Public aid in the banking system: rescuing ones to the detriment of others?*

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Ten of the most powerful EU economies have approved public aid schemes involving the use of public capital in banks that are solvent at first glance. Until March 2009, Spain had not submitted any such scheme, which has caused complaints by some banks due to the disadvantage this meant to them. However, such complaints are not shared by all. There are some who believe that the market will be able to make out the difference between banks with public capital and those without. Others think that the European Commission has included necessary protection to do away with any possible advantage. The present article intends to determine what is true about this variety of opinions and discusses the possible reasons that could justify awarding public aid to solvent banks, the distortion this creates in the markets and proposed solutions to minimise it. What we are concerned about is the impact hardly coordinated action of member states regarding solvent banks may have on pan-European bank competition.

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State aid and the role of the European Commission

In order to have a reference of the position of the European Commission related to aid to the banking sector, it is worth having a short overview over its current policy regarding state aid. The use of public resources to support certain companies is usually to the detriment of a country's welfare. This is so as it allows survival of companies less efficient than their competitors and thus spending resources that could be devoted to more productive activity. In certain cases, however, pubic intervention can be justified on grounds of equity or to correct market failures. Hence the European body in charge of looking after competition also has the task of supervising state aid, defined as transfer of state resources creating an economic advantage for the receiving company with respect to its market competitors, which it would not have obtained in the normal course of its business.

Generally speaking, article 87(1) of the European Union treaty states that state aid is incompatible with the single market if it can have an effect on competition and trade between member states. Whenever this risk exists, the European Commission has to examine if there is any reason of efficiency and/or equity compensating the negative effects on competition. The same article 87, in its section 3, establishes a set of possible reasons justifying the award of state aid.[1] These reasons have been later developed by the Commission through a set of regulations in order to provide states with a certain legal safety and enhance the process to review aid plans.

Generally speaking, the Commission distinguishes between two big types of state aid. A first group is made of state aid schemes aimed at mitigating market failures that may occur in any industry. These schemes have a clear efficiency goal and do not discriminate between companies or sectors that may benefit from aid, so they hardly bear any protectionist motivation for that state. Hence the Commission has a positive attitude towards such aid, declaring it compatible with the treaty. This group also encompasses aid to small and medium-sized enterprises as well as aid for R&D&I, environmental protection, employment and training and aid for venture capital. The one given to companies in worse-off regions (related to either the EU or the national average) also tends to be authorised on social or equity grounds.

The Union treaty states that state aid is incompatible with the single market if it can have an effect on competition.

A second group is made of aid defined by the Commission as sectorial. In this case, it is aid to companies operating in sectors subject to specific EU regulation (agriculture, fishery and transport), in declining sectors or in sectors having been recently submitted to regulation, thus increasing competition.[2] This category also includes aid to rescue and restructure companies in crisis. Apart from those sectors under specific regulation, the beneficiaries of sectorial aid are companies with efficiency problems challenging their survival.

Giving state aid to a particular branch is basically justified on grounds of social or regional policy, to facilitate sectorial restructuring processes and to compensate the damaged party for adjustment. For this reason, the concession includes restrictions on the use of the aid – for instance, in the case of declining branches, the aid cannot be used to increase the production capacity within the same branch – and is usually temporary. In the case of aid to companies in crisis – those that cannot ensure their own survival in the short and medium term – such restrictions are even more severe. First, given that it is awarded because it is believed that the company can be feasible in the long term, it requires a detailed restructuring plan that will be supervised occasionally. And second, it can only be given once to avoid that the company only survives thanks to state aid. The intensity of aid is restricted to the indispensable minimum to cover restructuring costs and needs to come with the maximum possible contribution by aid beneficiaries in the form of own resources. This contribution needs to be significant, so it is a clear signal that the owners believe in their company's survival. Finally, conditions are imposed to minimise negative effects on competition. For instance, assets may need to be sold or the production capacity of the company reduced.

