm-Leach-Bliley Act of 1999, which effectively repealed Glass-Steagall.

In the efforts to assign responsibility for the Debacle of '07-'08, there have been claims that the repeal of Glass-Steagall was somehow responsible or contributed in a major way to the Debacle. The sequence of events -- Glass-Steagall is repealed in 1999, the frenzied mortgage lending and securitizations occur a few years afterward -- offers some surface plausibility to the claim.

Any close analysis of the Debacle, however, would indicate otherwise. The frenzy of mortgage originations and securitizations that lay at the core of the Debacle -- some of it by commercial banks and thrifts, much of it by mortgage banks and investment banks -- could have and would have proceeded in much the same fashion even if Glass-Steagall had not been repealed in 1999. Further, it is ironic that commercial banking has played the role of "savior" of floundering investment banks, with JPMorgan Chase absorbing Bear Stearns, Bank of America absorbing Merrill Lynch, and Goldman Sachs and Morgan Stanley converting themselves to bank holding companies so as to reassure their creditors.

In sum, the repeal of Glass-Steagall has been part of the solution, not part of the problem. It would be a mistake to re-enact it.

Financial derivatives

The past three or four decades have seen a revolutionary outpouring of financial innovation, including the creation of new forms of financial derivatives. Much of this creation, and the trading of the instruments that are created, has occurred outside the bounds of regulation. Some of the mortgage-related securities that eventually became toxic were innovations, as were the credit default swaps (which are simply insurance contracts on bonds) that caused such problems for AIG (which, ironically is an insurance conglomerate). Again, proximity to the disaster has led to calls for reform, including tighter regulation.

It is worth keeping in mind that, for the most part, innovations -- even financial innovations -- are socially beneficial. They allow some financial market participants to hedge and shed risk --

trading the risks to others who (again, this shouldn't be an arena for widows and orphans) voluntarily take them on. But, of course, the innovations can be used by others to speculate and exacerbate risks; and their use by the ill-informed inevitably has a bad ending.

This assessment points toward the need for more information about the instruments and about who is involved. Requiring that derivatives be cleared through a clearing house, so that there is a central source of information as well as an extra party to provide certainty of execution of the contracts, seems like a reasonable way to proceed. Requiring that such instruments be subject to more formal regulation or that they be traded on exchanges (with accompanying regulation) is an over-reaction.

Regulatory landscape and architecture

Accompanying any package of financial regulatory reform will surely be a proposal for simplification of the current regulatory structure. This will not be a coincidence.

Any attempt to describe the American landscape of financial regulation is an exercise in frustration, because the system is so complicated. There are five federal regulators of depository institutions, as well as one or more regulator in each of the 50 states. The states also regulate lenders/originators that are not depositories. There's a separate regulator for Fannie Mae and Freddie Mac and the Federal Home Loan Bank System. There are two federal agencies that deal with securities and related financial instruments, as well as 50 state regulators (and 50 state attorneys general). The regulation of insurance companies is exclusively the domain of the 50 states. Pension funds are regulated by two federal agencies, and again all 50 states have a say. And consumer fraud in financial products can be the responsibility of yet another federal agency, as well as the 50 states.

There are overlapping responsibilities and jurisdictional disputes galore. Indeed, any attempt to diagram these multiple agencies and their responsibilities ends up looking far more complicated than a 1930s radio wiring diagram.

This crazy-quilt pattern -- and its extra costs -- provides the ammunition for periodic proposals to simplify the architecture of financial regulation, even in the absence of a financial crisis. The Treasury's recent "Blueprint for a Modernized Financial Regulatory Structure," for example, though released in March 2008, was initiated a few years earlier as yet another proposal to simplify the structure, even before the Debacle was a specter on the horizon.

In the consideration of any simplification proposals, however, two important points should be kept in mind. First, there is no credible argument that links this complexity to the Debacle. Yes, with 20-20 hindsight, we should have had the reforms advocated in this essay in place at least a decade ago. But they could have been implemented within the current architecture. And it is far from obvious that a simplified framework would have addressed these problems any more readily.

Second, there is an important advantage to the complicated structure that is never mentioned by simplification proponents: The duplication of agencies provides alternate outlets for someone with a good idea -- whether it's a better way to regulate or a better financial instrument. Just as a monopoly in the private sector can be an impediment to new ideas, so can a monopoly in government regulation.

