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Economic issues in restructuring cases in the financial sector

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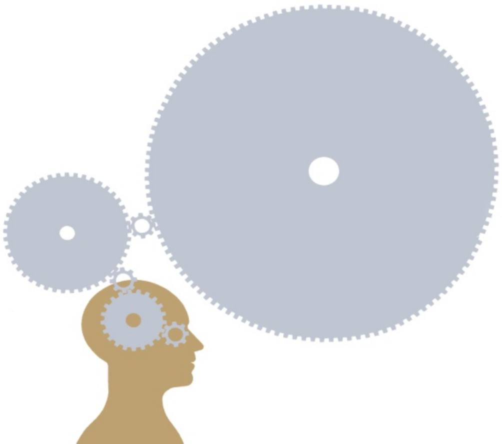
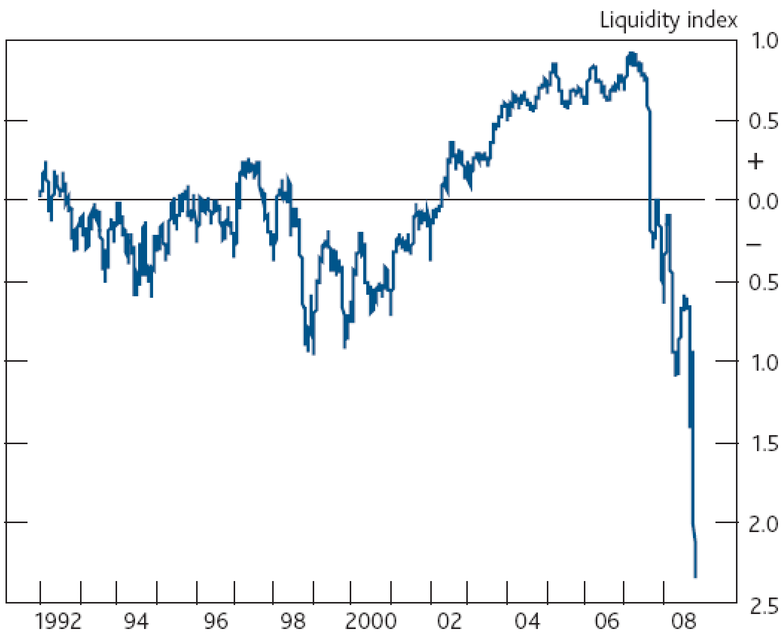


Market failure—financial market liquidity

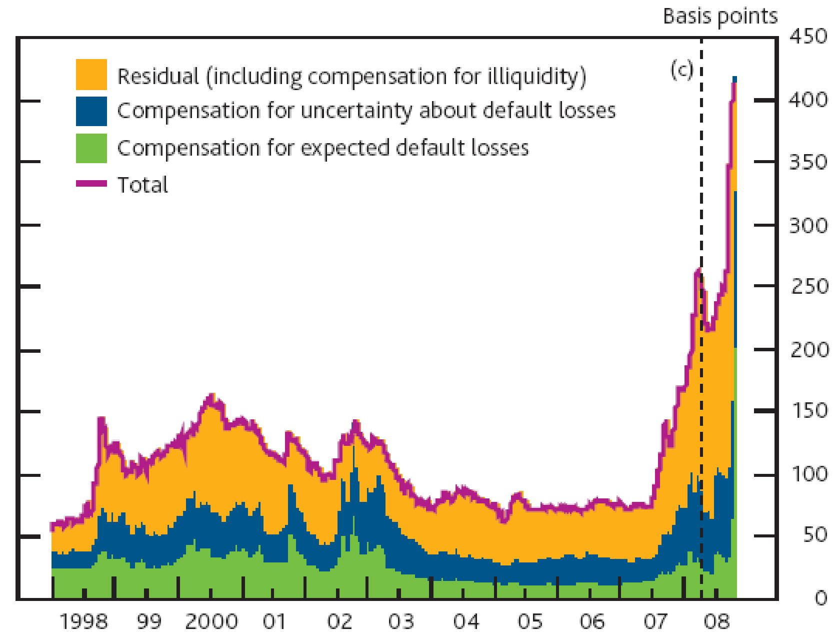
Financial market liquidity



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thomson Datastream and Bank calculations.

(a) The liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised on the period 1999–2004. The series shown is an exponentially weighted moving average. The indicator is more reliable after 1997 as it is based on a greater number of underlying measures. The recent fall in the indicator is largely due to a sharp decline in the interbank market liquidity measure.

Decomposition of corporate bond spreads



Sources: Bloomberg, Merrill Lynch, Thomson Datastream and Bank calculations.

(a) Webber, L and Churm, R (2007), 'Decomposing corporate bond spreads', *Bank of England Quarterly Bulletin*, Vol. 47, No. 4, pages 533–41.
(b) Option-adjusted spreads over government bond yields.
(c) April 2008 *Report*.

Source: Bank of England (2008), 'Financial Stability Report October 2008', Issue No. 24, p. 8, p. 11.

Remedies
State aid modernisation and policy in the financial crisis

- state aid modernisation:
  - ‘Modernised State aid control should facilitate the treatment of aid which is well designed, targeted at identified market failures and objectives of common interest, and least distortive (“good aid”).’[1]
- the financial crisis involved dysfunctional interbank lending
  - illiquid market, difficult even for well-run banks to access external funding, hence recourse to state aid
- policy on remedies going forward should distinguish between well-run banks (victims of the market failure) and others
  - otherwise less incentive in the first place to be a well-run bank
  - given credit crunch, certain **remedies can harm consumers**

Note: [1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0209:FIN:EN:PDF, para 12.

Counterfactual
Do we need to ask what happens without aid?