The bank aid avalanche and the reaction of the European Commission

Within the financial crisis started in summer 2007 and a context of increasing weakness of many international banking systems, the Lehman Brothers bankruptcy in September 2008 was a climax of uncertainty that triggered big mistrust in capital markets while causing panic among investors and virtually closing down short-term

***Chart 1.* Amount of aid to the banking sector since January 2008 (million euros)**

	Public recapitalisation	Guarantees on debt (amounts approved)	Guarantees on toxic assets
Germany	50,300	400,000	
Belgium	12,200	1,800	
USA	192,308	180,000 *	324,806
Spain	0	100,000	
France	13,500	320,000	
Netherlands	29,800	200,000	30,233
Italy	0	undetermined amount	
Austria	100	90,000 **	
United Kingdom	39,959	271,577	635,490
Switzerland	3,919	3,919	

Notes: Last update on 16 March 2009
(*) Estimate of the amount endorsed so far by the Temporary Liquidity Guarantee Program TLGP. http://money.cnn.com/2009/01/16/news/economy/fdic_tlgp/
(**) Includes 75 billion euros for a Clearingbank with state guarantee and another 15 billion in other guarantees for bank debt and assets.

Source: European Commission, ministries of finance and Bloomberg as well as own

Governments have intervened to prevent collapse of their financial systems.

financing markets. Given the inability of successive liquidity injections and interest rate cuts by central banks to restore the situation, governments of developed countries decided to intervene to prevent collapse of their financial systems. The aim was to avert massive withdrawal of citizens' deposits in banks, avoid liquidity troubles affecting the solvency of the system and prevent the financial crisis from spilling over to the real economy. Thus the banking sector added to the list of branches on public aid.

In the beginning, interventions were in the shape of capital injections into banks with massive solvency problems.

Devoting public funds to aid the international finance industry has taken different shapes and is still evolving as contagion of the real economy grows. In the beginning, interventions were in the shape of capital injections into banks with massive solvency problems. The aim was to comply with the first commitment taken by the G-7 countries at their October meeting: to avoid, by using all possible means, default of any major bank from a systemic perspective. The second step was to enlarge the amounts subject to bank deposit guarantee, and then extend it to other short-term debt. Public support to bank liabilities continued with «preventive» capital injections into solvent banks, and now the possibility is planned to offer insurance schemes against loss from potentially toxic assets still remaining on the balance sheet of banks.[3]

Not only have instruments used been manifold, but also the reaction of the states has been heterogeneous. In the case of the European Union, with twenty-seven states required to give notice of any state aid scheme, the challenge for the Commission of ensuring that none of these schemes distorts the functioning of the European single market is enormous, especially when events are developing at great speed and member states react almost simultaneously. The Commission therefore decided to set a general framework,[4] the Banking Communication, according to which the scheme of each country will be negotiated. This framework states the position of the Commission towards this aid, while specifying the instruments it considers appropriate to face the financial crisis, the criteria to follow to ensure proportionality of aid, potential competition problems that may come up and indispensable action to be taken in order to minimise them.

When analysing the different instruments to assist the banking sector that are being implemented, it is very important to acknowledge that the present financial crisis involves in fact two different problems, although they are basically linked to each other. The first is strong depreciation of the value of assets the risk of which was considerably undervalued. The magnitude of this depreciation is big enough to create solvency problems in banks owning them, so it is possible that there are banks unable to keep their commitment and will need to be liquidated or restructured. The second problem is uncertainty prevailing in financial markets, which makes it almost impossible to renew short-term financing of banks. If this liquidity problem is not solved in time, banks can be forced to sell assets, which would push down their value and create solvency problems where there were perhaps none.

The position of the European Commission regarding state aid to the banking sector is to distinguish between solvency and liquidity problems. Aid aimed at solving solvency problems – such as the emergency rescue of Northern Rock, Hypo Real Estate, Fortis Bank or Dexia – are analysed according to rescue and restructuring aid regulations. As has been mentioned above, such regulation is stricter and requires clear and feasible bank restructuring plans. Aid aimed at solving liquidity distress is analysed under the new framework defined by the Banking Communication. Thus, one requirement to receive state aid by this criterion is to demonstrate that the bank is solvent. The definition of a solvent bank is however in the hands of the supervisor of each member state.

