

State Aid Lessons from 2008 for a 'Troubled Asset Relief Program' for the Euro

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The European Union should move quickly to enact an American-style 'TARP'¹ in the eurozone to strengthen the financial sector and maintain lending. Through the European Financial Stability Facility, the EU now has the structure in place for a truly European support fund for the banking sector, which it did not have in 2008. This should be put into motion without delay, taking into account the lessons of the 2008 crisis and applying EU state aid rules. A eurozone recapitalisation fund would better limit distortions to the functioning of the single market than the current arrangement of ad hoc guarantees and support mechanisms.

The details of a European TARP matter hugely, however. How far should coverage stretch? What should be done if banks refuse to accept capital injections? And what conditions should be imposed for state purchases of bad assets?

The 2008 financial crisis led to a panoply of state recapitalisation and guarantee schemes.² Member states supported the financial sector through a mix of debt guarantees and bank-liquidity support schemes, recapitalisation arrangements, asset-relief schemes and individual bank support. In total the European Commission temporarily authorised 20 bank-debt-guarantee programmes and 15 recapitalisation arrangements. The scope and conditions differed significantly across countries, but the Commission managed to bring some comparability through its guidelines on the subject, which required aid to be non-discriminatory, temporary and remunerated. Individual aid was also contingent upon structural adjustment measures.

The total aid agreed upon through these schemes amounted to €4.1 trillion. Of this, €1.5 trillion, or 12.5% of EU GDP, had effectively been used by early 2010. This is an astronomical

¹ TARP refers to the 2008 Troubled Asset Relief Programme of the US authorities, which provided temporary capital assistance to the largest US-based banks.

² See Lannoo, K, (2010), *Bank state aid in the financial crisis*, CEPS Task Force Report, October, (<http://www.ceps.be/book/bank-state-aid-financial-crisis-fragmentation-or-level-playing-field>).

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amount, but it is comparable to what is now being mentioned as a possible size for the EFSF to cope with the sovereign crisis.

But the vast differences in the way member states have offered and implemented aid to the financial sector undermine the coherence of the single market. Comprehensive national support schemes that provided obligatory support for all financial institutions above a given size raised far fewer competition policy problems, as all were treated equally. A question could, however, be raised about the enforcement of the conditions imposed on the banking sector in return for the support, such as the marketing ban and restraints on executive remuneration. In other cases, tight control of the continuation of lending by aided banks proved to be beneficial for the economy.

That is why a European TARP should be strictly obligatory for all eurozone banks whose core-capital ratio is below 4% on a non-risk-weighted basis and taking into account reasonable haircuts on sovereign exposures. The core-capital ratio of the eurozone's banking system as a whole increased to 6.5% from 5.9% between the end of 2007 and the end of 2010, but large banks have significantly lower levels of capital. The balance sheet of Europe's 14 largest banks, with balance sheets of about or over €1 trillion, grew to 4.1% from 2.8% between 2008 and 2009, and 4.3% in 2010.

The IMF estimates the amount needed to recapitalise Europe's banks to be between €100 and €200 billion. These funds should be subject to clear conditions on lending, including structural reforms. The EU's state aid authority, in cooperation with national authorities, would be in charge of monitoring the implementation of these rules. Non-compliance would ultimately lead to full state control – and possibly to a winding up – of the bank.

In addition to a European TARP, a eurozone deposit guarantee scheme should also be created. All eurozone banks would be obliged to participate in a pre-funded scheme and to pay a premium based on their retail deposit base. Such a fund could, over time, be merged with a European TARP to become a market-funded, EU-wide bank resolution scheme. Discussions in the European Council and the European Parliament on amendments to the EU's deposit-guarantee schemes Directive have so far taken away any openings for an EU-wide fund, and member states are not very keen on an EU resolution mechanism anyway.

The EFSF is an opportunity to stop the unravelling of the single market and to create European mechanisms for European problems. Addressing the banking sector's funding problems first would limit the spillover of the sovereign crisis to the real economy.