A few anecdotes can illustrate the benefits of diversity and alternatives in regulation. In the 1970s, the introduction of exchange-traded financial derivatives happened in Chicago, on exchanges that had previously handled agricultural and minerals futures, and under the regulatory jurisdiction of the Commodity Futures Trading Commission (CFTC). This was not a coincidence. The instruments were seen as competition to the stocks and bonds that were traded in New York and that were under the jurisdiction of the SEC, which was usually sympathetic to the concerns of the New York-based brokerage community. Had there been only one regulator -- which surely would have been the SEC -- the development and flourishing of these instruments would have been restricted and delayed.

A second anecdote also focuses on the 1970s: Another of the legacies of the 1930s was the legal requirement that the Federal Reserve (through its "Regulation Q") place ceilings on the interest rates that banks (and, starting in 1966, thrifts) could pay on deposits. The Congressional intent was to restrict banks' competition for deposits, which had (mistakenly) been thought to have encouraged unprofitable lending by banks and contributed to the wave of bank failures in the early 1930s. The consequence of Reg Q for a generally competitive banking (and thrift) industry was exactly what is taught in Economics 101 to freshman: a shortage of supply (of deposits) by households and businesses, an excess of demand, and less efficient ways of inducing households to bring and keep their deposits in the bank (such as offering them toasters, which began in response to Reg Q).

The breaking of this gridlock started with a different regulator: the National Credit Union Administrator, which in the early 1970s placed no restrictions on the interest rates that credit unions could pay to their depositors. This competition then placed pressure on thrifts, which received some

exemptions, and then on banks, which also received some exemptions. Finally, in 1980, most of Reg Q was repealed (although a vestige remains in the prohibition on banks and thrifts from paying interest on business checking accounts). The competition inspired by the NCUA surely hastened the demise of this inefficient regulatory restriction.

A third anecdote involves regulatory expertise in the 1990s concerning methods of measuring and regulating interest rate risks embedded in the mortgages held by depository institutions. In this respect, the Office of Thrift Supervision (which regulated thrifts) had far better knowledge of the problems and regulatory procedures for dealing with them than did the commercial bank regulators at the time. It took a while for the latter to catch up.

This defense of a complicated structure is probably quixotic. And it is surely true that the initial designers of a regulatory structure would never create the duplication and overlaps of jurisdiction that this defense supports. Also, duplication sometimes risks a "race to the bottom" among regulators that try to keep financial institutions within their jurisdiction. Still, the proponents of simplification ought to think hard about the loss of diversity that would accompany it.

In Robert Bolt's "A Man for All Seasons," Sir Thomas More asks his son-in-law (William Roper), "What would you do? Cut a great road through the law to get after the devil?" When Roper replies affirmatively, More responds, "Oh? And when the last law was down and the devil turned 'round on you, where would you hide, Roper, the laws all being flat?" Think of a monopoly regulator versus the alternatives that the current regulatory structure offer.

Some Additional Measures

There are a few other measures that have little to do with the Debacle but ought to be part of a reformed financial landscape anyway. In the spirit that a debacle should never be wasted:

Let Wal-Mart (and others) enter banking

For the past decade, Wal-Mart and other non-financial firms -- many of them retailers, like Target and Home Depot -- have tried to enter the banking business. The federal agencies have largely stonewalled them, with mistaken beliefs that the holding company for a bank should be engaged only in financial services. Not surprisingly, this belief has been encouraged by incumbent banks, who don't relish the prospect of extra competition from a Wal-Mart branded bank. With respect to Wal-Mart, in particular, an unlikely alliance between the incumbent banks and

community activists -- who normally dislike banks but who dislike Wal-Mart even more because of its wage and benefits policies and because it sometimes out-competed locally owned retail establishments -- has succeeded in preventing the FDIC from authorizing a Wal-Mart-owned bank and in keeping the Congress hostile to the idea.

Preventing entry into banking by an otherwise successful company -- so long as it meets the conditions for prudential regulation outlined above -- is always a serious mistake. It is even more of a mistake because Wal-Mart's business model is one of catering to -- and doing well by -- low- and moderate-income households. These are exactly the same households who these same community activists claim (when they aren't campaigning against Wal-Mart) are being ill-served by the incumbent banks.

One argument that incumbent banks and their allies offer against "the mixing of commerce and finance" -- that the bank will somehow favor its parent at the expense of depositors and ultimately at the expense of the FDIC -- is a canard. The temptation for the owners of a bank to try to drain it for their benefit is well recognized (see #3 under "prudential regulation" above) by bank regulators, who have well-developed procedures to guard against it; and the problem is no different for a Wal-Mart-owned bank than for any other bank, regardless of who owns the bank.

Opening bank ownership to non-financial firms of any kind (so long as they meet the other requirements of prudential regulation) is a change in bank regulation that is long overdue. It ought to be first on the list of "extraneous" changes to be slipped into the financial reform legislation.