Finally, the Commission has adopted a more permissive position with this kind of aid than what would be normal under different circumstances. It has granted the legal base to exceptionally apply article 87(3)b of the treaty. According to this article, aid «to remedy a serious disturbance in the economy of a Member State» can be considered compatible with the single market. Thus the financial crisis is considered a mitigating circumstance in this case. This has several important implications. The first is that aid declared compatible will be so as long as the present financial crisis, the source of serious disturbance lasts. Thus the Commission has established a review every six months and aid will be extended according to its result. The second implication is that aid plans will be declared compatible if they are well pointed towards solving the present financial crisis.

So far, the Commission has established that state sureties on debt issues of banks and preventive recapitalisation with public funds are two instruments well pointed towards solving disturbance in the financial markets.[5]

The surety schemes

Uncertainty causing the lack of short-term bank financing has its origin in a problem of asymmetric information and creates big negative externalities on the real economy. Indeed, every bank has better information than the rest as to the risk it has incurred and the loss it may suffer. In normal times, such asymmetry between information available to the bank and to the market is minimised thanks to the role of given stakeholders like rating agencies investing in gathering information and issuing certificates. Nevertheless, the present crisis has revealed inaccuracy in certification given by these agencies, so the consequences of asymmetric information are heavily noticed. The liquidity crisis in inter-banking and debt markets is the most relevant of these consequences and the one extending the problems of the finance sector to the real economy.

The state surety is an instrument aimed at minimising the problem of adverse selection. The purchaser of endorsed debt only considers the risk of non-payment by the state.

When a bank comes back to the market to raise resources in the form of debt, the holders of such resources do not have enough information to distinguish between solvent banks needing liquidity from insolvent ones in the short or medium term. Asking a higher price for them does not solve the problem as a too high price can deter solvent banks and attract only those having more serious problems. This phenomenon is known as adverse selection and is a market failure due to the lack of transactions in the short-term financing market. The existence of such failure, which the market is unable to correct under the current situation and whose effects extend to the rest of economic areas, justifies state intervention to solve liquidity distress.

The state surety is clearly an instrument aimed at minimising the problem of adverse selection. With this instrument, the state commits to reimburse the debt holder in case the bank is unable to fulfil its duties. As the state is ultimately responsible for payment, the potential purchaser of endorsed debt only considers the risk of non-payment by the state. This risk is not subject to information problems, a fact proven by high demand of sovereign debt. So banks can obtain liquidity from the market through endorsed debt issues. As the state has better information on the probability of non-payment of these banks thanks to its banking supervising body, it could theoretically appraise the risk it takes on and set a price for the surety.

When establishing compatibility with the common surety scheme market, the Commission assesses the proportionality of that measure and possible distortion of competition. Proportionality is determined to a large extent by the kind of debt endorsed. If the aim is to solve the problem of asymmetric information to which new debt issues of banks are subject, it seems reasonable to think that the surety should be restricted to new debt issues in the medium term. However, this has not always been the case. The Commission has approved schemes guaranteeing old debt or covering the issue of subordinate debt, which accounts as capital for regulatory purposes.[6]

Discrimination between banks needs to be avoided as well as creating a vantage position for beneficiary against non-beneficiary banks.

Regarding possible distortion in competition, discrimination between banks in giving aid needs to be avoided as well as creating a vantage position for beneficiary against non-beneficiary banks in those markets they share. In this respect, it is paramount to set the right price at which sureties are given. On the one hand, price fixing conditions need to be objective to avoid discrimination between banks; on the other, the price has to reflect the real risk of that bank without including any hidden subsidy that may benefit banks of a member state in relation with the rest.

In most plans, the Commission has tried to harmonise all these goals by guiding the amount of the surety according to the risk of the bank as perceived by the market prior to the Lehman Brothers bankruptcy.[7] This risk is measured by the average quotation of credit default swaps (CDS) between January 2007 and August 2008, increased by 50 basis points. This way, there is neither full trust in current risk perception by the market nor is it up to every state to decide on the price to be set.[8] On the contrary, the Commission decided to keep the position related to bank risk as perceived by the market before the crisis became acute and to reflect worse conditions through a fixed portion of the price.