- existing R&R guidelines: (in principle) restructuring aid 'should be warranted on the grounds of serious social difficulties'[1]
  - but 'the presumption that the aid will actually save a considerable amount of jobs and activities which would otherwise disappear, has not been questioned...the Commission has **taken for granted** that the aid has positive effects on employment and the firm's activity'[2]
- for ordinary R&R cases, prohibit subsidies that merely keep inefficient firms on life support
  - hence consider the counterfactual to state aid
- but for the financial sector, externalities from systemic failure are catastrophic, and the counterfactual unquantifiable

Sources: [1] European Commission (2004), 'Community guidelines on state aid for rescuing and restructuring firms in difficulty', para 25(b); see also Decision 2005/878/EC *Herlitz* [2005] OJ L324/64, para 111.
[2] European Commission (2008), 'Specifications to invitation to tender COMP/2008/A3/015', July 15th.

Aid quantification
Implicit versus explicit subsidy

- aid quantum observed is only one possible manifestation of implicit state support to banks
  - far from clear what the value of the implicit guarantee is
  - distortion to the cost of funding between ordinary financial institutions and those that are ‘too big to fail’?
- given new regulation and taxes on the financial sector, the context is changing
  - the financial sector now bears a heavier burden; the risk is being transferred
  - state aid policy is not the best instrument to fix the problems, but at the time of the crisis it was uniquely placed
  - financial regulation, if coordinated, may be a better instrument

Aid quantification
Should we be using the MEIP?

- quantum of aid in the crisis is difficult to measure
  - either in aggregate or for individual banks
  - this matters in debates on burden-sharing, whether aggregate or individual
- the MEIP was not used as R&R aid is for circumstances where private capital is unavailable
  - but the Commission’s guidance required ‘market-oriented pricing’
  - for ‘good banks’, given the pricing terms attached to the state aid, how much aid was really granted?
  - away from the worst times of the crisis, is the MEIP applicable?

Aid quantification
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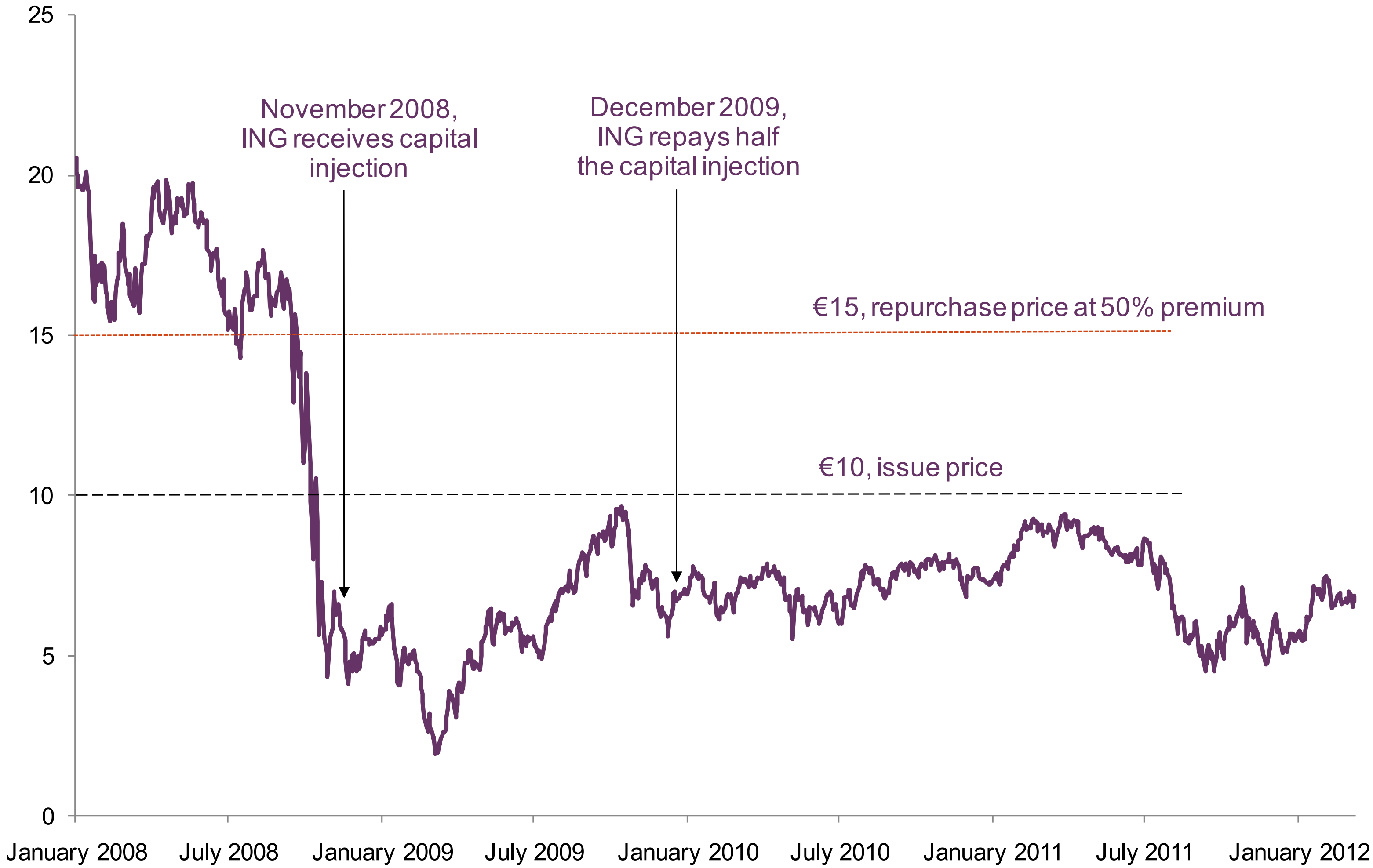

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