Strengthen the Pension Benefit Guaranty Corporation

The PBGC provides insurance for pension claimants for "defined benefit" pensions: the type of pension whereby a company promises its retirees a specified amount at retirement, usually based on the employees' earnings during their last few years of employment. After some companies went bankrupt in the 1960s and early 1970s and couldn't honor their promises to their employees, legislation in 1974 created a federal guarantee fund, administered by the PBGC.

The PBGC faces the same sorts of problems as are faced by bank regulators (and more specifically, a deposit insurer): It wants the pension fund to be solvent, with assets exceeding the obligations to current and future retirees. And, in principle, companies' defined benefit pension plans are supposed to have a separately maintained pool of assets that exceed the expected retirement claims. But pension fund accounting gives the companies too much leeway in the

interest rate and actuarial assumptions that relate the current condition of a pension fund to its future assets and claims. Worse, when a company makes new promises to its employees, it is not required to fund those promises immediately but is given extended periods of time -- usually stretching as long as 7 years, and sometimes longer -- to transfer sufficient assets to cover its promises.

None of this is a problem if the company stays in business. But if the company goes bankrupt, the underfunded liabilities of the pension fund are then the responsibility of the PBGC (subject to a maximum monthly amount that the PBGC covers).

The PBGC funds itself primarily from insurance premiums that are levied on the companies with covered plans. The premiums are only weakly related to the risk to the PBGC. More important, the PBGC has insufficient tools to require companies to fund their plans adequately. Both prongs need to be strengthened.

A federal insurance charter

Recall that insurance regulation is currently the sole responsibility of the 50 states. In the spirit of the regulatory diversity that was discussed above, a federal charter for insurance companies should be legislated. This would necessarily entail a prudential regulatory regime and a guaranty fund to protect insureds in the event that regulation was insufficient to prevent an insurance company from becoming insolvent.

Conclusion

Financial regulation is indeed arcane, complicated, and messy. But getting it right -- finding the right blend of reliance on markets but also providing adequate safety and information where they are needed -- is important.

Never let a debacle go to waste.

Appendix

A Primer on "Capital" and "Leverage"

"Capital" and "leverage" figure prominently in discussions of the Debacle of '07-'08 and in discussions of remedies. This primer is intended to clarify these terms, as they apply to financial institutions.

We need to start, however, somewhere else: with the stylized balance sheet of a typical manufacturing corporation, as portrayed in Figure 1. That firm has assets of $100, consisting of plant, equipment, inventories, accounts receivable, cash on hand, etc. Its direct obligations to creditors are $60, consisting of loans owed to banks, any bonds owed to bond investors, accounts payable, etc. By simple subtraction, its net worth or owners' equity -- the value of its assets minus the value of its direct obligations -- is $40.

This firm has a leverage ratio -- its ratio of assets to net worth -- of 2½ to 1. The sense of the leverage ratio can be seen as follows: If the firm's assets increase by $10 (to $110) -- say, because it makes and retains operating profits of $10, or its assets simply appreciate by $10 -- without an increase in its direct obligations, then its net worth also increases by $10 (to $50). Thus a 10% increase in the value of its assets results in a 25% increase in its net worth -- a notion of "leverage" that is comparable to the high school physics example of a plank and a fulcrum.

Leverage also works in reverse: A 10% decrease in the value of the firm's assets results in a 25% decrease in the value of its net worth.

One other point to keep in mind: In a legal system of "limited liability" for the shareholder-owners of a corporation, those shareholders cannot be required to support the company beyond their initial contributions. Thus, if the company's assets were to fall below $60 (which would wipe out its net worth) and thus be inadequate to cover the claims of the company's creditors, those creditors normally have no claim against the owners. The creditors will simply have to divide the (inadequate) assets among themselves to satisfy their claims, usually in a bankruptcy proceeding.

Accordingly, from the creditors' perspective the level of net worth is the extent of the buffer that protects them against a fall in the value of the assets that would expose them to a loss. The thicker the buffer (other things being equal), the more assured the creditors should feel. Typically, the terms of a bank's lending agreement or the covenants in bonds will allow the creditors to place restrictions on the actions of a company as that company's net worth buffer gets thinner.

Since net worth is also owners' equity, the extent of net worth is also a measure of the disincentive for the owners to take large risks, since a larger net worth means that they have more to lose and are farther away from the limit on their losses that limited liability provides.