Leaving the scheme open to all banks[9] at a price that follows objective and quite homogeneous criteria across all member states minimises the risk of distortion between beneficiary and non-beneficiary banks. The only problem is posed by those countries standing surety by inappropriate standards. Nevertheless, the Commission has in these cases imposed restrictions on the action of these beneficiary banks to avoid use of this advantage to expand their business. These restrictions, which will be discussed more in detail in relation with recapitalisation, can include limits on balance growth, publicity of surety, remuneration of managers or maintenance of solvency ratios.

Schemes of preventive recapitalisation

Adequacy of recapitalisation with public funds is much more controversial than that with sureties, as it is a measure that can be applied to solve both circumstantial problems out of financing needs and more serious problems of solvency. A first point of conflict is that this instrument may be used to help banks in great difficulties, thus avoiding the harsher restrictions of rescue aid.

As there is already an instrument – sureties – specifically aimed at counteracting liquidity distress in the debt market, the question is what can lead solvent banks to need financing through capital increase. A possible answer is the need of banks to have a capital cushion above that needed to cover solvency ratios required by the Basel Agreement. Indeed, when non-compliance with capital requirements leads to penalty for banks and the capital market suffers from any imperfection – e.g. the above-mentioned problem with asymmetric information – the best banks can do is to have a cushion that allows them to absorb possible future loss without any risk of non-compliance with capital requirements.[10] Within the present context, it is possible that banks, even those without loss, wish to increase this cushion as they perceive a rise in penalties due to improper capitalisation.

Penalties may come from the supervising body if it tightens its criteria or from markets, which can assess bank stock at a lower price or make its financing with long-term debt more expensive if there is any suspicion about its capitalisation level. In any case, given the high cost of capital increase amidst a crisis, banks have two ways of increasing their cushion. One is to reduce the amount of credit given by the bank. However, this reduction goes against the goals of a government intending to do away with recession. The other possibility is to sell assets. In this case, there is the risk that a big number of banks decide to sell at the same time, thus pushing the price of assets below their base value, which could create solvency problems where there were not any.

Hence it is possible that the wish of certain banks to increase their capital cushion creates inefficiencies, either because it will cause a shrinkage in the credit offer that will prevent feasible projects from being implemented, or because of the systemic consequences of massive asset sale. In this respect, preventive recapitalisation of solvent banks can be justified to counteract such inefficiencies as it allows them to reach their optimum capital level without any need of doing such adjustment.

The wish of banks to increase their capital cushion can create inefficiencies due to a shrinkage in the credit offer or the consequences of selling assets.

Nevertheless, preventive recapitalisation can generate a definitely big distortion in competition. Starting with conditions in access to aid, it is very difficult to set an objective level of capital remuneration the state should require. Although remuneration should approach the level a private investor would ask for, it is also true that the state internalises benefits from e.g. more available credit for the whole economy and could thus accept lower remuneration in exchange for this possibility. The difficulty in assessing both factors under present circumstances has created a certain degree of heterogeneity in remuneration required by the different member states so far. In a recent communication[11], the Commission pointed out that repayment of hybrid capital instruments used by states should be between the level required by the market for subordinate debt (ca. 7% average) and that required for ordinary shares (ca. 9.3% average).[12] Such repayment should be increasing with time to provide incentives for banks to replace public capital by private one as soon as possible.

Judging the proportionality of preventive recapitalisation to solve inefficiencies requires to determine what capital level every bank needs in order not to restrict credit to profitable projects. As opposed to the surety case, in which the decision on what amount needed to be issued with surety was basically determined by the sum due in the medium term, the demand of public capital by banks is not detached from how the plan is set up. This will depend on the price at which the state is ready to inject capital. As we will see, a too low price can provide banks with incentives to apply for cheap public capital above the social optimum. In such a situation, the Commission simply points out that it will be sympathetic towards preventive recapitalisation increasing the capital ratio by up to 200 basis points. This margin of available capital may be too large in the case of banks still having a relatively high ratio.

However, the main part of competitive distortion will be caused by the existence of some advantage for banks with public capital compared to the rest in every market they compete in. Having public capital can bear two advantages that will in their turn have an influence on competition in different markets.

On the one side, public capital can reduce the bank risk as perceived by investors. This would be an advantage to raise financing in the long-term debt market. On the other side, having access to abundant capital under better conditions than competitors allows to pursue aggressive strategies to capture customers. Distortion in competition will appear in this case in retail and corporate banking markets.

Distortion in the long-term debt market

The financial crisis has had serious consequences on debt markets. On the one hand, it has aggravated problems of asymmetric information

Chart 2. Recapitalisation schemes approved by the European Commission

	«Preferred» capital ratio	Instrument	Repayment asked by the state	Imposed limitations
Greece	Tier-1: 8-10 %	Preferential shares	10 %	• 1 board member • Limitation on balance growth • Restructuring plan • Limitation on manager remuneration • Prohibition to declare dividend as long as it benefits from public capital
United Kingdom*	Tier-1: 8 % Core T1: 4 %	Preferential shares	12 %	• Limitation on manager remuneration • For banks with problems: - Limitation on balance growth - Restructuring plan
Germany*	Tier-1: 10 %	Preferential shares	• Between 7% and 9.3% in the 1st year for solvent banks based on instrument and risk • 10% min. in the 1st year for banks with problems • Growing with time	• Limitation on balance growth • Requirements on solvency ratio • Limitation on manager remuneration • For banks with problems: - Restructuring plan
France*	Tier-1: 8,5-9 %	Subordinate debt	• Based on bank risk • 8% average	• Obligations on credit growth • Limitation on manager remuneration
Italy*	Tier-1: 8 %	Subordinate debt	• 7.5% - 8.5% in the 1st year • Growing with time	• On dividend, remuneration and other restrictions on conduct
Denmark*	Tier-1: 12 %	Hybrid capital Tier-1	9-12% based on bank risk	• Limitation on manager remuneration • Prohibition to declare dividend until 2010 • Obligations on credit growth • For banks with problems: - Restructuring plan

(*) Commission report undisclosed

Source: European Commission, ministries of finance and Bloomberg as well as own

▲ The Commission will be sympathetic towards preventive recapitalisation increasing the capital ratio by up to 200 basis points.

Chart 3. Conditions for preventive recapitalisation of British banks

		Preferential stock	Ordinary stock	
		Annual coupon	Discount for new investors	Capital increase (million £)
Through public capital	Royal Bank of Scotland	12 %	8.5 %	20,000
	Lloyds TSB	12 %	8.5 %	5,500
	HBOS	12 %	8.5 %	11,500
Through private capital	Barclays	14 %	22.5 %	6,500
	Standard Chartered	–	48.7 %	1,779

Source: UK Treasury and banks as well as own

In the United Kingdom, the preventive recapitalisation plan came along with the public surety scheme.