We can now describe a commercial bank or thrift institution. Figure 2 provides the stylized balance sheet of a well capitalized bank or thrift. Its $100 of assets are primarily the loans that it makes and the bonds that it owns. Its direct obligations of $92 are primarily its deposits. And, again, by simple subtraction, it has $8 of net worth or owners' equity. For financial institutions, this net worth is also called "capital".

Note that this bank has a substantially thinner net worth (capital) buffer than does the manufacturing firm. Equivalently, it is much more leveraged: 12½ to 1. A 10% increase in the value of the bank's assets yields a 125% increase in the bank's capital. Note also that "capital" is not "money", or "cash", or "liquidity". It is net worth. Although a bank can increase its "capital" by getting a "cash injection" from investors, the increase in capital occurs because the additional cash adds to the assets of the bank and therefore to its net worth. If the bank lends or invests the cash, its capital is still augmented by the investors' infusion. By contrast, a loan of an equivalent amount of cash to the bank would not increase its capital (and would instead increase its leverage).

Again, leverage also works in reverse. A 10% decrease in the value of the bank's assets wipes out its capital and exposes its depositors to losses (again, because of the limited liability of the bank's owners). This insolvent bank is portrayed in Figure 3. Of course, a larger decline in the value of the bank's assets would mean an even deeper insolvency.

If some depositors are unsure about the value of the bank's assets but are worried that the assets may be inadequate to satisfy all depositors' claims, those depositors may want to "run" to the

bank to withdraw their funds before other depositors get the same idea. Other depositors, seeing or hearing about the first group's actions, may similarly rush to withdraw their funds.

This general depositor "run" on the bank can be exacerbated by the realization that even a solvent bank is illiquid, in the sense that it has loaned out almost all of the depositors' funds and keeps only a small amount of cash on hand to deal with “normal” withdrawals. (Think of Jimmy Stewart's efforts, in "It's a Wonderful Life", to stop his depositors' run by explaining to them that their money is not in the till but has been loaned to their neighbors.)

And, if depositors in the bank across the street see the run on the first bank and they fear that the same problems may apply to their bank as well, the depositors in this second bank may start a run on their bank. Thus can a "contagion" or "cascade" of bank runs develop.

The roles of a central bank, a prudential regulator, and deposit insurance in maintaining a stable banking system can now be seen. The central bank can lend (provide liquidity) to an otherwise illiquid but solvent bank, to help it deal with any temporary nervousness that might develop among its depositors. Prudential regulation is intended to prevent the bank from becoming insolvent and thereby prevent depositors from being exposed to losses. And deposit insurance provides a back-up reassurance to depositors, in the event that prudential regulation has failed to prevent the bank's insolvency.

Finally, Figure 4 portrays a highly leveraged investment bank. Its $100 in assets are its investments in bonds, loans, shares of stock, real estate, and just about any other asset -- real or financial. Its $97 in direct obligations are in the form of loans, bonds, commercial paper, and other obligations. <u>By simple subtraction</u>, it has only $3 in capital.

The investment bank's leverage ratio is 33-1/3 to 1. Only a modest decrease in the value of its assets can expose its creditors to losses. It's easy to understand how creditors would become nervous and begin a run on such an institution. (It's harder to understand why anyone would lend to such an institution in the first place -- but that's part of the mystery of the general neglect of risk by investors and lenders that is at the heart of the Debacle of '07-'08.) Until March 2008 investment

banks did not have access to the Federal Reserve for liquidity, the SEC was a weak prudential regulator, and there was no creditor insurance.

For all financial institutions, capital levels are so thin that accurate measurements of the value of the institution's assets -- and thus of its capital (because capital is determined by simple subtraction) -- are crucial. An accounting system that relies primarily on market values for the determination of asset values (with some allowance for the vagaries of thin markets), rather than on historical costs or on projected cash flows, is essential.

Figures

Figure 1: The Balance Sheet of a Typical Manufacturing Corporation

Assets	Liabilities
$100 (plant, equip., inv., cash, etc.)	$60 (bank loans, bonds issued, accts. payable, etc.)
	$40 (net worth, owners' equity)

Figure 2: The Balance Sheet of a Well Capitalized Bank or Thrift

Assets	Liabilities
$100 (loans, bonds, investments)	$92 (deposits)
	$8 (net worth, owners' equity, capital)

Figure 3: The Balance Sheet of an Insolvent Bank or Thrift

Assets	Liabilities
$90 (loans, bonds, investments)	$92 (deposits)
	$-2 (net worth, owners' equity, capital)

Figure 4: The Balance Sheet of a Highly Leveraged Investment Bank

Assets	Liabilities
$100 (loans, bonds, stocks, real estate, investments)	$97 (bonds, loans, c.p.)
	$3 (net worth, owners' equity, capital)