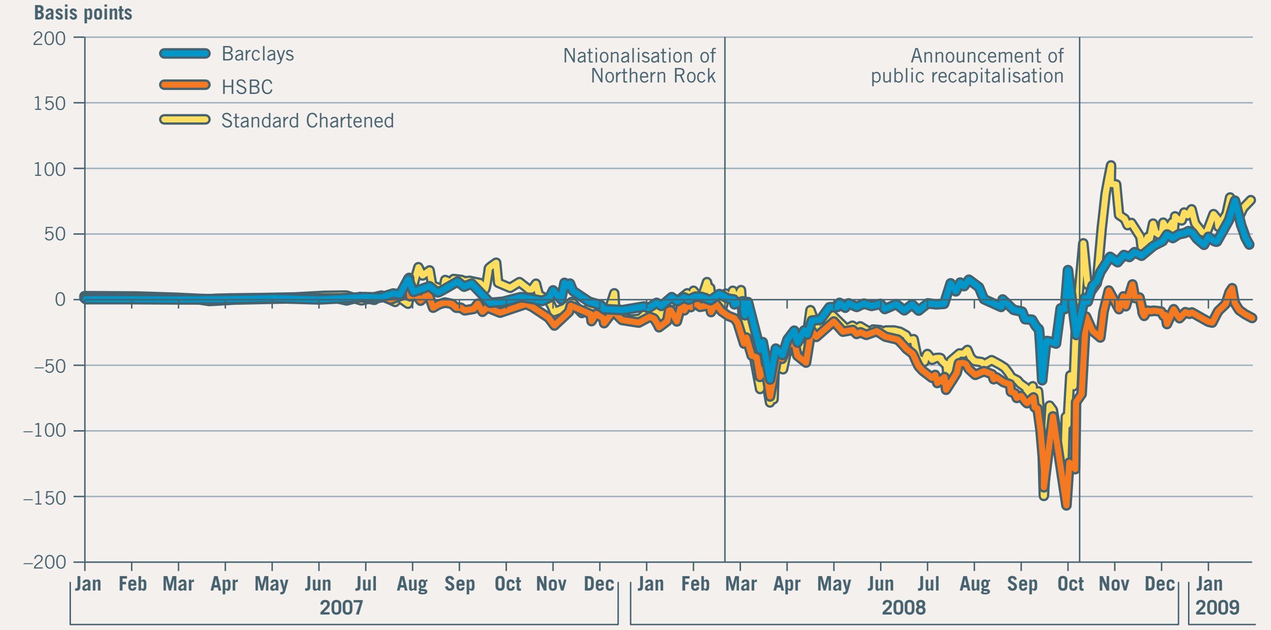
so any sign of risk for a bank has a great impact on the price of its issues. On the other, massive loss has constrained demand of bank debt. In this respect, any sign perceived as a reduction of risk could mean much smaller financing costs that those of competitors.

Hence competition in these markets can be distorted if the different public capital injections into banks change their risk perception. There are different reasons for which this may occur. First, as beneficiary banks can take advantage of more capital than others to absorb loss following public injection, any debt emission the former does will be perceived as having a lower risk. Besides, it is possible that public capital injection points towards a certain degree of public commitment to save that bank regarding any future contingency. Such commitment would contribute to reduce even more the risk perceived by the market. Finally, capital ratios explicitly mentioned by many states as being «preferential» for their banks, which are clearly above the requirements of the Basel Agreement, can be interpreted by markets as a new de facto regulatory minimum applicable to all banks.

The immediate consequence is that the capital cushion of banks not benefiting from aid is reduced, which pushes them to increase their capital (under increasingly costly conditions). In an extreme case, banks with an appropriate ratio by the Basel Agreement standards but far from the one preferred by states can be perceived by markets as having solvency problems, which makes their long-term debt expensive.

Hence it is possible that preventive recapitalisation done in other countries has placed Spanish banks in an unfavourable position, altering their financing cost in debt markets. It is certainly difficult to quantify this disadvantage as even

Graph 1. **Differential between 5-year CDS of non-beneficiary banks and synthesised CDS of banks with public capital**



Source: Datastream and own

The perception related to risk turned upside down just after the announcement by the British government of public recapitalisation.

under normal conditions the risk of a bank is determined by many parameters – such as country or market risk where it operates – that should be controlled to isolate the effect of public capital entry.

Nevertheless, it is possible to have an indication about the existence of a change in relative risk between beneficiary and non-beneficiary banks by looking at the case of preventive recapitalisation in the United Kingdom, given the nature of action taken and the different reactions of banks. In the United Kingdom, the preventive recapitalisation plan came along with the public surety scheme. The government established as an eligibility criterion to take part in this scheme that banks needed to have a Tier-1 capital ration appropriate in the government's view. Specifically, the British supervisor stated that it would consider a Tier-1 capital ratio at 8% and a core capital[13] one at 4% adequate. Those banks wishing to benefit from the surety scheme without complying with these ratios could apply for the governmental recapitalisation plan or try to increase capital on their own.

Among the main national banks, Royal Bank of Scotland (RBS), Lloyds TSB and HBOS applied for public recapitalisation, Abbey and HSBC injected own funds from their mother company, while Barclays and Standard Chartered went to the market to increase their capital. A CDS evolution analysis of these banks is a first approach to change in relative risk based on the different nature (public or private) of recapitalisation.

Graph 1 shows the CDS evolution of banks that did not receive public capital against a weighted CDS average of those banks that did receive it (RBS, Lloyds and HBOS). Till the no difference in risk between banks was stated. From that point, differences became apparent, especially following nationalisation of Northern Rock.

It is possible that preventive recapitalisation done in other countries has placed Spanish banks in an unfavourable position

The graph shows how, as the crisis makes headway, HSBC, Standard Chartered and to a lesser extent Barclays were perceived as banks with a lower risk than those receiving later public capital. Nevertheless, this perception related to risk turned upside down just after the announcement by the British government of public recapitalisation in October 2008, despite the injection of private funds these three banks did in those days.

Despite its simplicity, this analysis shows how the public or private nature of recapitalisation affects the risk perception of a bank in a different way. Thus Barclays, HSBC and Standard Chartered have seen their financing cost increase in relative terms compared to their competitors following public recapitalisation. We believe it can be argued that the effect on the risk of these three banks is representative of the effect on the risk of others without public capital (no matter their country of origin). In this case, the graph shows how action taken in one country can place banks of another member state in a disadvantage and create negative externalities reflected in higher cost of access to long-term financing. The consequence for the latter member state will be a higher cost in banking services and an even stronger credit crunch. This can lead states to start off competitive recapitalisation of their banks in order to prevent such externalities. This would be the case of recapitalisation of French banks, which despite enjoying a better situation and showing no signs of a credit crunch, accepted an injection of public capital to reach Tier-1 capital ratios between 8.5% and 9%, similar to their British counterpart.

Distortion in the retail and corporate bank markets

Retail banking has two features having a notable influence on the kind of strategies used by banks to compete. On the one side, their relational character has customers incur in exchange costs when they wish to operate with a different bank than the usual one – the new bank has no information on them and thus faces a problem of adverse selection similar to the one discussed before. As a consequence, the customer is rather inclined to go on operating through the same bank once they have taken a decision.

On the other hand, banks take advantage of economies of scale in distributing financial products, so they obtain cost advantages in a given product thanks to associated sales. Both features justify the use of short-term aggressive strategies to capture customers who are only profitable in the long term thanks to the capacity of retaining them. Considering that credit is one of the products most widely used to capture customers, having public capital provides a clear competitive advantage.

On the one side, banks having obtained public capital have the necessary cushion to continue giving credit and to do so under better conditions, as public capital is available and cheaper than private one. On the other side, if the state forces these banks to give credit on grounds of efficiency, the customers thus seized can be retained thanks to exchange costs once the state withdraws its share.

The disadvantage for Spanish banks shows in the corporate banking market, where the main competitors are other European banks.

In the beginning, these potential anti-competitive effects on the retail market were acknowledged by the Commission in its Banking Communication, urging for restrictions on action of beneficiary companies to authorise both surety and recapitalisation schemes. It thus imposed a limit on balance growth of beneficiary banks aimed at preventing credit growth beyond what was needed to reactivate the economy – thus implying that it would be reducing the market share of banks without public capital. However, in a new communication on recapitalisation, the Commission stepped back and set an end to the limitations on balance growth in case of solvent banks. They have been replaced by applicable and effective national protection ensuring credit concession to the real economy.

It seems that the Commission trusts the price of public capital and credit requirements to make sure that capital injections are used for the desired purposes and not to finance aggressive commercial expansion. However, if the price is too low, there is the risk of giving incentives to banks to apply for cheap public capital above the social optimum.

In fact, despite the possibility of aggressive expansion in the domestic retail market not being profitable if all banks have access to public capital, it may be interesting to expand the subsidiaries operating in geographical markets where the state has not such a scheme in place. Another possibility is to compete more aggressively in larger markets than the national, as is the case of corporate banking, understood as the market for traditional financial brokerage services for large corporations.

From a Spanish perspective, distortion in the local retail banking market can be relatively low as there are not many subsidiaries of public capital beneficiary banks having a significant presence in the market (except ING). Nevertheless, the disadvantage for Spanish banks can show in the corporate banking market, where the main competitors are other European banks.

In this case, the disadvantage with respect to other banks with public capital is double: the price at which the latter can offer credit is influenced not only by their cushion of cheap capital but also by their smaller cost of long-term financing.

Conclusion

This article has tried to argue that some recent public intervention to help the banking system features serious competition problems for which the European Commission has not established any counteracting measures. The main problems are created by preventive recapitalisation of solvent banks.

This sort of public aid not only creates negative effects by fostering competitive recapitalisation and distortion of competition in the different markets but it also hampers deeper integration of the European market. This is due to the fact that access of the state to the shareholder structure of banks may have replaced access of private banks from another member state with the necessary capital.

One should ask if the distortion created is not undermining the real benefit of aid or if there is no other instrument allowing to meet the same goals.

Despite efficiency arguments justifying public capital injection into solvent banks, one should ask if the distortion created is not undermining the real benefit of aid or if there is no other instrument allowing to meet the same goals. In this respect, if the main problem is great uncertainty among banks – regarding both alien and own risk – it seems reasonable to think that the best solution is to do away with such uncertainty as soon as possible. The current recapitalisation schemes are not good for that. On the contrary, assurances on toxic assets could be a step in the right direction. The problem with such assurances is that they would require stronger protection as well as strict and credible supervision in the eyes of the Commission. The ability of the Commission of penalising single companies or states affected by a particular problem is high. Nevertheless, under present circumstances, in which all member states are affected by the same problem, the Commission's real negotiation power seems much lower. This is shown in the heterogeneity of action it has accepted, which raises doubts on its ability to supervise aid schemes with an increasing impact on the competitive situation of the branch.

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Notes

1. Article 87(2) also provides for exceptions to incompatibility of public aid but refers to very specific cases such as aid to repair damage caused by natural disasters or needed to consolidate German reunification. It also establishes social aid aimed at individual consumers as being compatible, as far as this does not discriminate consumed products based on their origin.

2. Apart from agriculture, fishery and transport, the beneficiary branches of sectorial aid are audio-visual production, radio broadcasting, coal, power, postal services and shipbuilding.

3. As this article was written, the United Kingdom was the only European country having initiated an insurance scheme against toxic assets, which was pending approval by the Commission. This is the reason why the article does not consider this sort of instrument. However, it needs to be said that these assurances can be a better instrument than preventive recapitalisation given the uncertainty of the value of toxic assets of banks. Nevertheless, in the light of the complexity of such assessment, it will be very difficult to prevent premiums and other conditions of such assurances from including a significant part of public aid distorting competition.

4. Communication from the European Commission 2008/C 270/02. «The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis».

5. Apart from surety and recapitalisation, some member states have submitted other additional instruments approved by the Commission (e.g. the Fund to Acquire Financial Assets in Spain). Given their rather specific character, tailormade to the financial system of each country, the present article will not deal with these other instruments.

6. In Ireland, the surety scheme covers old subordinate debt, accounted as Tier-2 capital. In the case of Denmark, the scheme covers non-subordinate senior debt without guarantee already in place for a two-year period. Austria also includes a three-year coverage for previously existing lenders.

7. The surety price in Denmark, Ireland and France does not follow this rule, but every bank will contribute to a portion of the cost of the scheme estimated by the state.

8. Nevertheless, the states still have a certain margin to influence the final price of the surety. For instance, the CDS reference period has been fixed between July 2007 and July 2008 in the UK. Another example is the case of Spain and the Netherlands, where the surety price calculated according to the former rule is limited by a maximum based on the bank rating. This maximum amount is the average of CDS quotations of banks with an identical rating (AA or A) during the same period.

9. To avoid discrimination, the communication of the Commission also requires that the concession of surety follows objective, non-discriminatory eligibility criteria, especially regarding subsidiary banks from other member states.

10. For a model on the optimum capital level of banks considering the Basel Agreement and imperfection of the capital market, cf. Van den Heuvel (2007). *The Bank Capital Channel of Monetary Policy.* The Wharton School, University of Pennsylvania, mimeo.

11. Communication from the European Commission 2009/C 10/03. «The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition».

12. The Commission is also of the opinion that required remuneration should increase with the risk of the bank, apart from depending on the type of instrument chosen.

13. According to the definition of «core capital» by the Financial Services Authority (FSA).